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This special edition of the *SFC Regulatory Bulletin* provides an uu l 734te j 9 s6.437 762.981 l mront-loaded r

Key policy initiatives since 2016

Joint SFC-HKEX[a] press release on highly dilutive rights issues
Guideline for intermediaries and joint SFC-HKEX statement on GEM stocks Statement on recent GTj 0 0 0 1 524.4094 493.4783 cm 0 0 m 0 22vCscF cm 0 0 m 0 22vCscF cm 0 0 m 0 22vCscF 0 0

IPO sponsors

Sponsors play a unique role in ensuring market quality. They coordinate the IPO process, give advice to directors and are centrally involved in the due diligence on a listing applicant. Sponsors have to ensure that the listing document contains sufficient information to enable investors to form a valid and justifiable opinion about the applicant's business.

Our recent thematic review of licensed corporations engaged in sponsor business identified a number of deficiencies in their due diligence practices and internal systems and controls. We shared our findings [3] and reminded sponsors of their responsibilities and our expected standards.

Due diligence

Recurrent problems in sponsor work include failing to apply professional scepticism and turning a blind eye to obvious red flags uncovered by due diligence. Sponsors should assess the applicant *scrupulously* and *objectively* with a questioning mind and be alert to information which contradicts or brings into question the reliability of the facts they are seeking to understand. Detailed records of due diligence should be kept to demonstrate compliance with regulatory requirements.

Enforcement actions against sponsor firms

Since the launch of the new sponsor regime in October 2013, we have taken disciplinary actions against 11 sponsor firms resulting in fines totalling $922.5 million.

Corporate transactions

Tackling misconduct by listed companies remains our top priority. We seek to address the following misconduct and regulatory concerns using our front-loaded, multi-pronged approach, including suspending the trading of a company's listed securities:

Concealed share ownership and control

Concealed share ownership and control often appears as a component of shell-related activities, networks of companies, shareholders' vote rigging and "pump and dump" schemes. Some corporate transactions appear to be part of schemes to transfer control without disclosing the identities of the incoming controllers. In some cases, nominee accounts, margin financing, third-party financing arrangements and alternate forms of investment vehicles such as private funds have been used to conceal ownership.

Suspect valuations

Valuation activities are currently unregulated in Hong Kong. Boards are free to appoint any apparently qualified persons as valuers. Listed companies, directors and other professional parties rely on valuation reports and often allow them to override their own professional judgment.

We issued a statement [4] in 2017 reminding listed company directors of their fiduciary duties in the valuation of corporate transactions along with a circular to remind intermediaries of the duties and standards of care due from financial advisers. Another statement [5] in July 2019 set out common scenarios in corporate transactions involving serious misconduct or lapses by directors or valuers.

Warehousing of shares and nominee arrangements

We look carefully at arrangements commonly used for improper purposes including warehousing of shares, where actual control is disguised through the use of nominees and where nominee arrangements are used for vote rigging and market manipulation.

We issued a circular [6] in October 2018 reminding intermediaries to be vigilant in identifying potential red flags which may suggest the use of these arrangements for illegitimate purposes, make follow-up enquiries with clients and report suspicious transactions promptly.

Highly dilutive rights issues

In recent years, we have seen highly dilutive rights issues and open offers structured or conducted in a manner which appeared to be against the interests of minority shareholders. After discussions with us, SEHK introduced a series of measures to address this. Coupled with our front-loaded approach, the result was a substantial drop in the number of these transactions. There were also fewer deeply-discounted share placements, an area where we often directly intervened.

[4] *Statement on the liability of valuers for disclosure of false or misleading information* and *Circular to Financial Advisers in relation to their Advisory Work on Valuations in Corporate Transactions,* 15 May 2017

[5] *Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals,* 4 July 2019.

Case studies

I. Overvalued acquisitions

A company proposed to acquire a majority interest in a target with minimal net profit and assets. The vendor would provide a profit guarantee for 2019 which was 20 times higher than the net profit realised in 2017. We

III. Dubious fundraising

A company proposed a placing of new shares to raise money to develop its food and beverage business. The placing price was at steep discounts to net asset value and cash. The company carried no debt. The amount raised from the placing would be small, the company did not appear to have an imminent need for funds and the dilution effect on its shareholders would be significant.

We were concerned that the company's business might be conducted in a manner which is oppressive or unfairly prejudicial to its shareholders. We issued an initial letter of concern followed by a letter of mindedness. The company subsequently announced the termination of the transaction.

In another case, we suspended the trading of a listed company after it completed two rounds of highly dilutive fundraising and proposed a third round under very suspicious circumstances. We discovered undisclosed connections between some of the directors and shareholders who voted in favour of the fundraisings, and some directors also appeared to be connected to the buyers of the company's shares during the fundraising.

Directors' duties

Many dubious corporate transactions involve directors' negligent conduct or failure to avoid conflicts of interest. This is worrying given the important roles directors play in managing the affairs of the company and guarding shareholders' interests.

Shareholders are highly dependent on company directors having unswerving probity when dealing with conflicts of interest, being professional when deciding on important corporate transactions, and remaining vigilant in promptly and reliably disseminating corporate information.

Directors should ensure that they have first-hand and in-depth knowledge of the business and its prospects and should place themselves in a position where they can fully discharge their duties. Their obligations to investors are embodied in statute, in the common law as well as in non-statutory provisions such as the Listing Rules.

Although independent non-executive directors do not take part in the daily management of listed companies, they nevertheless serve an indispensable role in supervising the corporate management team and protecting shareholders' interests, and by extension, play an important role in helping to safeguard the overall quality of our markets. When they have disagreements with the management team or believe that the interests of shareholders have been compromised, they should openly communicate their views to all shareholders and, if they choose to resign, disclose to investors substantive reasons for doing so.

Directors and senior officers who fail to discharge their duties should expect tough enforcement action. In a recent enforcement case involving a network of listed companies and their associated entities, we worked jointly with the Independent Commission Against Corruption (ICAC) to crack down on a highly suspicious and sophisticated scheme, allegedly designed to defraud shareholders. Our joint operation resulted in four former executive directors of Convoy Global Holdings Limited being charged with conspiracy to defraud by the ICAC.

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