Capital Markets Hong Kong IPOs : A Broken Regime?

The efforts of the Securities and Futures Commission to eliminate financial fraud perpetrated by Hong Kong listed companies and their directors is laudable. What is unclear is why they have chosen to focus almost exclusively on the sponsors who have brought these companies to the market. This unnatural preoccupation with the sponsors sends an unfortunate message that directors engaged in fraud have nothing to fear but the remote risk that they will be deprived of their ill-gotten gains and that auditors have little, if any, responsibility for assuring the public as to the financial position of these companies.

Stock market regulation remains at the core of the Securities and Futures Commission's (SFC) responsibilities, despite a decades-long tussle with the Hong Kong Stock Exchange (HKEx) for control of related regulatory functions. A new sponsor regime introduced in 2013 sought to make initial public offerings (IPO) listing sponsors more explicitly accountable for the quality of IPOs and sponsors currently face heightened SFC scrutiny and threat of disciplinary action. Meanwhile, however, some of the perpetrators of listing fraud escape unpunished

Primary responsibility for the truth, accuracy and completeness of a listed company's disclosures should lie with its directors, with the auditors of a listing applicant providing assurance as to the applicant's financial disclosures. This is the position in many jurisdictions, but it would seem that the SFC does not agree. Undoubtedly, sponsors also have a role to play as gatekeepers of the Hong Kong stock market, ensuring fraudulent or unprofitable companies don't get listed. However, recent enforcement action by the SFC shows an unnatural preoccupation with the role of sponsors in cases of listing fraud and listed company misconduct, to the exclusion of other responsible parties.

September 24, 2018

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While in some cases the SFC may seek redress from company founders and senior managers who knowingly defraud Hong Kong investors, it generally does not press criminal charges. Nor has the SFC shown any inclination to take enforcement action against the accountants who audit and sign off a company's financial statements that turn out to be false. The SFC's clear preference is to target the sponsors, even though the sponsors are further removed from accounting fraud than the accountants.

Given that the sponsor firms recently disciplined by the SFC have almost all been subsidiaries of major financial institutions, the absence of rigorous action against the directors and the auditors of listed companies engaged in misconduct begs the question whether, in determining enforcement priorities, the SFC has prioritised the newsworthiness of the public disgrace of these institutions over the need to hold the true perpetrators of misconduct accountable.

Recent regulatory action

Tensions between the SFC and the sponsor community have grown in recent years. Since 2013, the SFC has returned or rejected 44 listing applications, and also sought to sanction alleged misconduct or incompetence. While having had limited success in court with civil or criminal actions, the SFC can in effect wield its disciplinary powers as prosecutor, judge and jury. In February 2018, the enforcement division announced that it had formally investigated 15 sponsor firms (from a current population of 111) and issued notices of proposed disciplinary actions against eight firms and four sponsor principals (from a current population of about 230 individuals), with more such actions under consideration.

The SFC can also use its inspection and supervisory powers to favour particular sponsors with extra attention. In March 2018, the Intermediaries Division announced that sponsors with a history of returned or rejected listing applications or which are found to have had serious deficiencies may expect more frequent inspection visits and supervisory actions.

This burst of regulatory actions perhaps effectuates the front-loaded regulation approach that the SFC formally introduced in July 2017, emphasising earlier, more targeted intervention to pre-empt or limit investor losses from major corporate misfeasance and market misconduct. That was followed with an announcement that sponsor misconduct will be one of the SFC's top enforcement priorities this year. With SFC investigations moving at a snail's pace, however, conduct standards have been imposed retrospectively, in relation to work that sponsors may have done many years earlier.

