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Red Flags Identification During Sponsors' Due Diligence

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INTRODUCTION

There had been a number of disciplinary actions reported against IPO sponsors in Hong Kong in recent years, including, one in August 2022 and two in October 2021. As we have seen, third party payments and distributor arrangements continue to be the major “red flags” that sponsors should pay extra attention to and, through these disciplinary actions, the Securities and Futures Commission (“SFC”) has sent strong deterrent messages to the industry and the market that a sponsor’s failure to discharge its due diligence duties will not be tolerated. Many sponsor firms were reprimanded and fined by the SFC and the licences of the responsible principals were suspended. These cases provide a reminder as to the importance of adhering to the regulatory due diligence expectations on sponsors and the mindfulness required when certain red flags are found during the IPO process.

The following sets out the key issues relating to the recent cases of disciplinary actions against IPO sponsors:

(a) Third party payment arrangements

These refer to payments made to the listing applicant by third parties on behalf of others, such as the customers. Third party payments have been considered as a red flag as they might be used to disguise the original source of funds and facilitate a fraudulent scheme, particularly where the third party is connected, for instance, to a supplier, and there will be heightened regulatory concerns where such third party payments accounted for a significant percentage of the listing applicant’s revenue during the track record period.

In the recent disciplinary action reported in August 2022, a significant portion of revenue of the listing applicant during the track record period was contributed by two top customers who settled most of their payments to the listing applicant through multiple third parties. As shown in the due diligence documents, the sponsor was in fact aware of such third party payments but it did not turn its minds to the question of whether further enquiries were necessary and/or assess with a questioning mind as to whether such payment method was legitimate.

In another disciplinary action reported in October 2021, the listing applicant received payments from customers through third parties and these third party payments represented a significant portion of the company’s revenue during the track record period. It was found that the sponsor did not verify the relationships between the third party payers and the customers of the listing applicant, simply relied on the representation by the listing applicant as reasons for the third party payments and failed to make appropriate follow-up enquiries.

As shown in the above disciplinary actions, it is crucial that the sponsors perform all reasonable due diligence in respect of the third party payment arrangements, including critical assessment of the reasons behind any third party cash settlement arrangement and make adequate follow-up enquiries to discharge its duties to

ensure the transactions and payment methods are legitimate and reasonable. Sponsor should also conduct due diligence to understand the relationships between the third-party payers and the customers and carry out sufficient due diligence to be comfortable that the payment arrangements do not raise concerns as to a circular flow of funds or similar scheme, having regard to the flow of financing arrangements.

(b) Distributor arrangements

In certain circumstances, where a listing applicant sells to distributors, there may be concerns that such sales may be used to inflate sales figures during the track record period or give an unsustainable impression of demand. For example, “channel stuffing” may take the form of the sale of an excessively large quantity of product to distributors taking advantage of discounts or extended payment terms, often with return flexibility, in order to inflate a company’s revenues.

In one of the disciplinary actions reported in October 2021, the revenue of the listing applicant increased significantly during the track record period as a result of its sales to a distributor and a substantial portion of the products were allegedly ultimately sold to foreign end customers via the distributor. It was imperative in such circumstances that the sponsor should conduct adequate due diligence to assess the reasonableness of such sales, but instead, the sponsor performed minimal due diligence, and following a telephone interview that the sponsor did conduct with a major foreign customer, the sponsor did not seek to obtain any objective data to verify information provided by or conduct any independent background search on the major foreign customer. Its late effort of performing further due diligence, such as interviewing the foreign customer and visiting its retail stores subsequent to receiving comments made by the regulators after submission of the listing application, was not sufficient to discharge its duties as a sponsor.

Based on the above statement of disciplinary action, it is crucial that the sponsors carry out due diligence on the ownership structure, management and employees of the distributors to ascertain if any is connected with the listing applicant, its directors, shareholders or suppliers, and conduct adequate due diligence to assess the reasonableness of the sales to distributors, in particular, the verification of end-customer demand.

