



HONG KONG MONETARY AUTHORITY
香港金融管理局

Report on Thematic Examinations of Sponsor Activities

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I. Executive summary

1. Between Q4/2010 and Q2/2011, the Hong Kong Monetary Authority (“**HKMA**”) conducted thematic on-site examinations (“**Sponsor Examinations**”) on the initial public offering (“**IPO**”) sponsor activities¹ of the five registered institutions (“**RI**s”) engaged in such activities to assess their compliance with relevant regulatory requirements and to require appropriate remedial actions to address any supervisory concerns and areas for improvement identified.
2. The HKMA places a high value on maintaining the integrity of the market and the transparency in fund raising exercises. In order to achieve this objective, the HKMA adopts the same regulatory standard as the Securities and Futures Commission (“**SFC**”) in supervising the IPO sponsor activities of intermediaries. The two regulators maintain close dialogue to facilitate supervision and exchange of sponsors-related supervisory information.
3. The Sponsor Examinations revealed that in general, the Bank Sponsors examined had put in place policies and procedures with reference to regulatory requirements. The examinations, on the other hand, revealed certain main or common types of deficiencies in the work performed by some of the sponsors as well as areas for improvement in the internal controls and management supervision. These findings relate to the following aspects:
 - (a) *Policies and procedures*
 - (b) *Management supervision*
 - (c) *Standard of due diligence work*
 - (d) *Disclosure in prospectus*
 - (e) *Audit trail and documentation of due diligence*
4. The senior management of the sponsors have been advised of the relevant examination findings and recommendations. The HKMA will continue to monitor the progress of the sponsors in the implementation of the recommendations.

¹ Sponsor means a licensed corporation or registered institution licensed or registered under the Securities and Futures Ordinance for type 6 regulated activity and permitted under its license or certificate of registration to act as a sponsor in respect of an application for the listing of any securities on a recognized stock market.

II. Background

5. Under the present regulatory framework as stipulated in the Securities and Futures Ordinance (“SFO”), the SFC is the lead regulator for the securities industry. Any authorized institution (“AI”) that intends to carry on a business in any regulated activity as defined under the SFO must be registered with the SFC as a RI. The SFC sets the standards, through rules, codes and guidelines issued under the SFO, with which intermediaries should comply in carrying on their regulated activities. On the other hand, the HKMA acts as the frontline supervisor of RIs. When an AI applies to become an RI, the HKMA will advise the SFC whether the AI is fit and proper to carry on the regulated activities for which it seeks registration. After registration, the RI is supervised by the HKMA and subject to the relevant regulatory requirements issued by the SFC and the HKMA.
6. Sponsor activities are performed by RIs as part of type 6 regulated activity under the SFO. In supervising the conduct of such activities, on-site examination is one of the HKMA’s supervisory tools to monitor whether RIs’ conduct of sponsor activities complies with the relevant regulatory requirements under the Listing Rules² (including the Practice Notes), the Sponsor Guidelines³, the Corporate Finance Adviser Code of Conduct (“CFA Code”) and all other applicable requirements of the regime.
7. In order to ensure a level playing field between the banking industry and licensed corporations under the sponsor regulatory regime, the HKMA applies the same on-site examination standards as the SFC. To facilitate co-operation, the HKMA and the SFC have established a mechanism under the Memorandum of Understanding between the two regulators for regular communication on matters related to the supervision of regulated activities and interpretation of the applicable requirements. Within this framework, the HKMA maintains frequent dialogue with the SFC in respect of the supervision of sponsor activities through various means, including regular meetings to discuss matters of mutual regulatory and supervisory interest, exchange information, staff training and development etc.

III. Thematic examinations of sponsor activities

8. During the examination period, there were five RIs conducting sponsor activities. They were all covered in the current round of thematic on-site examinations. The main purpose of the Sponsor Examinations was to gauge

² Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (“Main Board Listing Rules”) and Rules Governing the Listing of Securities on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited (“GEM Listing Rules”) (collectively, “Listing Rules”)

³ The Additional Fit and Proper Guidelines for Corporations and Authorised Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers

the sponsors' compliance with the relevant regulatory requirements, and to require the sponsors to take appropriate actions to address any supervisory concerns and areas for improvement identified. The examinations covered a review of:

- the sponsors' internal policies and procedures, as well as management supervision of their conduct of sponsor activities; and
- the due diligence work undertaken by the sponsors in selected IPO transactions.

