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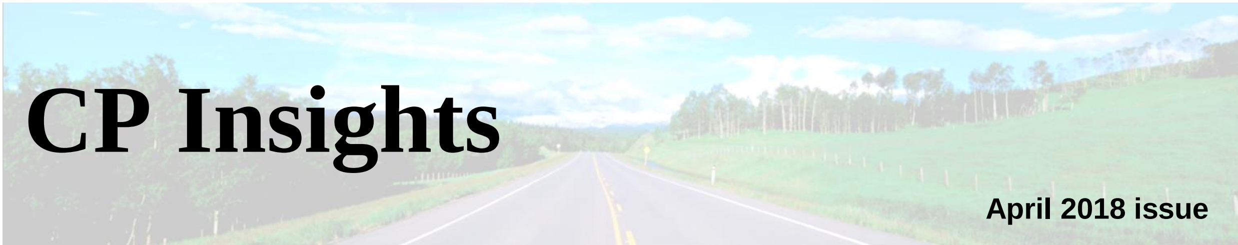

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HK SFC Report on the Thematic Review of Licensed Corporations Engaged in Sponsor Business

A discussion on Report on the Thematic Review of Licensed Corporations Engaged in Sponsor Business ("Report") released by the Securities and Futures Commission of Hong Kong ("HK SFC") in March 2018.

Background

The HK SFC has conducted a thematic inspection covering 31 licensed corporations ("LCs") engaged in sponsor business and has identified a number of compliance failures primarily in relation to SFC Code of Conduct requirements and Corporate Finance Adviser Code of Conduct ("CFA Code") requirements. The deficiencies and instances of non-compliance noted during the review are mainly related to due diligence, record keeping, control, Chinese walls and receipt or provision of benefits.

The article aims to discuss the main points to note raised in the Report and issues that LCs that engage in sponsor business should pay attention to.

1. Deficiencies in relation to SFC Code of Conduct requirements

Due Diligence

Under the SFC Code of Conduct, a sponsor is expected to exercise reasonable judgement and applying professional scepticism when conducting due diligence on the listing applicant, its directors, key senior managers and controlling shareholders. As sponsor, to discharge the due diligence responsibilities satisfactory, the LC should carefully examine the truthfulness of the information obtained from listing applicant and should also bear a critical mind when assessing information that may adversely affect the reliability of the provided information.

While during the recent thematic inspection, HK SFC has observed issues that despite obvious red flags, some sponsors did not take reasonable steps to follow up on the due diligence process. For instance, when sponsor spotted material differences between sales amount and payment made, no follow-up action was taken. Or in some cases, representatives are the one who is responsible for the liaison between customers and listing applicant, however, under such irregular arrangement, LCs did not conduct any follow-up due diligence process. Such excess authority delegated to the representatives and lacking of follow-up due diligence may bring the reliability of the reported sales into question.

When conducting the due diligence work, not only should the relevant LCs follow the standard due diligence checklist, LCs should also ensure that specific listing applications will have different circumstances and should adapt the due diligence process in a more flexible and pragmatic approach.

Proper Record

LCs should also take notes that the SFC Code of Conduct requires all sponsors to maintain adequate records and document its systems and controls governing the sponsor work. For every single assignment a sponsor should keep records which should include but not limited to any relevant supporting documents and correspondence, control relating to a due diligence plan, results of due diligence, any matters in relation to the course of the listing process etc.

Yet, the HK SFC found that many of the sponsors inspected were unable to provide relevant records that were up to HK SFC’s standard. Or the sponsors failed to maintain proper due diligence records or documents to demonstrate to the HK SFC’s satisfaction that certain due diligence was properly conducted.

To better comply with the requirements set out in the SFC Code of Conduct, sponsors should keep proper records documenting the breadth and depth of their due diligence and the results. Any material risks and issues identified should also be properly logged with stand-alone due diligence note.

Resource, system and control

Sponsors should have adequate systems and controls in place to govern its conduct and monitor its staff. Critical matters such as resolution of suspicious circumstances, difficult or sensitive issues, conflicting information and material non-compliance by a listing applicant should be escalated to and handled by a designated committee or Management. Sponsors are expected to demonstrate to the HK SFC appropriate escalation channels and Management’s involvement in the consideration of key concerns. Review process should be in place to ensure that matters are promptly escalated and resolved. Establishing committees, with members including from different departments and seniority to supervise and regularly review on the due diligence processes can considered good corporate governance practice.