(c) Inadequate due diligence with respect to customers and suppliers

In a disciplinary action reported in May 2019, prior to the filing of the listing application, the sponsor discovered that one of the largest Mainland customers (Company A) of the listing applicant had been deregistered but it continued to enter into sales contracts with the listing applicant group thereafter. Despite various red flags identified in investigation reports, company registration documents, legal opinions and sales agreements, the sponsor accepted the explanation by the listing applicant that Company B, whose beneficial owner was the same as Company A, had entered into contracts with the listing applicant in the name of Company A, and Company B was eventually described as one of the largest customers of the listing applicant in the application proof prospectus.

Based on the above statement of disciplinary action, sponsors must always ascertain the true identity of all customers and suppliers, carry out due diligence on their ownership and management structure and take steps to verify the representatives, business premises and reasonableness of transactions of such customers and suppliers. There are circumstances where sponsors join an IPO project at later time after the commencement of listing preparation work, such sponsors may argue that they are not involved in certain due diligence conducted before they come in, but SFC emphasized that sponsors have an independent duty to conduct due diligence in order to have a thorough knowledge and understanding of the listing applicant and to satisfy itself in relation to all the information disclosed in the prospectus.

(d) Failure to maintain proper records of due diligence work

In the recent disciplinary action reported in August 2022, the SFC's investigation revealed that there were no records showing how the sponsor enquired about the third party payments and/or came to the conclusion that the third party payments were immaterial to warrant disclosures in the listing applicant's prospectus. There was also no audit trail demonstrating the sponsor had turned its mind to certain discrepancies identified in the due diligence documents and what conclusion it had reached.

Sponsor shall ensure that it maintains all proper records of due diligence work, especially where there are third party payments, distributorship model and other matters red flags as to the fair and reasonableness of the transactions.

SPONSORS' "RED FLAGS" DUE DILIGENCE

Paragraph 17.4(a)(i) of the Code of Conduct for Persons Licensed by or Registered with the SFC ("Code of Conduct") requires a sponsor to have "performed all reasonable due diligence in respect of a listing application". Factors required to be taken into account by sponsors include the listing applicant's history and background; the personal and business backgrounds of the senior management and controlling shareholders; financial information; material disclosures; and the legality and compliance of the business operations. It is essential that sponsors identify and disclose any material deficiencies in relation to the above factors and see to that the listing applicant is able to address and remedy them.

In order to identify "red flags" relating to the listing applicant, sponsors may pay attention to the following aspects when conducting due diligence for an IPO project:

(A) Apply "Red Flag Mindfulness" During Standard Procedures for Identification of Potential Issues

When performing checking procedures, sponsors should do so with "red flag mindfulness" on potential frauds, non-compliances and problems posing hurdles to listing and other similar public transactions.

For instance, Sponsors of IPOs should have such "red flag mindfulness" when performing the risk-related IPO checking and disclosure procedures required by standard guidance letters and checklists (see **Schedule 1** for a summary of key IPO guidance materials and checklists), to ensure the completeness and integrity of the checking and disclosure process. Taking such a perspective will reduce the likelihood of overlooking suspicious activity and evidence.

Based on the above disciplinary actions, the following points sets out some of the key things that sponsors should do to discharge its duties to exercise due diligence:

- Exercise all reasonable due diligence before submitting the listing application, for example, critically assess the reasons behind any third party cash settlement or distributorship arrangements. Sponsors should not merely accept at face value assurances that the arrangements were for convenience or a private arrangement, and should always carry out all necessary due diligence on the ownership, management and relationships of all the relevant parties
- Exercise reasonable judgment on the nature and extent of due diligence work needed having regard to all relevant facts and circumstances
- Examine with professional skepticism the accuracy of the information provided by the listing applicant and be alert to information that contradicted or brought into question the reliability of such information. The sponsor should consult internally and (where applicable) with external lawyers if they detect something significantly anomalous.
- Undertake additional due diligence to ascertain the truth and completeness of the information provided by the listing applicant, after the sponsor became aware of circumstances that could cast doubt on the information provided to it or otherwise indicated a potential problem or risk. For

example, the sponsor must carry out sufficient due diligence to be comfortable that any payment arrangements do not raise concerns as to a circular flow of funds or similar scheme, having regard to the flow of financing arrangements. Sponsor should also follow up on unwilling or untraceable interviewees;

- Conduct independent due diligence steps to inquire directly of knowledgeable persons within or outside the listing applicant and in relation to material matters and independently obtain information from sources outside the listing applicant
- Maintain records to demonstrate the due diligence carried out, including discussions with the listing applicant's directors and reporting accountants.

