FTI CONSULTING

Are Hong Kong Sponsors Taking Their Due Diligence Seriously?

In September of this year, Hong Kong-listed Tianhe Chemicals received a huge blow following the release of a research report, which accused the Chinese company of committing fraud and overstating profits in its initial public offering (IPO) prospectus ahead of its listing in June. Despite a month-long suspension in response to researcher group Anonymous Analytics' report, Tianhe — whose IPO was led by Morgan Stanley, UBS and Bank of America Corporation — lost more than HK$27 billion in stock value once trading of its shares resumed in October. Morgan Stanley's Asia private equity arm still holds an estimated 8.6% of Tianhe, its biggest equity investment in Asia, after it reportedly spent more than US$2 million on due diligence over three years.[1] Nonetheless, we expect the due diligence work conducted for this IPO to be very closely scrutinised.

Tianhe is only one example of an increasing number of short seller reports targeting PRC-based companies listed in Hong Kong (and elsewhere), which have drawn attention to the sponsors and auditors involved in the listings.

Endeavouring to address growing concerns, the Securities and Futures Commission (SFC) has taken a far more aggressive approach to evaluating listings on the Hong Kong Stock Exchange (SEHK) and has put in place numerous IPO requirements to encourage greater risk management amongst sponsors. This emphasis began in December 2012, when the regulator published the "Consultation Conclusions on the Regulation of IPO Sponsors" (the 2012 Conclusions) on the heels of a series of high-profile accounting scandals involving Chinese-listed companies, as well as prevailing concerns that IPOs had been accompanied by unsatisfactory due diligence. At the time, the SFC reported that it has seen a "number of cases" in which underwriters had submitted an application for a listing before completing their due diligence.

In September 2013, FTI Consulting released an article outlining the potential effects of the then-proposed IPO requirements for new listings on the SEHK. Since these regulations came into effect just over a year ago, it is opportune to assess how/if the Hong Kong IPO market has changed, particularly in light of the new regulatory environment.

The Current Regulatory Environment

As a follow up from the 2012 Conclusions, the SFC published its "Supplemental Consultant Conclusions on the Regulation of IPO Sponsors - Prospectus Liability" (the Supplemental Conclusions) on 22 August 2014. This paper emphasised the role of the sponsors as legally bound to provide an IPO prospectus that is ***"true, accurate and complete in all material respects."*** The SFC was careful to clarify that this liability on the part of sponsors is already covered by existing law and that the previously proposed legislating amendments regarding criminalization do not need to be pursued. In essence, sponsors are liable only if they have been wilfully negligent.

While the SFC may not have gone as far as some had expected (or hoped), making it clear that a due diligence failure will not of itself involve criminal liability, the regulator has taken strong steps to develop a culture of robust risk management and greater transparency. Sponsors are ultimately responsible for the due diligence work, the parameters of which the SFC clearly laid out in its Code of Conduct in October 2013.

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The SFC requires:

(i) a listing applicant to formally appoint a sponsor at least two months before a listing application;

(ii) a sponsor to notify the regulators of any instances of non-compliance and to explain why, if and when, it ceases to act for a listing applicant;

(iii) a listing applicant commits that it and all professional advisers involved in the IPO will fully co-operate with the sponsor in discharging the latter's duties; and

(iv) sponsor fees must be specified in a sponsor's terms of engagement, and be based solely on a sponsor's role.

As illustrated, there has been pressure for IPO sponsors in Hong Kong to adapt, and there is now an increasing awareness for the need to assess the strength of their operating procedures. The most important aspect of this has been the call for more thorough due diligence. In the current regulatory environment, no sponsor wants to be 'named or shamed' by the Hong Kong regulators for failing to bring an

[1] "Tianhe Chemicals CEO buys back shares after price plunges on fraud claims," Reuters, http://www.reuters.com/article/2014/10/09/us-tianhe-chemicals-results-idUSKCN0HY0JV20141009

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applicant to market because of insufficient due diligence. However, recent high-profile short selling reports and accusations of fraud have illustrated that this increased focus on expecting sponsors to adopt comprehensive due diligence has perhaps not been as rapid or systematic as the SFC had hoped.

A lack of thorough due diligence on the part of a sponsor has the potential to seriously damage the bank's reputation, regardless of the regulatory consequences. In mid-October, the SEHK suspended China Tuna Industry Group's IPO, the sole sponsor of which was Deutsche Securities Asia, due to scrutiny surrounding information in its prospectus, which revealed that the company had been breaching legal fishing quotas for years and planned to continue to do so. Investigative journalists subsequently discovered that the company is registered in the Cayman Islands, and one of its largest shareholders is a 24-year-old woman called Li Li, who holds a Saint Kitt's passport. Efforts on the part of journalists to contact employees of the company or its subsidiaries have been unsuccessful.

