

## **Supervising sponsors in a changing IPO landscape**

### **Hong Kong Conference 2019: IPO Sponsors and Regulations**

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Ladies and gentlemen, good afternoon.

I want to thank Kenneth and Dennis for inviting me to speak this afternoon. As Executive Director of the SFC's Intermediaries Division, I am responsible for the supervision of sponsors. Also with us today from the SFC is Megan Tang, who is chiefly responsible for listing policy, and Lisa Chen, who is responsible for enforcement action against IPO sponsors and disciplinary matters. They will be speaking on the panels after the coffee break. So as you can see, you're going to hear from three regulators who matter a lot to IPO sponsors.

One of the SFC's top priorities is maintaining and improving the quality of our market, and this is reflected in the size of the SFC's representation here today. Our presence here is also an acknowledgement that sponsors act as key gatekeepers to ensure market quality. At the heart of this lies the expectation that sponsors conduct sufficient due diligence to properly understand and assess the companies seeking to be listed. The health of any stock market depends on the confidence that investors have in the reliability of the information provided to them. This begins when a company first joins the market through an IPO and continues thereafter through periodic updates.

An IPO is the culmination of an intensive and collaborative process. Company directors perform a key role and take primary responsibility for the information in the listing document, but the process also involves accountants, lawyers, valuers and other experts as well as underwriters, sponsors and the regulators.

The role of sponsors is unique. Only sponsors have a function that begins and ends with the IPO itself and in that capacity they are specifically licensed by the SFC. They perform a lead role in coordinating all of those involved in the IPO process. They advise and guide directors. They are also centrally involved in the intensive due diligence to ensure that investors have sufficient information to form a fair and justifiable opinion about the company's business and its prospects.

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Note: This is the text of the speech as drafted, which may differ from the delivered version.

## Changes in the IPO market landscape

Over the past decade, the landscape of the IPO market has changed. Hong Kong remains a top listing venue, ranking first in the world in three of the last five years. Multi-billion dollar IPOs still dominate and attract the most media attention, but a high proportion of IPOs are relatively small. In terms of numbers, IPOs on GEM only constituted roughly six percent of the total in 2008, but they accounted for 50% and 36% of all IPOs in 2017 and 2018 respectively, even though GEM companies made up less than one percent of the total market capitalisation.

The number of listing applications received in 2018 was close to 400, which more than doubled from 2012. The number of deals has grown but more of them are smaller sized. Between 2016 and 2018, IPOs with an offer size of less than \$100 million were roughly 40 to 50 percent of the total number of IPOs. In comparison, only 20 to 30 percent of the IPOs in the years between 2011 and 2015 had an offer size of less than \$100 million.

When we look at the smaller offers completed in recent years, we find that a notable portion have shareholdings that are relatively concentrated upon listing.

Hong Kong has clinched top positions in IPO fundraising and market capitalisation, but it lags other major markets in liquidity. At the end of 2018, the Stock Exchange was ranked fifth globally in terms of market capitalisation and eighth in terms of average daily turnover value. However, the Stock Exchange only ranked 13<sup>th</sup> amongst major exchanges in terms of the ratio of its annualised turnover to market capitalisation. This shows that, compared to other major exchanges, there is room to raise the turnover in Hong Kong.

The SFC, together with the Stock Exchange, is studying the possible causes behind the relatively lower trading volumes with a view to enhancing overall liquidity in our markets. This is a complex subject that is well beyond the scope of today's discussion. But a consistent theme that has emerged from our research and stakeholder engagement is that the lack of turnover and liquidity in a certain segment of our stock market is related to perceived problems with the listed companies and the securities.

As a market regulator, the SFC is most concerned about the implications of these findings for the quality of the market and the conduct of intermediaries. In recent years, many listing applicants, particularly those coming to the market with small offers, did not have a convincing rationale for seeking a listing. Not only that, the cost of the listing was often disproportionate to the funds raised and there was no real need for new capital. Many of these companies changed hands or had significant assets injected into them shortly after their IPOs. These trends were accompanied by manipulative activities such as extreme price swings, overpriced acquisitions and highly dilutive capital raisings.

Three years ago, the SFC formed a multi-disciplinary team to identify patterns of misconduct that aim to manipulate stock prices, rig shareholders' votes or scam minority shareholders. These activities may affect investor confidence and harm our market's reputation.

Our response to this kind of misconduct was clear – better gatekeeping at both the front gate and the back gate. In cases where we suspected serious problems, the SFC exercised its power to query the listing applications and a number of applications subsequently lapsed or were withdrawn. The Stock Exchange also rejected a number of applications on suitability grounds where there did not appear to be a commercial rationale for the listing. The

percentage of listing applications that either lapsed, withdrawn or rejected rose to 51% in 2018 from 33% in 2016. Meanwhile, the percentage of successful new applications declined from 67% to 49%. At the back gate, the Stock Exchange tightened backdoor listings and continuing listing criteria through amendments to the Listing Rules.

