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# Due Diligence Requirements for Corporate Finance Advisers

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## INTRODUCTION

Corporate finance advisers in Hong Kong are required to comply with various due diligence requirements. The Securities and Futures Commission (“SFC”) issued the Corporate Finance Adviser Code of Conduct (“**CF Code**”) and the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“**Code of Conduct**”), and the Stock Exchange of Hong Kong Limited (“**HKEX**”) issued the Rules Governing the Listing of Securities on The Stock Exchange Of Hong Kong Limited (“**Main Board Listing Rules**”) and the Rules Governing the Listing of Securities on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited (“**GEM Listing Rules**”, together with the Main Board Listing Rules, the “**HKEX Listing Rules**”). These requirements are aimed at ensuring that the advisers have conducted sufficient research and analysis to provide accurate and reliable advice to their clients. For example, corporate finance advisers are required to obtain detailed information about their clients and their business structure, ownership, and financial position, conduct industry research and financial analysis relating to client’s businesses and make sure the clients comply with all relevant regulations, including the Securities and Futures Ordinance, the Takeovers Code, and the HKEX Listing Rules.

The Monetary Authority of Singapore (“**MAS**”) recently issued the Notice on Business Conduct Requirements for Corporate Finance Advisers (“**Notice**”) on 23 February 2023. At the end of this article, we will compare the due diligence requirements set out in this notice with those of Hong Kong.

## OUTLINE OF DUE DILIGENCE REQUIREMENTS OF CORPORATE FINANCE ADVISERS IN HONG KONG

It is expected that due diligence will be conducted and coordinated principally by the listing applicant’s sponsor and the sponsor’s own advisers and any questions on due diligence from regulators will be addressed directly to, and answered by, the sponsor. The primary responsibility for designing due diligence procedures will

also rest with the sponsor with appropriate input from the listing applicant and other experts.

The following sets out some of the main due diligence requirement for corporate finance advisers in Hong Kong:

### *Acting with due skill, care and diligence*

Under paragraph 5.1 of the CF Code, a Corporate Finance Adviser must act with due skill, care and diligence and observe proper standards of market conduct. Under paragraph 17.4(b) of the Code of Conduct, before submitting an application on behalf of a listing applicant to the Stock Exchange a sponsor should come to a reasonable opinion that the information in the Application Proof is substantially complete except in relation to matters that by their nature can only be dealt with at a later date.

A listing applicant is required to submit a listing application form, an application proof of the listing document and all other relevant documents under Rule 9.10A(1) of the Main Board Listing Rules, and the information in these documents must be substantially complete except in relation to information that by its nature can only be finalised and incorporated at a later date. If the HKEX decides this information is not substantially complete, the HKEX will not continue to review any documents relating to the application and will return the application. The listing applicant will only be able to refile the listing application eight weeks after the letter returning the listing application.

While the principal responsibility for the truth, accuracy and completeness of a listing document rests with the listing applicant’s directors, individually and collectively, the due diligence of corporate finance advisers relies on the active cooperation and assistance of the listing applicant’s directors and senior management and this responsibility cannot be assumed by other parties engaged in the production of a listing document. The listing applicant and the sponsor should ensure that the listing document filed with the listing application clearly and adequately discloses information which a

reasonable investor would require to make a fully informed investment decision. The information contained in the listing document must be accurate and complete in all material respects and must not be misleading or deceptive. The sponsor should independently assess the standard of disclosure and not rely on the vetting process by the regulators for initiation for disclosure.

A sponsor should examine with professional scepticism the accuracy and completeness of statements and representations made, or other information given, to it by a listing applicant or its directors. An attitude of professional scepticism means making a critical assessment with a questioning mind and being alert to information, including information from experts, that contradicts or brings into question the reliability of such statements, representations and information.

A sponsor should not merely accept statements and representations made and documents produced by a listing applicant or its directors at face value. Depending on the nature, materiality and source of the information and the context in which the information is given, the sponsor should perform verification procedures that are appropriate in the circumstances, such as reviewing source documents, enquiring of knowledgeable persons or obtaining independently sourced information.

