

Hong Kong SFC Continues To Step Up Its Enforcement Action amidst Enhanced Regulation of IPO Sponsors

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With the date for the introduction of the new regulatory regime for IPO sponsors now just a matter of weeks away on October 1, 2013, the Hong Kong market has witnessed further action taken by the Securities and Futures Commission (SFC) against a Hong Kong-listed company accused of behaviour that the new regime is intended to address. On this occasion, the SFC has for the first time exercised its powers under the Securities and Futures Ordinance (SFO) to petition the High Court to wind up a listed company, on public interest grounds. We saw another instance of a "first" earlier this year when the SFC forced Cheung Kong (Holdings) Limited to unwind a sale of individual units in a hotel known as The Apex Horizon^[1] which the SFC considered amounted to a collective investment scheme and where the promotional materials and offer process lacked SFC authorization.^[2] The theme of stepped-up enforcement action is an ongoing one and it is to be expected that more examples are likely to follow.

The SFC's winding-up petition in the Hong Kong Court of First Instance was against China Metal Recycling (Holdings) Limited, a scrap metal recycling company operating in China which is listed on the Hong Kong Stock Exchange (HKSE) and incorporated in the Cayman Islands. On July 26, 2013, the Court granted orders for the appointment of provisional liquidators (PLs) of China Metal and a hearing date for the winding-up has been set for October. A number of arrests connected to China Metal followed the presentation of the petition.

Trading in the shares of China Metal was suspended at the end of January, 2013 following the release of a report by Glaucus Research Group, a US-based short selling firm, which had alleged that "many of China Metal's key financial and operational metrics deviate so significantly from other scrap metal recyclers that its reported performance defies credibility". China Metal denied the allegations. The suspension also came three days after China Metal announced that its Chairman, CEO and founder had agreed to sell 55% of his shares in the Company to a Chinese State-owned Enterprise. China Metal had in fact been under investigation by the SFC since late 2009 following its IPO in the middle of that year.

The petition and the appointment of PLs marks another milestone in the SFC's use of previously unused powers, and in the increasingly proactive approach being taken by its Enforcement Division to pursue those who it believes have breached Hong Kong's securities laws.

Petition to Wind Up - Remedy of Last Resort

There is no lack of earlier examples of court-appointed PLs to Hong Kong-listed companies, but in these cases the petitioner would usually have been a creditor bank. The fact that the SFC chose to intervene before any creditor took action is a further sign of the increased willingness of the SFC to make use of its powers in new directions.

It is worthwhile comparing the action taken against China Metal with that taken by the SFC in 2010 against fabrics manufacturer Hontex International Holdings Company Limited. In the latter case, the SFC took swift remedial action shortly after Hontex's IPO in December 2009, when its prospectus was discovered to have contained materially false and misleading information. The SFC obtained an injunction to freeze assets and later a court order requiring Hontex to return monies to investors in the IPO and purchasers of shares in the secondary market. This was achieved by means of a share repurchase offer made by Hontex which was completed in October, 2012. Coincidentally, at the time that Hontex's shares ceased trading, its share price was very close to the IPO price and this helped the repurchase process. The remedy in this case was directed exclusively at compensating shareholders.

This is to be contrasted with China Metal where, at the time of the suspension in trading, the shares were trading at a substantial premium to the IPO price, and by the time of the presentation of the winding-up petition, more than four years had elapsed since the IPO. Given these factors, seeking a court order to restore investors to their original position would have been unworkable.

During their investigation of China Metal, the SFC had found evidence that showed that the suspected inflation of its financial position was continuing and this remained an ongoing issue for the accuracy of its latest annual financial results, which China Metal had failed to issue. The Company also had failed to satisfy the conditions imposed by the HKSE for the resumption of trading in its shares. The last-resort nature of the remedy used by the SFC shows that the SFC had run out of patience with a delinquent listed company that had deliberately flouted its compliance obligations. A key point about this course of action is that unlike the remedy obtained in the Hontex case, at the end of the process, shareholders may find themselves empty-handed. The duties of the PLs of China Metal (and of its liquidators, once appointed) are first and foremost to the Company's creditors rather than to shareholders. In the order of ranking for distributions in a liquidation, shareholders (i.e., contributories) stand at the very back of the queue and will only receive distributions of surplus assets after creditors have been paid in full. If the debts are at all significant, any recoveries that shareholders might expect to receive can quickly be eroded to nothing.