Hong Kong's Position as a Global IPO Centre

In our previous article, we highlighted reported worries that these regulatory moves may discourage companies from filing for an IPO in Hong Kong and lead to increased costs for sponsors. Indeed, the first half of 2013 was relatively weak in terms of IPO proceeds raised in Hong Kong. However, by the end of the year, funds raised by IPOs reached HK$169 billion (88% more than the HK$89 billion raised in the previous year), with a total of 112 new listings, up 75% from 2012.[2] Due to this, Hong Kong was ranked as fourth in global IPOs, after the NASDAQ, in 2013.

This trend continued into 2014, with proceeds of HK$131 billion by the end of September and a total of 98 IPOs by the end of October, compared to HK$58 billion and 62 IPOs in the same time period for 2013. Furthermore, three Mainland companies, including the country's largest nuclear-plant operator, CGN Power, have recently announced plans raise a total of HK$77 billion by listing on the SEHK later this year.

While the recent democracy protests in Hong Kong have affected share prices, they do not appear to have scared off IPO applicants, with several other large mainland companies planning to list in November and December of this year.

The Situation in China

On the Chinese mainland, 2013 saw an imposed IPO freeze, designed to reform a system that had seen increasingly excessive offering prices and sharp declines once trading commenced. The China Securities Regulatory Commission (CSRC) had approved 64 companies to list on the Shanghai and Shenzhen stock exchanges by the end of August 2014, with an estimated total of 150 planned for the year.

There are currently over 600 companies on the waiting list for IPO approval by the CSRC, which suggests a large appetite for public fund raising on the domestic market. However, this protracted regulatory approval process has led to a number of mainland companies, such as Central China Securities, to change their plans and opt to list in Hong Kong. In part aiming to discourage this, the CSRC has proposed a move towards a less restrictive U.S.-style registration system, which companies such as Alibaba have seen as preferential.

The highly-publicised "Shanghai-HK Stock Connect Program," which was expected to launch in late-October but has been experiencing delays will, if implemented on 17 November as recently announced, open foreign investors to direct trades on PRC-listed companies (and vice versa), and has been touted as developing the internationalisation of the renminbi and opening up of China's capital market. Despite many foreign retail banks' reservations regarding the transparency of the Chinese market, this new program is likely to increase liquidity in the Chinese stock market and possibly encourage more companies to list domestically.

The Code of Conduct laid out by the SFC and the Due Diligence Guidelines are intended to enable and encourage sponsors to take a responsible, proactive and constructive role when leading IPOs and, overall, to maintain investor confidence in Hong Kong's IPO market.

Essential Compliance

In an effort to meet the standards of the current regulatory regime, a group of investment banks, co-ordinated by the Hong Kong law firm, Charltons, published a 750-page Due Diligence Guidelines report in September 2013, which set out to "provide a regulatory basis for defining the expected quality of sponsor work in the interests of public investors and all other stock market participants".

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[2] Hong Kong Exchanges and Clearing Limited (HKEx), Statistics & Research, http://www.hkex.com.hk/eng/stat/statistics.htm

The regulatory framework will undoubtedly encourage scrutiny of specific sponsors. Chinese firms have increasingly used joint sponsors for their offerings in Hong Kong and, while the large foreign investment banks have seen a 10% fall in market share since 2011, they are still chosen in conjunction with their Chinese counterparts. Foreign sponsors have historically been seen as a seal of approval for companies seeking an IPO, but this will now need to be supported by a transparent due diligence process.

With the emphasis on early and comprehensive due diligence, sponsors are being encouraged to take a longer view and a far more proactive role in the listing process. Sponsors are not only obliged to spot problems during the due diligence phase of the transaction, but also remedy any identified issues before advising the SEHK of its appointment.

The Global Risk and Investigations practice of FTI Consulting regularly works with sponsors, by undertaking reputational due diligence into potential Hong Kong listing candidates (as well as for candidates listing in other capital markets) and has noted significant variance in the depth to which this important due diligence phase is requested. Some sponsors are conducting minimal reputational checks, primarily based on public record sources, whilst others seek far more in-depth due diligence into the candidate, all of its actual operating businesses, its directors and senior management, as well as key customers and key suppliers. This therefore begs the question: are all sponsors taking their due diligence seriously?

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