CCB International

In July 2018, the SFC reprimanded and fined CCB International Capital (CCBIC) $24 million for failing to conduct all reasonable due diligence on the unsuccessful 2014 listing application of Fujian Dongya Aquatic Products. The sanction was imposed despite the SFC finding 'no evidence that suggests that there is a systemic failure in CCBIC's policies, procedures and practices in respect of its sponsor work.' Quite apart from whether CCBIC's due diligence in this case was satisfactory, the SFC observed that CCBIC instructed its lawyers to devise a due diligence plan, but that CCBIC did not complete the plan. This observation suggests a disturbing disregard to the principle that minimum required standards of regulatory conduct should be uniform, rather than dependent on whatever particular advice a sponsor may

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happen to have received from its lawyers. It appears that the SFC took its eyes off the fact that the sponsor, not its service providers, must have ultimate responsibility for determining its own due diligence plan.

Citigroup Global Markets

In May 2018, the SFC fined Citigroup Global Markets Asia HK$57 million ($7.3 million approximately) in relation its sponsorship of Real Gold Mining. Real Gold has been suspended ever since 2011, two years after its 2009 listing, when it emerged that the company's disclosure to the HKEx of RMB543 million ($69 million approximately) in annual profits was contradicted by a filing to mainland authorities of a RMB7.5 million loss. Also, the company revealed that it had transferred HK$1.5 billion to its billionaire founder and controlling shareholder, Wu Ruilin, in loans and to acquire one of his wholly-owned companies, without the knowledge of other shareholders. Wu also improperly pledged assets of Real Gold's subsidiaries as collateral for bank loans to his telecom empire, Cosun Group.

Although these scandals were a more proximate cause of the company's downfall, to hold Citi responsible, the SFC had to identify deficiencies that occurred before the initial public offering (IPO) rather than after it. Accordingly, the SFC criticised Citi's supervision of its sponsor transaction team and its due diligence of Real Gold's customers. Citi argued that, gold being a commodity with a ready market, it was reasonable to focus its due diligence on the company's production, rather than its customers. The SFC disagreed.

The SFC issued a writ claiming (compensation for investors) against Wu a year ago. However, the generally endorsed writ has yet to be served on Wu. The SFC has also not taken any action against Real Gold's auditors, Deloitte, who signed off the firm's accounts and failed to detect that they were fraudulent.

UBS

In March 2018, the SFC fined UBS Securities Hong Kong HK$119 million and suspended its ability to act as a sponsor for Hong Kong listed IPOs for 18 months. UBS is appealing the decision. Whilst the basis for the penalty has not yet been disclosed, UBS was notably the sponsor for the 2009 listing of China Metal Recycling, which was eventually wound up, after years of forging documents to fabricate sales and profits data. UBS was also a joint sponsor for the 2009 listing of China Forestry Holdings, which was suspended just over a year later, after auditors found accounting irregularities.

It was not until June 2018 that the SFC commenced Market Misconduct Tribunal (MMT) proceedings against China Forestry's former chief executive, Li Han Chun, and former chairman, Li Kwok Cheong, alleging disclosure of false or misleading information in the 2009 prospectus, and falsification of supporting documents such as bank statements and forestry rights certificates. MMT proceedings can, at most, result in a disgorgement to the government of profits made. They cannot result in prison terms and indeed, once commenced, MMT proceedings preclude criminal proceedings for the same conduct. Moreover, it appears that any court proceedings to seek compensation for investors is now time barred. As a result, while investors are left with significant losses and the UBS corporate finance franchise is on life support, the actual perpetrators of any misconduct will at most be deprived of their ill gotten gains (together with costs) and those responsible for providing a level of assurance of the accounts of the company will face no repercussions.

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Others

In March 2017, the SFC reprimanded and fined BOCOM International (Asia) HK$15 million, including for failure to disclose in a 2014 listing application that connected persons of the listing applicant guaranteed several short-term loans to its customers. Earlier, in August 2016, the SFC fined Quam Capital HK$800,000, primarily for its failure in relation to a 2011 prospectus that falsely stated that none of the directors of the listing applicant had any interest in four of its five largest suppliers.