Why appoint provisional liquidators?

Owing to the court timetable and the litigation process, it would usually take several months to obtain a winding-up order. In the meantime the element of surprise is lost, and assets may disappear.^[3] For this reason, when it can be shown that there is a danger that the company's assets are in jeopardy, PLs can be appointed swiftly after the presentation of a winding up petition as a precursor to a court order for winding up. To quote the Hong Kong Court of Appeal, "[t]raditionally the primary object of appointing a provisional liquidator has been regarded as the need to maintain the status quo and to prevent anybody from obtaining priority over other creditors".^[4]

PLs usually are given wide powers by the court to take possession of the assets and to operate the business of the entities to which they have been appointed, as well as to investigate their affairs. On their appointment, all powers of the directors cease so that they no longer have authority to deal with the Company's assets or its undertaking. Subsequently, if the court makes a winding-up order, the PLs will be discharged and liquidators appointed in their place.

Although China Metal's directors have now been displaced, given that many of its assets will be located in mainland China, a significant question mark hangs over the ability of the PLs to obtain recovery of those assets. The issue faced by PLs and liquidators appointed under one legal system who seek to recover assets located in a second legal system is a perennial one as there is no formal basis for the recognition in China of a Hong Kong liquidation.

Other Recent Enhanced Regulatory Action

The first-time action taken against China Metal also should be seen in the light of the separate SFC action against the now defunct New York-based hedge fund, Tiger Asia. The outcome of these proceedings has clarified a wider spectrum of enforcement powers available to the SFC. The SFC had brought proceedings under section 213 of the SFO seeking remedial orders and injunctions in relation to allegations that Tiger Asia had contravened Hong Kong's insider dealing and market manipulation laws. During 2008 and 2009, after receiving price-sensitive information relating to disposals of shares of Chinese banks and agreeing to be "wall crossed", Tiger Asia had short sold shares in those banks. In the meantime, following its prosecution in the US courts for the illegal use of inside information, Tiger Asia entered a guilty plea and settled both criminal and civil actions for a substantial sum.

In Hong Kong, the SFC was successful in arguing before the Final Court of Appeal that section 213 of the SFO provides for a free-standing and self-contained remedy that is not conditional on there being criminal proceedings or proceedings before the Market Misconduct Tribunal (MMT). As the SFC succeeded in its application, those proceedings are still ongoing. In the meantime, as Tiger Asia has been subject to criminal proceedings in the US, given the double jeopardy rule that a person cannot be subject to a second set of criminal proceedings for the same offence, the SFC has now commenced civil proceedings in the MMT against Tiger Asia and several of its officers and the hearing is set to commence in May 2014. The amounts being claimed by the SFC are not yet known.

New Regulatory Regime for IPO Sponsors

The SFC's recent enforcement action described above anticipates the new regulatory regime for IPO sponsors which will come into effect on October 1, 2013. They should be viewed together as part of a wider enhancement of Hong Kong's regulatory regime. The SFC and the HKSE will be in a position to exercise wider powers over listing applicants and their sponsors, as well as delinquent listed issuers, where the SFC has shown itself to be more willing to step in and take action.

The introduction of the new regime comes after a period of consultation by the SFC following concerns expressed by the SFC that standards of sponsor work had fallen short of reasonable expectations, and in particular that in a number of cases sponsors did not substantially complete their due diligence before making a listing application.[\[5\]](#) Both the Hontex and China Metal cases, where compliance issues were present from the outset, no doubt will have served to throw fuel on the fire.

