
Regulatory Enforcement Trends against Gatekeepers

Presented to by CFRED's Sixth Securities Law Colloquium

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26 July 2013

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Overview

- Gatekeepers of Capital Markets in Hong Kong
- Regulatory Enforcement Philosophy for Gatekeepers
- Sponsors
 - Renewed focus on sponsors as gatekeepers
 - Regulatory enforcement history and trends
 - Observations for the future
- Accountants
- Other Gatekeepers

Capital markets “gatekeepers” in Hong Kong

- Regulators (SFC, HKEx)
- Sponsors/ Compliance Advisors
- Accountants
- Directors (in particular INEDs)
- Liquidity Providers
- Rating Agencies
- Research Analysts
- Lawyers

Regulatory Enforcement against Gatekeepers

- Regulatory targeting of Gatekeepers is not new
- Stephen Cutler (then SEC Head of Enforcement) 20 Sep 2004:

What do I mean by "gatekeepers?" The sentries of the marketplace: the auditors who sign off on companies' financial data; the lawyers who advise companies on disclosure standards and other securities law requirements; the research analysts who warn investors away from unsound companies; and the boards of directors responsible for oversight of company management. They're paramount in ensuring that our markets are clean. And Congress recognized that when it enacted Sarbanes-Oxley....

This isn't a brand new idea for us. For as far back as the early 70s, the Commission's enforcement program has focused on gatekeepers. Actually, Judge Sporkin had his own name for this approach. He called it the "access theory." Ensure good behavior by those who control "access" to our capital markets and you could achieve more than you would by going after every bad actor. In short, pursuing gatekeepers was the most targeted and effective way of using the agency's limited enforcement resources.

Sponsors as Gatekeepers

- SFC Consultation Paper/ Conclusions on Regulation of Sponsors
 - “Investors rely on sponsors to act as key gatekeepers of market quality and at the heart of this lies the expectation that sponsors have conducted sufficient due diligence to properly understand and assess a company aspiring to join the stock market.”
 - “The market relies heavily on the sponsor as a principal “gatekeeper” to protect investors.”
 - “A sponsor performs a unique role as a key gatekeeper of market quality in an IPO and therefore has an explicit public interest function throughout the process.”
 - “The way in which the market deals with the IPO process has over the years moved closer to the US model ... many of the characteristics of the US market which underpin that model are, however, absent in Hong Kong, including the widespread use in the US of investors’ private rights of action and class suits ... It follows that in Hong Kong there is a clear investor protection justification for a regulatory focus on sponsors to act as key gatekeepers of market quality and themselves to conduct sufficient, reasonable due diligence in every listing.”

Regulatory Sanctions against Sponsors

Date	Sponsor/ (Issuer)	Action
17 Dec 2004	Oriental Patron Limited	Suspension of sponsor and principal supervisor for 6 months and 9 months respectively for withholding information from the SEHK
27 Jan 2005	ICEA Capital Limited/ (Euro Asia Agricultural (Holdings) Company Limited (In Liquidation)	Without admission of liability, payment of HK\$ 30 million
7 March 2006	CSC Asia Limited (SFC inspection)	Voluntary agreement by sponsor to not act as a sponsor for 13 months. Voluntary undertaking not to act as principal supervisors for 8 months.
27 June 2006	Deloitte Touche Corporate Finance (Codebank Limited)	Without admission of liability, voluntary undertaking not to act as sponsor for 9 months Voluntary undertaking not to act as a supervisor for 6 months
19 Dec 2007	South China Capital Limited	Suspended sentence (18 month suspension if similar re-occurrence within 3 years). Independent audit review.

Regulatory Sanctions against Sponsors

Date	Sponsor/ (Issuer)	Action
17 Apr 2008	Core Pacific-Yamaichi Capital Limited (Tungda Innovative Lighting Holding Limited)	On no-admission of liability basis: (a) HKD2.8m fine (being the fee for sponsor work); (b) Independent audit firm review. (c) Suspended sentence (18 months suspension if recurrence within 3 years)
27 July 2009	V C Capital Limited	HKD1.5 million fine (books and records inadequacies)
22 April 2012	Mega Capital (Asia) Company Limited/ (Hontex)	Public reprimand Fined HK\$42 million Licence to advice on corporate finance revoked.

Sponsors: trends and observations

- The trend towards more aggressive regulatory investigation and discipline of sponsors in Hong Kong is clear.
- Need for regulators also to proceed against principals
 - Complicated by Hong Kong's position as on offshore capital raising platform
- Creation of disincentives to take sponsor roles?
 - Are sponsors adequately paid for the risks they are now being asked to take?
 - Trend towards banks joining underwriting syndicate but not taking sponsor role?
- Where does heightened sponsor responsibility and enforcement leave the secondary (GEM) market?

Accountants

- Accountants are integral to public listings (initial and ongoing).
- Traditional reluctance by SFC to challenge accountants
- More aggressive regulatory enforcement/ scrutiny of accountants
 - In US and Hong Kong, accountancy firms caught between regulatory demands for production and China secrecy law (in Hong Kong, SFC issued proceedings against Ernst & Young as reporting accountant for Standard Water Limited)
 - More active role expected from Financial Reporting Council
- Increased incidence of resignations of auditors of listed companies
- Auditor whistleblowing to financial regulators?

Other Gatekeepers

➤ **Directors**

- Directors have an inherent gatekeeper duty to investors in company's securities
- New statutory obligations for continuous disclosure of price-sensitive information
- Notable uptick in regulatory investigation/enforcement against directors
- INEDs have particular responsibility in the Hong Kong market

➤ **Liquidity providers**

- Regulatory expectation that market-makers will ensure integrity of the market to which they provide liquidity.
- Example: the Hong Kong warrants market

➤ **Research Analysts**

- Traditional concerns: independence, conflicts, exposure to PSI

Other Gatekeepers

➤ **Rating Agencies**

- Rating Agencies have a key role in debt/structured security issuance
- Concerns arising from financial crisis: independence, objectivity, quality
- Licensed by the SFC with effect from 1 June 2011 to ensure greater regulatory oversight

➤ **Lawyers**

- Lawyers do not normally face the investing public
- But owe professional duties; not merely facilitators of transactions
- Gatekeeper role in relation to regulatory/public disclosure?
- Note the Shanghai Land prosecution in Hong Kong