In cases where the SFC suspected corporate misconduct, we exercised our powers under the Securities and Futures (Stock Market Listing) Rules, or SMLR, to object to a listing or to order the suspension of trading in the shares of listed companies. We then investigate the company directors involved and take action against them where necessary. For 2017 and 2018, there were a total of 27 IPO cases and 43 post-IPO cases where our direct intervention involved the actual or potential use of our SMLR powers. Megan will have more to say about this in the next expert panel.

### **Supervisory regime for sponsors**

As I said, sponsors play a key gatekeeping role. The change in the IPO landscape has been accompanied by an increase in the number of licensed sponsor firms, which grew from 75 as at the end of 2012 to 123 today. More sponsors means more competition, driving down sponsor fees. Sponsors must be careful not to allow these trends to compromise the quality of their due diligence. The standard of due diligence expected of a sponsor is not affected by the amount of fees, the size of the firm or the resources that it has.

How do we supervise sponsors? Primarily, we conduct onsite supervision. We identify intermediaries (such as sponsors) as targets for inspection by looking at information such as licensed firms' compliance histories, the volume of complaints and our internal impact assessment. Our colleagues who vet listing applications provide information about the concerns they identify during the vetting process. These include potential deficiencies in sponsor work for returned or rejected applications. Sponsors who have a history of substandard work are likely to be subjected to more frequent inspections<sup>1</sup>.

We also collect information directly from sponsors. We rolled out a revamped Business and Risk Management Questionnaire, or BRMQ, and licensed firms have started to submit the new BRMQ to us for the financial years ended on or after 31 March 2019. Information submitted via the BRMQ includes the number of sponsor engagements, how sponsor work is managed and how long due diligence would normally take. This is very useful for our supervisory purposes.

### **Reasonable Due Diligence**

The main focus of our inspections is to establish whether the sponsor has performed reasonable due diligence and has sufficient internal controls. I want to emphasise that sponsors are not required to prevent fraud, but they do need to ensure that red flags are properly followed up.

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<sup>1</sup> See "Circular to licensed corporations on expected standards for sponsor work" issued on 26 March 2018.

Reasonable due diligence should not be a new or foreign concept. It has always been part of the Listing Rules and Practice Note 21. The key obligations of sponsors are consolidated in paragraph 17 of the updated Code of Conduct<sup>2</sup> which came into effect in 2013. A key requirement is for a sponsor to take reasonable due diligence steps in respect of a listing application. Paragraph 17 defines the expected quality of work.

Another requirement is for sponsors to complete the due diligence work prior to the submission of a listing application, except matters which can only be dealt with at a later stage. Before October 2013, sponsors often submitted shoddy or incomplete prospectuses, leaving it to the Stock Exchange and the SFC to spot problems and raise queries. Thankfully, this highly unsatisfactory situation has changed. If we note serious problems in a listing application and the sponsor due diligence might have fallen short of the required standards, we inspect the sponsor or start an enforcement investigation. That also applies to listing applications which were ultimately unsuccessful. We have taken regulatory action against poor sponsor work for failed listing applications.

I am sure that all of you are familiar with our thematic inspection report and circular on sponsors issued in March 2018<sup>3</sup>. It highlights five big failings:

#### 1. *Adopting a box-ticking approach*

A consistent theme in our inspections is the failure to consider the extent of the due diligence required, and resorting to a box-ticking approach. The plans we inspected mainly confirmed that broad due diligence measures were taken, but they often failed to demonstrate the factors considered in planning the due diligence, the specific due diligence conducted, the issues identified and the steps taken to resolve them.

We have repeatedly emphasised how important it is for sponsors to develop comprehensive due diligence plans at the start of each engagement, and not rely on a generic checklist. The due diligence plan should be customised for the applicant's unique business model. Careful consideration must be given to the entire due diligence process at an early stage. If this is done too late, for example, just before the listing application is submitted, sponsors may face pressure to meet the timetable. Major issues might be brushed aside.

#### 2. *Ignoring red flags*

Another consistent theme is sponsors' failure to take reasonable steps to follow up on obvious red flags. For example, we expect sponsors to verify that the business operations are accurately described in the listing application.

In one particular case, we noted that around 90% of a listing applicant's revenue during the track record period was derived from sales to a group of customers, and around 90% of this was paid by the customers through third-party payers. This was

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<sup>2</sup> Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

<sup>3</sup> See the *Thematic Review of Licensed Corporations Engaged in Sponsor Business* report issued on 26 March 2018.

an obvious red flag. The sponsor should have followed up to establish the authenticity of the sales.