The new regime will tighten the obligations of sponsors during the listing process, in particular in respect of due diligence and the quality of disclosure in draft application proof prospectuses submitted to the HKSE. A key part of the regime is that starting from April 1, 2014, the HKSE will publish the names of any new applicant and the sponsor whose listing application has been returned where the HKSE considers that its application proof prospectus is substantially incomplete. Subject to certain transitional arrangements, the regime will require that a redacted version of the application proof prospectus be published on the Web site of the HKSE at the time of submission. This is a major step in the listing application process and shifts the regime more into alignment with the process for an IPO in the US when a draft prospectus is filed with the US Securities and Exchange Commission. The impact of these changes will be to "front load" much of the work that goes into preparing a prospectus and the listing application to ensure that a prospectus will be a substantially complete document at the time of submission. Inevitably, this will impose greater pressures of work and time on the advisors to an IPO.

Implementation of the new regime will involve changes to the HKSE Listing Rules, the Code of Conduct for Persons Licensed by or Registered with the SFC, the Corporate Finance Advisor Code of Conduct and the "Sponsor Guidelines" set out in the Fit and Proper Guidelines, all of which will take effect simultaneously on October 1, 2013.

Proposed Legislative Amendments regarding Prospectus Liability of IPO Sponsors

One of the more controversial proposals made by the SFC in its consultation paper on the regulation of IPO sponsors was to clarify that the existing laws under the Companies Ordinance (CO) that deal with civil and criminal liability for untrue statements, including a material omission, in a prospectus would extend to sponsors. Currently, there is no Hong Kong case law on whether sponsors are subject to such laws. The SFC stated that as the position was unclear, it believed that there was merit in removing this ambiguity by clearly identifying sponsors as also being liable for untrue statements in prospectuses. The SFC has recommended legislative amendments to make it clear that the civil and criminal prospectus liability provisions apply to sponsors and that criminal liability requires the prosecution to bear the burden of proving that: (a) a person authorizing the issue of the prospectus knew that, or was reckless as to whether, a statement in the prospectus identified by the prosecution was untrue; and (b) the untrue statement was materially adverse from an investor's perspective.^[6] This approach follows that taken in parts of the SFO imposing criminal liability for knowing or reckless acts. The SFC has stated that it aims to introduce the legislative amendments into the Legislative Council in 2013-14.^[7]

The SFC also pointed out that although the amended criminal liability provisions of the CO will only apply directly to a sponsor firm, the general criminal law would also extend to situations where there is evidence that an individual (not limited to directors and senior management), whether or not in the sponsor firm, has colluded in the making of an untrue statement in a prospectus. Any such individual may be prosecuted for aiding and abetting the offence under the Criminal Procedure Ordinance (CPO).^[8] In addition, if there is evidence that a sponsor firm committed an offence with the consent or connivance of its directors and other officers concerned with its management, such directors or officers could also be guilty of a criminal offence under the CPO.^[9]

^[1] See our client alert of May 18, 2013 - [Hong Kong – Applying Securities Laws to Sales of Hotel Units](#).

^[2] The SFC has issued a recent timely reminder of the laws relating to the offer and promotion of a CIS, reiterating its application to real estate.

^[3] Even this wasn't enough, as the newly appointed PLs of China Metal quickly discovered that China Metal had paid out more than HK\$1 billion in cash to other parties shortly before their appointment.

[\[4\]](#) Re Legend International Resorts Limited (CACV 207/2005 and CACV 210/2005) per Justice Rogers VP.

[\[5\]](#) SFC Consultation Paper on the regulation of sponsors (May 2012).

[\[6\]](#) SFC Consultation Conclusions on the regulation of IPO sponsors (December 2012).

[\[7\]](#) Legislative Council Panel on Financial Affairs – Sponsor Regulation and Other Investor Protective Initiatives (SFC, May 2013).

[\[8\]](#) Section 89.

[\[9\]](#) Section 101E.

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