Key Findings

Policies and procedures

9. Sponsors are required to have adequate policies and procedures as well as effective controls to properly discharge their role as sponsors with reference to Practice Note 21 to the Main Board Listing Rules (“**PN 21**”) and other regulatory requirements. Specifically, the Supervisory Policy Manual issued by the HKMA places the responsibility for formulating policies, procedures and controls⁴ on the sponsor's senior management.
10. The Sponsor Examinations revealed that the sponsors in general had established policies and procedures to govern the conduct of sponsor activities. In addition to this, the sponsors were aware of their duty to ensure the effectiveness of implementation as well as the adequacy of the coverage of the policies and procedures.
11. Despite the control mechanism already put in place by the sponsors, the examinations revealed deficiencies. Common deficiencies among some of the sponsors were found in:
 - (i) monitoring of the progress of implementing the due diligence plan;
 - (ii) reviewing the standard and extent of due diligence, and the performance of the Principal⁵ and the Transaction Team; and
 - (iii) guidance on the key approach to deal with due diligence issues such as handling suspicious scenarios.

⁴ Sub-paragraph 4.1.1 of module SB-1 “Supervision of Regulated Activities of SFC-Registered Authorized Institutions” of the Supervisory Policy Manual

⁵ “Principal” means an executive officer appointed by the RI to be in charge of the supervision of the transaction team.

Case example 1

- ❖ The policies and procedures of a sponsor did not provide guidance to the staff performing the sponsor activities on areas such as handling of questionable or sceptical information, due diligence on the listing applicant's major stakeholders and senior management, the scope of due diligence work, and documentation standard and record retention.

12. In response to the Examination Team's queries on the deficiencies identified in the policies and procedures, one of the sponsors explained that prescriptive or exhaustive guidance would restrict an appropriately experienced transaction team's flexibility in applying professional scepticism, critical assessment and a questioning mind and that a more experienced team requires less guidance.
13. The HKMA considers that the deployment of experienced staff does not mitigate the necessity for establishing adequate policies and procedures for setting guidance to staff in respect of senior management's expected standards and practices in relation to the conduct of sponsor activities.
14. The HKMA expects that sponsors should be able to demonstrate that the relevant policies and procedures are properly established and effectively applied. The management of a sponsor is ultimately responsible for the supervision of the sponsor work undertaken by the sponsor, as well as compliance with all relevant rules, regulations, codes and guidelines.

Management supervision

15. General Principle 9 of the Code of Conduct⁶ provides that the senior management of a licensed or registered person should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm. Paragraph 1.2.4 of the Sponsor Guidelines also sets out that while the management may delegate the operational functions to the staff of a sponsor, the management remains responsible for the discharge of these functions and such responsibilities cannot be delegated.
16. The Sponsor Examinations revealed that the duties of the sponsor were set out in the sponsors' policy manuals, and so were the responsibilities of the Principal. Also common was the use of management committee as a tool to manage and supervise the Principal and the Transaction Team. Annual assessment was another means that sponsors deployed to review the effectiveness and adequacy of controls and systems.
17. Notwithstanding these findings, how the management ensured adequate

⁶ The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

supervision and performance of its staff and proper standard of the due diligence performed is an area which requires improvement. For some of the sponsors, the supervision of some key areas, such as the depth of the due diligence review and making critical assessment of the results of the due diligence, appeared to be less than satisfactory.

18. There were cases where sponsors placed great reliance on the management committee to demonstrate their satisfactory performance of management supervision. However, the examinations revealed some instances of lack of audit trail to demonstrate management supervision of major issues such as the review of the due diligence plan by the management, and supervisory responses to repeated non-compliance of house rules and regulatory requirements. These findings gave rise to concerns about the effectiveness of the management supervision of sponsor activities of some sponsors.
19. Annual assessments of sponsor activities, which are required under section 1.5.3 of the Sponsor Guidelines, were performed by the sponsors. Some of the sponsors, however, carried out the annual assessment in a form of an internal audit with focus on annual risk assessment of business but did not include an evaluation of the effectiveness of internal systems and controls in relation to the sponsor activities.
20. Regarding the annual assessment carried out by the sponsors, areas of concerns revealed by the examinations included:
 - (i) the scope and key areas of the review were not clearly set out;
 - (ii) the assessment was a high level review and not intensive enough; and
 - (iii) the annual assessment did not cover certain areas such as record retention simply because there was no change in policy.

Such practices therefore could not adequately serve the purpose of reviewing the effectiveness of the systems and controls.

Case example 2

- ❖ In one case, the information disclosed in the prospectus about the costs of materials apparently contradicted similar information in different sections. While realising that the calculation methodology of the figures was inconsistent, the sponsor chose to disclose the conflicting figures without addressing the implications thereof. The finding raised question on the accuracy of the figures disclosed in the prospectus.
- ❖ Furthermore, the Examination Team found that in this case the management did not appear to have been involved in any review of the issue.