Until recently, the record penalty imposed on an IPO sponsor in Hong Kong was in 2012 against Mega Capital (Asia) Company, a firm that, unlike the SFC's more recent targets, was not part of a well-known financial group. Mega Capital's only claim to fame remains its handling of Hontex International's listing in 2009. With false or misleading information in its prospectus, Hontex traded for just 64 days before its suspension. While the Court of First Instance ordered Hontex International to buy back all the shares owned by its small shareholders, the SFC did not commence any criminal proceedings against the majority shareholders who had sought to profit from the fraudulent listing. Nor did Hontex International's accountant company, KPMG, face any enforcement action, despite the fact that one of its senior managers accepted HK$400,000 from a Hontex consultant during the listing process. The senior manager was acquitted of bribery charges, in part because he reported the payment to his supervisor, but she did nothing about it. The SFC only punished the sponsor, fining Mega Capital HK$42 million and revoking its licence.

Pass the parcel - liability for untrue statements

Under Hong Kong's listing regime, though the SFC reviews and comments on the draft prospectus and other documents, it takes no responsibility when errors subsequently become apparent or when fraudulent listings occur.

Liability under the Companies Law

Section 40 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance provides that directors, promoters and persons who authorised the issue of a prospectus have civil liability to persons who subscribe for shares on the faith of the prospectus and who sustain a loss due to any untrue statement therein. No person is liable if he can prove that he had reasonable grounds to believe the truth of the untrue statement or, in relation to untrue statements purporting to be made by an expert, he had reasonable grounds to believe that the expert was competent.

Section 40A also imposes criminal liability on any person who authorised the issue of the prospectus containing an untrue statement, unless he proves that the statement was immaterial or that he had reasonable grounds to believe that the statement was true.

These legislative provisions clearly contemplate that liability may extend to directors of a listed company as well as to an accountant or other expert who consents to the inclusion of his expert opinion in the prospectus, if that opinion contains an untrue statement. And yet there is little evidence that the SFC pays the same level of attention to the role of directors and accountants in cases of fraud by listed companies as it does to the role of sponsors.

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Regulatory duties

The HKEx's listing rules prescribe basic content requirements for an accountant's report that must be included in a prospectus or other listing document. The listing applicant's sponsor, meanwhile, is responsible under the Code of Conduct for Persons Licensed by or Registered with the SFC for taking 'reasonable steps to ensure that true, accurate and complete disclosure about a listing applicant is made to the public.

While the sponsor accordingly has a degree of responsibility in relation to the content of a prospectus, there is no evident public policy rationale for the sponsor to assume a greater responsibility for the accuracy of the financial statements of a listed company than the company's auditors. To the contrary, the auditors are engaged for their expertise in providing assurance as to these financial statements and the name of the auditor speaks more to the quality of the financial statements than the name of the sponsor.

Indeed, the Code of Conduct issued by the SFC itself acknowledges that 'as a reporting accountant performs audit procedures on information received from a listing applicant under applicable professional standards, a sponsor is not expected to carry out any further due diligence on this information.'

Going forward

The SFC's renewed effort to improve the quality of new listings is laudable. There is no place for fraud in the Hong Kong market. While fortunes may be won or lost through investments in companies on the HKEx, losses should arise from misjudgments as to the prospects of the market or a particular company rather than as a result of the dishonest shenanigans of fraudsters.

Whilst sponsors no doubt play a role as gatekeepers, the SFC would do well to remember that the public expects directors of listed companies to bear primary responsibility for disclosures by those companies and the auditors of those companies to bear responsibility for the assurances they provide in respect of financial disclosures by those companies. At the same time, the SFC should bear in mind the unspoken message of its campaign against sponsors, namely that those who perpetrate financial fraud and those who are tasked with providing assurances as to financial statements have little to fear.

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Timothy Loh is the Managing Partner of Timothy Loh LLP. He has extensive experience in SFC enforcement action. His recent representations have included:

- Representing a director of AcrossAsia in the first case before the MMT alleging a breach by a director of the statutory requirement to disclose inside information.
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