(B) Apply Forensic Accounting Checking Concepts Where Appropriate

There are several checking procedures that may aid sponsors in conducting due diligence that sets out frameworks for measuring and identifying any deficiencies of the listing applicant, such as the IRFS standards and other accounting guidelines.

IFRS 13 sets out methods to measure the fair value of the listing applicant for financial reporting. This standard was incorporated by the Hong Kong Institute of Certified Public Accounts into Hong Kong Financial Reporting Standard 13 Fair Value Measurement. Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date” and applies when another standard requires fair value measurements or disclosures about such measurements. Regulatory guidance can be found in standard materials under Schedule 1 and specific guidelines such as SFC's guidance note on directors' duties in the context of valuations in corporate transactions, HKEX's guidance letter GL46-12 and listing decision LD66-1. In general, sponsors should watch out for any improper asset valuations in the form of inventory valuation, accounts receivable, business combinations or fixed assets. These may go hand in hand with other schemes, such as those to inflate sales, deflate or defer corresponding costs, inventory provision adjustments and provision write-backs. Generally, any significant deviation from the norms of industry peers should be checked.

IFRS 3 outlines accounting procedures performed when an acquirer obtains control of a business through an acquisition or a merger. The assets acquired and liabilities assumed in such business combinations have to be measured at their fair values at the acquisition date. This “acquisition method” involves identifying the acquirer; determining the acquisition date; measuring the identifiable assets acquired and liabilities assumed; measuring the consideration transferred; and measuring goodwill or a gain.

Example: A listing applicant acquired a design company during the track record period. The company does not engage in any production, meaning that most of its business is intangible. Excessive reserves from prior charges were booked, to be “released” gradually later to cover up otherwise poor performance.

Another important “red flag” is timing difference, which is the recording of revenues or expenses in improper periods. This improper practice serves the purposes of increasing and decreasing earnings by transferring revenues or expenses between different periods. There are several situations that may make due diligence by the sponsor harder with regards to timing difference, including long-term contracts, channel stuffing and sales with conditions. Long-term contracts are a challenge because it is easy to manipulate revenues and expenses as progress on a project is made by recognizing revenues prematurely. Channel stuffing may take the form of the sale of an excessively large quantity of product to distributors taking advantage of discounts or extended payment terms, often with return flexibility, in order to inflate a company's revenues. Sales with conditions are sales with incomplete terms where the rights of the goods have not been transferred to the purchaser, in which case, sales cannot be recorded as revenue before the conditions have been fulfilled.

Example: A company is involved in event management where sales are not completed until the event occurs because clients are not obligated to complete payment until then. However, the company records sales revenues before the event has taken place, sometimes weeks and months before it is scheduled.

Example: A company is engaged in the manufacture and design of kitchen appliances. The company established a program to distributors involving discounts, mark-ups and the right of return or exchange on unsold products to encourage them to buy their products before the end of the financial year. The company does not disclose this practice in its financial reports.

(C) Apply Other Relevant Methodologies

In addition to financial forensic analysis skills, sponsors should also make use of relevant methodologies like computer technologies, which include data recovery, decryption, e-discovery, and data analytics, to identify red flags. These skills may be crucial in determining the hidden liabilities or any vulnerabilities of a listing applicant suspected of fraud in order to conduct a full investigation. These computer technologies can recover deleted or lost files, establish timelines of computer usage and uncover data patterns. The results can then be used to trace old transactions, locate assets and recreate lost records, which contribute to painting a full picture of a company. In a world where digital media and tools continues to evolve and expand, the accountability of digital evidence and the analysis of electronic data could be vital.