Case example 3

- ❖ The sponsor formulated a due diligence plan for the IPO transaction in the form of a checklist which documented the due diligence steps to be performed in accordance with the PN 21 requirements. The final version of the due diligence plan provided to the Examination Team was incomplete. There were no audit trail of checks done for around 30% of the list of items in the due diligence plan and no record to demonstrate that actions were taken as required under the due diligence plan for around 15% of the items, while a number of deficiencies in due diligence process itself was also revealed, for example, no due diligence was conducted on some major stakeholders or obtaining confirmation from experts regarding the latter's independence etc.
- ❖ No evidence was found in respect of any management reviews of the actual due diligence work and progress pursuant to the due diligence plan. The deficiency revealed concerns about the effectiveness of the sponsor's management supervision.

21. Overall, sponsors should strengthen reporting lines and channels to engage management's contribution on key issues. The use of management committee as a supervision tool is unobjectionable but the process should be demonstrably effective, and key issues should be brought to the attention of, and discussed by, the management committee.

Standard of due diligence work

22. Sponsors should demonstrate that they have turned their minds to the question of what inquiries are necessary and reasonably practicable in the context and circumstances of the case⁷.
23. It was a general observation of the Examination Team that most of the sponsors had performed due diligence in areas as laid down in the listing rules and other regulatory requirements, such as disclosure of material information, reviews of the applicants' internal controls, assessment of the applicants' business model, financial situation etc., by way of conducting enquiries of major suppliers and customers, major bankers, risk areas and relevant parties of the applicants.
24. Notwithstanding the general observation, review of the selected cases indicated that the standard of due diligence work performed by some of the sponsors appeared to be less satisfactory in some areas, for example:
- (i) handling conflicting or suspicious information;
 - (ii) extent or sufficiency of due diligence work; and
 - (iii) follow-up of due diligence enquiries.

Case example 4

- ❖ The sponsor, whilst noticing the figures of the applicant's sales to a particular customer to be disclosed in the prospectus were substantially (at least twice) larger than those disclosed in the prospectus of that customer, simply conducted an audit confirmation with the listing applicant's customer. No additional due diligence work (such as further examination of documents and interviews with relevant parties to ensure the accuracy of the figures) was conducted.

⁷ Paragraph 4 of PN 21

Case example 5

- ❖ Of the major customers reported during the track record period, the sponsor only conducted on-site visits of two customers. Other major customers only had interviews conducted through mobile phone numbers provided by the listing applicant. The sponsor did not properly verify the identity of the interviewees or request the interviewees to endorse the interview notes.

25. There were also items unveiled during the examinations which raised concerns about the extent or sufficiency of due diligence work, for example:
- (i) there was a case where only phone enquiry was conducted (but no additional due diligence work) with one of the applicant's key suppliers who contributed over 25% of the supply to the listing applicant during track record periods;
 - (ii) in another case, the sponsor failed to perform due diligence with any of the listing applicant's bankers as required under PN 21; and
 - (iii) in the due diligence process with major customers, questions or issues of the questions were unanswered and some key items were not addressed in the due diligence questionnaire, for instance, issues about any pending litigation/disputes with the applicant etc.
26. Notwithstanding the findings, the examinations found that sponsors generally had awareness of and plans to meet regulatory requirements. However, the approach and the standard of due diligence that sponsors strived for need improvement particularly in areas which required second level of enquiry and discharging the duties as a sponsor.
27. The regulator expects the sponsor to make such enquiries as may be necessary until the sponsor can reasonably satisfy itself of compliance with regulatory requirements in relation to the disclosure in the listing document. The sponsor should perform additional due diligence work with a questioning mind in response to sceptical circumstances.

Disclosure in prospectus

28. The prospectus regime in Hong Kong is a disclosure-based regime. The Listing Rules and the Companies Ordinance require the listing documents to comply with the minimum content requirement. If material information about the listing applicant's financial position and business prospects is not properly disclosed, investor's ability to make informed decisions may be prejudiced in the absence of true, accurate and complete information.
29. The consequences of inadequate disclosure of material information can be very serious. The Listing Rules require sponsors to use reasonable endeavour

to ensure all information provided to The Stock Exchange of Hong Kong Limited during the listing application is true in all material aspects and does not omit any material information.

30. The on-site examinations found issues of concern in relation to the accuracy and completeness of statements disclosed in the prospectus. While accepting that some issues may require judgement call as to the materiality and sufficiency of the details of information to be disclosed, sponsors should act with due skill and care in the interest of investors⁸.