Management should also have in place appropriate procedures to ensure that each Transaction Team is properly supervised by at least one sponsor Principal. While management should ensure that such sponsor Principal should possess the essential capacity and competence to perform the supervision. Staff conducting sponsor work should have sufficient resources and guidance to undertake their work. Continuous trainings and feedback mechanisms should be in place to ensure that all staff understands the expected standards of conduct. Establishing specified thresholds for internal escalation and requiring sponsor Principals to attend key due diligence interviews together with junior team member are also considered sound practices under the current regulatory requirements.

Sponsors should regularly assess the effectiveness of its systems and controls, taking into account the rapid changing market environment and risks. This review practice should be done at least annually, while monitoring, feedback and escalations should be conducted continuously. Senior management, directors and MICs should be included in evaluating the strength and vulnerabilities of the current controls and practices. Mere reliance on the attestation by the sponsor Principals, without detailing the work done or samples reviewed to ensure that key policies and procedures are effectively implemented, is unsatisfactory manner of practice.

2. Deficiencies in relation to CFA Code requirements

Chinese walls

Paragraph 4.3 of the CFA Code requires sponsors where it is part of a professional firm or group of companies undertaking other activities, e.g. auditing, banking, research, stockbroking and fund management, to ensure that an effective information barrier (i.e. Chinese wall) is established to prevent exchange of sensitive and confidential information that may potentially lead to conflicts of interest. For an effective system, physical separation between staffs for various business activities would be an important element.

The HK SFC has discovered cases where certain information relating to the listing applications which was not yet made public was passed from the Transaction Teams to staff from related LCs before wall-crossing approvals were obtained. As mentioned in the section of “Resource, system and control” above, Chinese walls should also be subject to at least annual review by Management and proper escalation channels should be established for Management to react promptly to any potential flow of information to any unintended parties.

Receipt or provision of benefits

Paragraph 4.6 of the CFA code states that a sponsor should neither offer nor accept any inducements involving its clients prior to disclosing such inducements to its clients. LCs acting as sponsor should also ensure that written policies in relation to disclosure of gift and benefit are properly and clearly established, which should specify the monetary limit and the circumstances in which they were offered or received.

However, the HK SFC has found some deficiencies and non-compliance in relation to the requirement. It was observed that sme sponsors lack written policies to monitor and govern the provision of gifts and benefits to its clients. Even in the existence of written company policy, HK SFC still observed non-compliance in relation to the receipt of benefits. The lack of documentation is also a common issue observed by the SFC.

Conclusion

The HK SFC will continue to conduct onsite inspections to monitor sponsors' performance. Sponsors with a history of returned or rejected listing applications or serious deficiencies and instances of non-compliance may expect more frequent inspection visits and supervisory actions, as these factors may cast doubt on a sponsor's capability to discharge its responsibilities as well as potential compliance risk. Future listing applications submitted by these sponsors may also be subject to closer scrutiny by the regulators.

To summarise, sponsors are advised to observe the following good practices to meet the expected standards of the HK SFC:

1. Have a sound understanding of the business of a listing applicant based on reasonable due diligence.
2. Perform background research on the listing applicant and update it regularly.
3. Develop robust, comprehensive and customised due diligence plans at the start of each engagement, instead of merely relying on a generic due diligence checklist.
4. Keep proper records documenting the breadth and depth of their due diligence and the results, including the specific issues identified and how they were resolved.
5. Remain responsible for matters related to the tasks undertaken by a third party and do not simply use a third party's work as evidence that the obligation to conduct reasonable due diligence has been conducted.
6. Critically review the expert's opinion and conduct follow-up work to resolve any material discrepancies, irregularities or inconsistencies.
7. Take reasonable steps to identify red flags and cross-check information obtained from different sources.
8. Exercise due care in confirming the bona fides of interviewees in order to be satisfied that they have the appropriate authority and knowledge.
9. Have clear policies requiring critical matters to be escalated to its Board, responsible MICs or its designated committee for consideration.
10. Ensure that sufficient resources are allocated to each engagement and provide sufficient training, guidance and management supervision over sponsor work.
11. Conduct reviews of policies and procedures to ensure compliance with the relevant codes, rules and regulations.

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