DUTY TO MAINTAIN PROPER RECORDS

In relation to the extent of the requirement of maintaining proper records of due diligence work, the SFC recommends sponsors use the decision of the Securities and Futures Appeals Tribunal (**SFAT**) in *Sun Hung Kai International Limited v Securities and Futures Commission* as guidance, which provides that:

“The rules and principles of conduct within which sponsors work demand that they maintain records that are sufficiently exact and detailed to enable them, upon request by the SFC, to provide a ‘proper trail of work done’. Such a trail must include documentation of due diligence planning which itself demands a demonstration that sponsors have turned their minds to what enquiries are necessary by way of reasonable due diligence in the context and circumstances of an application. Importantly, sponsors are required to document the conclusions they reach regarding an applicant’s compliance with the listing rules.”

Comprehensive records should be maintained of due diligence on matters which are material to the listing applicant’s business including, among others:

- Major customers, suppliers, bankers and creditors as well as the listing applicant’s directors and senior management;
- Material assets used or to be used in connection with the business;
- Contracts material to the business;
- Legal proceedings and other material disputes the listing applicant or its subsidiaries are involved or may be involved in; and
- The existence, validity and business aspects of proprietary interests, intellectual property rights, licensing arrangements and other intangible rights.

Sponsor should critically assess the reliability of documents relied upon, look out for incomplete identification documents and ensure dates of documents are consistent with other related documents or other supporting information. In addition, sponsors should ensure that records can be located and retrieved if/after the members of the transaction team leave the sponsor firm.

Schedule 1 - Summary of Risk-Related IPO Guidance Materials and Checklists in Hong Kong

1 Basic: M100 and G100 IPO Checklists

<https://www.hkex.com.hk/-/media/hkex-market/listing/rules-and-guidance/forms/new-applicants/M100>
<https://www.hkex.com.hk/-/media/hkex-market/listing/rules-and-guidance/forms/new-applicants/G100>

2 Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (especially paragraph 17)

https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code_of_conduct_05082022_Eng.pdf?rev=0fd396c657bc46feb94f3367d7f97a05

and related Due Diligence Guidelines Adopted by the Industry

3 PN21 (Main Board) and PN2 (GEM) Checklists of HKEX:

https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Listing-Rules-Contingency/Main-Board-Listing-Rules/Guidance-Practice-Notes/pn_21.pdf
https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Listing-Rules-Contingency/GEM-Listing-Rules/Practice-Notes/pn_2.pdf

4. Main Disclosure Related Guidance Letters Issued by HKEX

- **GL86-16** Guide on Producing Simplified Listing Documents Relating to Equity Securities for New Applications

http://en-rules.HKEX.com.hk/net_file_store/new_rulebooks/g/l/gl8616.pdf

- **Appendix 2 to the above GL-86-16** - other relevant guidance letters:

Industry-specific guidance letters			
1	HKEX-GL26-12	01/2012	Business models with significant forfeited income from prepayments
2	HKEX-GL28-12	01/2012	Restaurant operators
3	HKEX-GL36-12	05/2012	Distributorship business
4	HKEX-GL52-13	03/2013	Mineral companies
5	HKEX-GL71-14	01/2014	Gambling activities

Other guidance letters on disclosure in a Listing Document			
6	HKEX-GL8-09	07/2009	Disclosure of statistics and data quoted in listing documents
7	HKEX-GL24-11	03/2011	Disclosure requirements for IPO cases – Formal Notice
8	HKEX-GL30-12	02/2012	Disclosure of intellectual property rights
9	HKEX-GL34-12	04/2012	Disclosure of hard underwriting
10	HKEX-GL38-12	06/2012	Latest practicable date and the latest date for liquidity disclosure
11	HKEX-GL37-12	06/2012	Indebtedness, liquidity, financial resources and capital structure disclosure
12	HKEX-GL41-12	08/2012	Disclosure of material changes in financial, operational and/ or trading position after trading record period
13	HKEX-GL63-13	07/2013	Disclosure of material non-compliance incidents
14	HKEX-GL65-13	09/2013	Disclosure of property valuation report and market