Case example 6

- ❖ The Examination Team noted deficiencies in the sponsor's due diligence on the listing applicant's directors and senior management, as well as the disclosure of their biographical details in the prospectus. In the prospectus, it was disclosed that the Chief Financial Officer ("CFO") of the listing applicant became a certified public accountant in a specified year. The document in support of the CFO's professional qualification was a printout from the online members' registry of the relevant professional body, which shows that the CFO's licence was cancelled at the relevant time. Notwithstanding this result, this fact has not been disclosed in the prospectus.
- ❖ The sponsor should demonstrate that it had made necessary inquiries and reasonably satisfied itself about the due diligence conducted on the directors and senior management of the listing applicant.

⁸ Paragraph 5.1 of the CFA Code

Case example 7

- ❖ It was disclosed in the prospectus that the listing applicant's advisory board consisted of several experts who were responsible for assessing the viability of the potential products to facilitate the applicant's further research and development. The examination, however, revealed the non-disclosure of another board member in the prospectus.
- ❖ The sponsor advised that the member, who was concurrently a committee member of a government body responsible for the approval of licence for the manufacturing of the products for the applicant's industry, objected to the disclosure of his appointment on the listing applicant's advisory board.
- ❖ The omission cannot be justified on such basis. Moreover, the sponsor should have taken steps to address the conflict of interest that might arise from the said member's dual position and ensure proper disclosure in the prospectus.

31. The sponsor should undertake sufficient due diligence work and use reasonable efforts to ensure that it is reasonably satisfied that the disclosure of information in the prospectus complies with the relevant legal and regulatory requirements.

Audit trail and documentation of due diligence

32. Specifically, PN 21 and Sponsor Guidelines set out the requirements and guidance for sponsors to follow in respect of audit trail and documentation of due diligence. As noted in the Sponsor Examinations, the sponsors in general had stated policies and manuals established in respect of the requirement, but the effectiveness of implementation of such policies and procedures was an issue of concern in some cases.
33. Documentary proof in respect of due diligence as detailed in the sponsors' due diligence plan and the work done of their staff as claimed was not available for the Examination Team's inspection in some of the cases. Depending on the extent and the seriousness of the failure, this may implicate the sponsor's supervision and adequacy of its controls.

34. In some cases, the Examination Team found examples of lack of records showing deliberation of material issues which involved sponsor's decisions of making disclosure of events, and incomplete documentation about enquiries made with relevant parties of the listing applicant.
35. In certain cases, there was significant documentation shortfall. The concerns may not simply, coupled with suspicious circumstances, be a documentation issue, but also call into question whether some of the due diligence steps as required by regulations had been performed as claimed. In such a case, the sponsor may be implicated as being not only in breach of the requirement of retention of proper documentation but also other regulatory requirements as well.

Case example 8

- ❖ A sponsor claimed that due diligence interviews in respect of some of the customers, experts and directors were performed but it failed to produce records to support the claims.
- ❖ When inspected, records about the purported interviews or results of the enquiries were not found. In addition, the due diligence plan and minutes of meetings showed no audit trail about any review or assessment having been performed.
- ❖ The due diligence questionnaires issued to directors and senior management as kept in the transaction files were unanswered, and the sponsor also failed to produce any other records to support that these questionnaires had been completed.

Case example 9

- ❖ The sponsor advised that the due diligence plan provided to the Examination Team was only a draft and thus any final changes and due diligence work performed on the outstanding items were reflected directly in the prospectus or submissions to The Stock Exchange of Hong Kong Limited. There was no evidence to suggest that the due diligence plan, which involved substantially non-completed items, had been critically reviewed and assessed in respect of the adequacy of work done.
- ❖ The sponsor failed to produce for inspection satisfactory documentary proof about some of the claimed due diligence steps.

36. Record retention is the key to evidence the trail of due diligence. The HKMA found that overall the sponsors recognised the regulatory requirements in respect of documentation, in particular, that sponsors should maintain proper books and records, and be able to provide a proper trail of work done for inspection⁹. However, the examination findings demonstrate that the sponsors are in need of more controls, and in so doing ensuring the compliance of the regulatory requirements, which requires the support of an effective implementation process and efficient supervision.

IV. Way forward

37. The HKMA expects sponsors to achieve a higher standard of due diligence in conducting the sponsor activities. The HKMA will continue to monitor and follow up with the sponsors in relation to the implementation of the required actions to address the concerns identified in the Sponsor Examinations. For issues that may warrant further enquiries, there will be appropriate follow up action. The HKMA will continue to maintain close dialogue with the SFC whenever necessary regarding the supervision of sponsors. A copy of this report has been provided to the SFC.

⁹ Paragraph 2.3 of CFA Code