Continued focus of the SFC on the conduct of intermediaries involved in IPOs

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Earlier this year, the Securities and Futures Commission (the **Commission**) concluded disciplinary actions against a number of sponsor firms and principals after a multi-year investigation. These sponsor firms and principals have been subject to various penalties for deficiencies in their work.

Delivering her speech at a conference on 21 October 2019, Ms Julia Leung, the Commission's Deputy Chief Executive Officer and Executive Director of the Intermediaries Division, reiterated that the Commission will continue to uphold the high standards of conduct of intermediaries who are involved in the IPO process in order to maintain and improve the quality of the listings and trading liquidity in Hong Kong.[1] This client briefing will focus on the Commission's regulatory approach to intermediary supervision as addressed by Ms. Leung in her speech.

Sponsors play a key, and indeed unique, gatekeeping role in the IPO process. One of the important functions they serve is to conduct reasonable due diligence on listing applicants to ensure that investors are provided with adequate and correct information to form a fair and justifiable opinion about these applicants. The Commission has therefore tightened its regulation and supervision over sponsors to ensure that these key players in the IPO market meet the standard of conduct expected of them when conducting due diligence. Given that there has been an increase in the number of licensed firms engaged in the sponsor business which resulted in intensifying competition among sponsors which may call for more competitive pricing, the Commission is concerned that some sponsors may compromise their quality of their work.

In her speech, Ms Leung highlighted the following five major failings in sponsor due diligence that the Commission has identified in its last sponsor-related thematic review:[2]

1. **Adopting a box-ticking approach:** instead of a generic, box-ticking approach, sponsors are expected to carefully consider, develop and customise comprehensive due diligence plans at the beginning of each engagement.
2. **Ignoring red flags:** sponsors are not required to prevent fraud but are expected to take reasonable steps to follow up on obvious red flags which bring into question the reliability of the information obtained during the IPO process.

1 https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/IPO%20Sponsors%20and%20Regulations%20-%20Keynote%20Speech_final_INT.pdf

2 On 26 March 2018, the Commission issued the Thematic Review of Licensed Corporations Engaged in Sponsor Business report after reviewing the sponsor work undertaken by over 30 sponsor firms from October 2013 to December 2017.

3. **Deficient interview practices:** sponsors are required to comply with the detailed sponsors' interview practices as set out in the Code of Conduct.[3] In particular, sponsors should independently verify the bona fides of interviewees, including calling the interviewee's company to establish that the interviewee works there.
4. **Over-reliance on experts and third parties:** sponsors cannot simply accept expert advice at face value and are instead expected to critically review the advice to identify any material discrepancy, irregularity or inconsistency which requires follow-up. Sponsors should also consider whether a third party's work is sufficient to discharge their due diligence obligations.
5. **Improper supervision and inadequate resources:** sponsors' management is expected to ensure that sufficient resources are allocated to each engagement and demonstrate that the transaction teams are in fact adequately supervised during the IPO process so that critical matters are escalated to and addressed by the management.

Licensed corporations engaging in sponsor work should be alert to the above shortcomings, as they are likely to be the Commission's focuses when scrutinising sponsor due diligence work.

Successful enforcement actions against sponsors and sponsor principals have a strong deterrent effect. However, recognising the complexity of sponsor cases and accordingly the time required to investigate these matters, the Commission has taken a "front-loaded" approach to sponsor supervision. Through onsite inspections and the IPO vetting process, the Commission is able to detect potential deficiencies in sponsor work and serious internal control failures and intervene at an early stage. In terms of early intervention, the Commission may request the sponsor firm concerned to voluntarily undertake to enhance its governance structure and strengthen its internal systems and controls. That may include the appointment of independent directors to the board to ensure effective oversight of the sponsor business or the appointment of a sponsor principal independent of the transaction team to evaluate the sponsor work conducted by the team. If the sponsor refuses to give the requested voluntary undertakings, the Commission will impose licensing conditions on the sponsor.

Much emphasis has been placed on the role of sponsors in the IPO process. However, they are not the only class of intermediaries involved in the IPO process who are being scrutinised by the Commission. In her speech, Ms Leung also highlighted the role of lead underwriters as a guardian of market quality. She noted that misconduct in the book building process (e.g. underwriting syndicates submitting inflated or fictitious orders) may ultimately damage investor confidence in the integrity and transparency of the market. The Commission will issue guidance after completing the thematic review of the book building processes in both the equity and debt capital markets.

Since the introduction of the sponsor regime in 2013, a number of investment banks have been subject to disciplinary action by the Commission due to their substandard sponsor work. Sponsors who have a history of substandard sponsor work are likely to be inspected by the Commission. The actions taken and regulatory approach adopted by the Commission have shown that the Commission is resolute in ensuring that sponsors, as key players in the IPO process, continue to meet the standards expected of them. As the

[3] Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

financial sector increasingly look to the more lucrative returns of the underwriting business, the Commission is now expanding its scope of scrutiny to underwriters who, in the regulators' eyes, also play a crucial role in the quality of the stock market in Hong Kong.

Should you require any further information regarding the content of this client briefing, please do not hesitate to contact the authors or your usual Slaughter and May contact:

Wynne Mok
Partner
T +852 2901 7201
E wynne.mok@slaughterandmay.com

Kevin Warburton
Counsel
T +852 2901 7331
E kevin.warburton@slaughterandmay.com

Jonathan Kao
Associate
T +852 2901 7227
E jonathan.kao@slaughterandmay.com

Ruby Chik
Associate
T +852 2901 7292
E ruby.chik@slaughterandmay.com

Jason Cheng
Associate
T +852 2901 7211
E jason.cheng@slaughterandmay.com

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