

Third-Party Due Diligence in Hong Kong IPOs

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In light of the penalties levied by Hong Kong's regulatory body, the Securities and Futures Commission (the SFC), in late April 2012 against Mega Capital (Asia) Company Limited (Mega Capital) stemming from the IPO of Hontex International Holdings Company Limited, we set out in brief our observations of 2012 industry practices for third-party due diligence in Hong Kong IPOs. Sponsor banks may wish to review their current practices to ensure they meet the standards articulated by the SFC in the Mega Capital situation.

In reaching its decision to revoke Mega Capital's license and impose a fine of HK\$42 million, the SFC cited Mega Capital's "inadequate and sub-standard due diligence work," "failure to act independently and impartially," an "inadequate audit trail of due diligence work" and "inadequate supervision of its staff." While we note that each due diligence exercise is unique and it is a sponsor's duty to exercise professional judgment as to what is necessary and appropriate for each particular transaction, we believe that the SFC's actions and the matters highlighted in its press release of April 22, 2012 regarding Mega Capital as well as the SFC's statements in the March 2011 "Report on Sponsor Theme Inspection Findings" merit a review of third party due diligence practices. With that in mind, we set out some thoughts below.

Scope

The scope of due diligence on third parties should be tailored to suit the specific facts and circumstances of the transaction. As a general matter, the due diligence review should cover all third parties that are material to the listing applicant's business and operations (whether during or after the track record period); and the more important a specific third party is to the listing applicant, the greater the scope of the necessary diligence. In addition to inquiries about the relationship between the third party and the applicant, the scope of the diligence should include searches of the public record with respect to the third party, review of material transactional documentation between the third party and the listing applicant and, if potentially material, investigation of the financial position of the third party. For example, in the case of suppliers of a product of particular importance to the listing applicant (*i.e.*, the sole supplier of bottles to a beverage manufacturer), a site visit to the supplier's principal manufacturing facilities may be appropriate.

Timing

Third party due diligence should be conducted sufficiently in advance of the filing of the listing application with The Stock Exchange of Hong Kong Limited (the HKEx) to ensure adequate time for follow-up work before the filing. If new information comes to light or if there is a significant lapse of time between the initial interviews and the launch of the transaction, additional interviews with the same third parties, or interviews with additional third parties, may be necessary.

Interviewees

Sponsors should assess whether the interviewees from the third parties are of a sufficient authority and experience, and are in possession of sufficient information regarding the third party's dealings with the listing applicant, to ensure they are in a proper position to respond to questions meaningfully. If, during the course of an interview, it becomes apparent that the person lacks sufficient authority, experience or information, a further interview should be arranged with a more appropriate interviewee. Sponsors also should take steps to verify or, at a minimum, cross-check the identity of the interviewee and his or her relationship with the third party. Sponsors should retain the business card of each interviewee.

Process

To the extent possible, due diligence should be conducted independently from the listing applicant, its shareholders and management, and, where true independence is not possible, with a high degree of professional skepticism. Some of our specific recommendations in this regard are:

- due diligence interviews should be arranged independently of the listing applicant. Where the listing applicant's participation in arranging the meetings is unavoidable, that involvement should be limited. For example, the listing applicant can supply the names of specific interviewees, but those persons should be contacted through the publicly available address and telephone number of the third party;
- the third parties to be interviewed should be selected by sponsors and not by the listing applicant or its management;
- any assertions by the listing applicant that interviews cannot be arranged should be treated with a high degree of skepticism;
- to the extent possible, due diligence questionnaires should be sent by sponsors to third parties and received by sponsors from third parties directly, and communications relating to diligence should be directly between the sponsors and third parties;
- interviews should, to the extent possible, be conducted face-to-face and at the offices of the third party;
- no member of the listing applicant's management or other person connected to the listing applicant (*e.g.*, a substantial shareholder) should be present during diligence interviews;
- sponsors should obtain written confirmations of (a) third parties' independence from the listing applicant, its shareholders and management and (b) transaction records between third parties and the listing applicant, in each case directly from the relevant third party and not through the listing applicant. Confirmations should be signed by someone with sufficient authority who, ideally, is not responsible for dealings with the listing applicant. In the case of material customers or suppliers, sponsors should check the names of such third parties and their principals against the names of the listing applicant's directors and controlling persons (and their known family members); and
- diligence should be integrated with other aspects of the diligence process (*i.e.*, legal, financial and industry) and cross-checked for consistency with information provided by the listing applicant or obtained from other sources.

Sponsor Staff Participation

Diligence work should be handled by staff with sufficient experience, seniority, capacity and familiarity with the transaction. While the most senior representatives of the sponsors do not need to participate in every interview, they should consider participating in interviews of particular importance. Where senior representatives do not participate, they should discuss the planning and results of the interviews and document their participation in such planning and reviews. As with other aspects of the due diligence exercise, internal policies and procedures, including clear lines of communications and reporting procedures, should be adopted. Interviews should be conducted by the staff of the sponsors. The SFC has indicated that it does not consider it appropriate to outsource this work to lawyers or other advisers (although the participation of lawyers or other advisers (*e.g.* industry experts) in the interviews will be appropriate in some circumstances). The SFC also has indicated that it does not consider it appropriate for a responsible officer to be concurrently involved in a large number of active listing applications (while a maximum number was not specified, it is implicit that the SFC may call into question the ability of a responsible officer to adequately discharge their functions if they are handling more than two or three applications at the same time).

Documentation

Clear and detailed records should be kept of the planning, execution and follow up with respect to the third party due diligence exercise. In addition to following up to ensure all written confirmations and any other necessary information is obtained from third parties as appropriate, we also recommend that sponsors document the planning of the diligence exercise and any follow up (both internal and external). We would recommend, for example, that a written record or note be made of any discussions regarding the basis upon which selection of third parties to be interviewed is made. Sponsors that have adopted an internal form “checklist” to provide a written record of the diligence process should review their checklists in light of the above and apprise their staff of making a thorough record of the diligence process. Again, please note that the SFC expects this work to be performed by the sponsors themselves, although legal counsel review and input clearly will not detract from the completeness of the records kept.