### 3. *Deficient interview practices*

Next, the Code of Conduct sets out detailed requirements for sponsors' interview practices, but our thematic inspection found that sponsors failed to comply with them. Some sponsors failed to confirm the bona fides of interviewees and that they had the appropriate authority and knowledge.

We saw cases where sponsors conducted interviews of customers without independently verifying that the interviewee was a genuine representative of the customer. Reasonable due diligence requires the sponsor to at least call the interviewee's company to establish that he or she works there.

### 4. *Over-reliance on experts and third parties*

Fourth, sponsors should critically review an expert's opinion and conduct necessary follow-up to resolve any material discrepancies, irregularities or inconsistencies. The decision of the Securities and Futures Appeals Tribunal in the IPO of Sino-Life is clear that the difference between figures provided by two auditors is a material matter that the sponsor should look into and disclose to the regulators. Sponsors should exercise professional scepticism and cannot assume that expert advice can be accepted at face value.

Sponsors are also responsible for work done by third parties and have to demonstrate that due consideration has been given to whether a third party's work could form the basis to discharge their due diligence obligations. For example, a third-party investigation report cannot form the basis of a sponsor's due diligence work if the sponsor does not properly follow up on the concerns it flags or the recommendations it makes.

### 5. *Improper supervision and inadequate resources*

Fifth, we came across situations where the sponsor principals might not have the capacity to adequately supervise the transaction teams<sup>4</sup>. Sponsor fees are not attractive enough to provide the right incentives to do a proper job. In one case, a sponsor principal was reported to be overseeing six active listing applications. This raises doubts as to whether he could adequately supervise all the work.

We expect management to demonstrate sufficient supervision. In some cases, the transaction team failed to escalate critical matters. One listing applicant refused to accept the sponsor's due diligence measures and threatened to change sponsors if it insisted on carrying them out. This is clearly an important issue for management to consider. Management responsibility is now a particular focus following the implementation of the SFC's Manager-In-Charge regime in 2017.

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<sup>4</sup> As defined under Paragraph 17.15(s) of the Code of Conduct.

In summary, it all boils down to having an inquisitive mind set. Sponsors are expected to exercise reasonable judgement and professional scepticism. They should examine the accuracy and completeness of the information with a questioning mind and stay alert to anything that brings into question its reliability. Appropriate verification procedures are also important.

### **Regulatory action**

Where we identify material deficiencies and serious failures to comply with the expected standards in our inspections, we usually refer them to our Enforcement Division for investigation and potential disciplinary action. This is an effective deterrent. The SFC imposed fines of over \$900 million in disciplinary actions against eight sponsor firms and three sponsor principals over the past 30 months. Suspending the licences of firms as well as sponsor principals has sent a strong message that we have little tolerance for misconduct and will be resolute in upholding conduct standards. This is Lisa's area and she will talk more about it.

As you can appreciate, sponsor cases are often complex and take time to investigate. To tackle misbehaviour, we have looked at ways to intervene at an early stage. In cases where our concerns were sufficiently serious and the same sponsors were repeating the same type of conduct, we requested voluntary undertakings to enhance the sponsors' governance structure as well as their systems and controls. The undertakings could include appointing independent directors to the board to exercise effective oversight or appointing a sponsor principal independent of the transaction team to conduct a peer review of listing applications.

If they refuse to provide voluntary undertakings, we will impose licensing conditions. The difference is that licensing conditions will be disclosed to the public.

We hope that by taking this "front-loaded" approach to sponsor supervision, we can focus on the key risks and concentrate on rectifying serious internal control failures to prevent actual harm to IPO investors.

### **Going forward**

While sponsors have an important role in gatekeeping IPO listing applications, you are not the only guardian of market quality. Also playing a key role are lead underwriters who guide the book building process and who often are also sponsors.

Both the buy and sell sides have raised concerns about the competitive pressure to get a share of the often lucrative IPO underwriting fees. Underwriters may be improperly incentivised to generate a lot of orders at the expense of quality. In some extreme cases, members of the syndicate might submit inflated or fictitious orders. This kind of misconduct may severely undermine the price discovery process and ultimately investor confidence in the integrity and transparency of the market.

We are now doing a thematic review of book building processes in both equity and debt capital markets and will issue guidance based on what we find. We are also talking to the listing division of HKEX about the structure of the IPO process.



In conclusion, let me remind you once again that the amount raised by IPOs should not be the only focus. We also need to ensure the quality of the listings and trading liquidity. The regulation of a quality IPO market includes establishing appropriate thresholds for the entry of listed companies, supervising corporate finance activities and upholding the high standards of conduct for intermediaries. Ultimately, we hope this leads to an environment with reduced risks for investors and all those involved in IPOs including sponsors and other professionals.

I hope you enjoy today's panels.

Thank you.