15	<u>HKEX-GL82-15</u>	08/2015	Disclosure of unaudited quarterly/interim financial information in the listing document where the new listing applicant or any of its subsidiaries is listed on another exchange
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5. HKEX Reported Returned Cases

- HKEX LISTING DECISION HKEX-LD92-2015 (published in June 2015)
<https://www.HKEX.com.hk/eng/rulesreg/listrules/listdec/Documents/ld92-2015.pdf>
- HKEX LISTING DECISION HKEX-LD101-2016 (published in April 2016)
http://en-rules.HKEX.com.hk/net_file_store/new_rulebooks/l/d/ld101-2016.pdf
- HKEX LISTING DECISION HKEX-LD100-2016 (published in April 2016)
http://en-rules.HKEX.com.hk/net_file_store/new_rulebooks/l/d/ld100-2016.pdf
- HKEX LISTING DECISION HKEX-LD106-2016 (published in May 2017)
http://en-rules.HKEX.com.hk/en/display/display.html?rbid=4476&element_id=5068
- HKEX LISTING DECISION HKEX-LD107-2017 (published in May 2017)
http://en-rules.HKEX.com.hk/en/display/display.html?rbid=4476&element_id=5069
- HKEX LISTING DECISION HKEX-LD120-2018 (published in March 2018)
http://en-rules.hkex.com.hk/en/display/display.html?rbid=4476&element_id=5102
- HKEX LISTING DECISION HKEX-LD121-2019 (published in March 2019)
https://en-rules.hkex.com.hk/pdf-manipulate?/sites/default/files/net_file_store/ld121-2019.pdf
- HKEX LISTING DECISION HKEX-LD126-2020 (published in June 2020)
https://en-rules.hkex.com.hk/pdf-manipulate?/sites/default/files/net_file_store/LD126-2020.pdf
- HKEX LISTING DECISION HKEX-LD127-2020 (published in June 2020)
https://en-rules.hkex.com.hk/pdf-manipulate?/sites/default/files/net_file_store/LD127-2020.pdf
- HKEX LISTING DECISION HKEX-LD133-2022 (published in May 2022)
https://en-rules.hkex.com.hk/pdf-manipulate?/sites/default/files/net_file_store/LD133_2022.pdf
- HKEX LISTING DECISION HKEX-LD134-2022 (published in May 2022)
https://en-rules.hkex.com.hk/pdf-manipulate?/sites/default/files/net_file_store/LD134_2022.pdf

6. SFC Reported Enforcement Cases relating to sponsor failures

- SFC reprimands and fines TC Capital International Limited \$3 million and suspends its responsible officer for sponsor failures (published in August 2022)
<https://sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=22PR58>
- SFAT affirms SFC decision to reprimand and fine Yi Shun Da Capital Limited for sponsor failures (published in October 2021)
<https://sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=21PR104>
- SFC reprimands and fines Ample Capital Limited \$5.5 million and suspends its responsible officer for IPO sponsor failures (published in October 2021)
<https://sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=21PR103>
- SFC reprimands and fines China Merchants Securities (HK) Co., Limited \$27 million for sponsor failures (published in 27 May 2019)
<https://sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=19PR44>
- SFC reprimands and fines Merrill Lynch Far East Limited \$128 million for sponsor failures (published in March 2019)
<https://sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=19PR22>

- SFC reprimands and fines Morgan Stanley Asia Limited \$224 million for sponsor failures (published in March 2019)
<https://sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=19PR21>
- SFC reprimands and fines Standard Chartered Securities \$59.7 million for sponsor failures (published in March 2019)
<https://sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=19PR20>
- SFC fines UBS \$375 million and suspends its licence for one year for sponsor failures (published in March 2019)
<https://sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=19PR19>

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