Where a sponsor becomes aware of circumstances that may cast doubt on information provided to it or otherwise indicate a potential problem or risk, the sponsor should undertake additional due diligence to ascertain the truth or completeness of the matter and information concerned. Over-reliance on management's representations or confirmations for the purposes of verifying information received from a listing applicant cannot be regarded as reasonable due diligence.

#### *Reasonable Reliance on Third Parties and Experts*

It is recognised that the production of a listing document is a cooperative exercise which, while coordinated by the listing applicant's sponsor, is the product of input by the directors and senior management, the third parties engaged to undertake specific due diligence tasks, and the experts retained by the listing applicant, in addition to the sponsor. Further, it is recognised that the sponsor does not have the expertise, competence, statutory authority or qualifications, as the case may be, to undertake the work of third parties which undertake specific due diligence tasks, such as lawyers engaged to undertake verification of title to properties and accountants engaged to review internal controls, or that of the experts retained, such as reporting accountants and valuers. However, the sponsor cannot rely at face value or blindly on the work of third parties or experts. The sponsor is expected to perform the due diligence procedures in paragraph 17.7 of the Code of Conduct

with respect to an expert and its report and, having performed those procedures, should have no reasonable grounds to believe that the information in the expert report is untrue, misleading or contains any material omission. In order to rely on the work of a non-expert third party, the sponsor is required to perform the due diligence procedures in paragraph 17.6(g) of the Code of Conduct.

#### *The Desirability of Direct Third Party Confirmations*

To the extent it is appropriate and practicable, it is expected that a sponsor will seek the direct confirmation of information from parties with which the issuer has an important relationship: for example, major suppliers, customers, licensors and bankers. It is accepted that such parties have no obligation to cooperate with the due diligence and their participation is voluntary. It is also acknowledged that certain third parties, such as the listing applicant's bankers or joint venture partners, may be prevented by privacy and/or confidentiality requirements from contributing fully to the conduct of due diligence. The sponsor should seek to address any such issues through confidentiality arrangements to the extent that these are appropriate and practicable. If they are not, the sponsor may consider alternative methods of corroborating the relevant information or assess the materiality of not obtaining confirmation of such information to the veracity of the due diligence as a whole.

#### *Reasonable Due diligence*

Under paragraph 17.4(a) of the Code of Conduct, before submitting an application on behalf of a listing applicant to the HKEX a sponsor should have performed all reasonable due diligence on the listing applicant except in relation to matters that by their nature can only be dealt with at a later date, and ensure that all material information as a result of this due diligence has been included in the Application Proof.

In assessing whether a sponsor has performed reasonable due diligence, regard would be had to all of the facts and circumstances available at the time of making the listing application. Where a specific matter exists prior to submission of the listing application, the sponsor should reach a view that all reasonable due diligence has been completed, even if changes may occur subsequently. The reasonable due diligence standard should be determined based on what a sponsor's peers would consider to be objectively appropriate, having regard to all relevant facts and circumstances at the time of making a listing application.

While it is expected that the due diligence will be substantially complete, apart from matters which post-date it, by the time an Application Proof is lodged with the Exchange, the due diligence should be designed to

be able to respond to changes affecting the listing applicant's business and prospects during the period from lodging an Application Proof to the completion of the listing. The SFC acknowledges that a sponsor has to update the due diligence after submission of the listing application where there are subsequent changes.

### *Reasonable Judgment*

Under paragraph 17.6(a) of the Code of Conduct, a sponsor should conduct due diligence in order to have a thorough knowledge and understanding of a listing applicant and to satisfy itself in relation to the disclosure in the listing document. A sponsor should exercise reasonable judgment on the nature and extent of due diligence work needed in relation to a listing applicant having regard to all relevant facts and circumstances. A sponsor should recognise that the nature and extent of due diligence varies from case to case depending on the facts and circumstances and there is no exhaustive list of due diligence steps that would apply in all circumstances.

The SFC does not expect sponsors to be able to detect all attempts by the listing applicant or other parties to conceal information in order to mislead others. The SFC acknowledges that the requirement to carry out reasonable due diligence cannot be expected to amount to a guarantee of an absence of fraud, forgery or deliberate non-disclosure.

In assessing the nature and extent of due diligence work needed, the sponsor should bear in mind that it is required to provide a confirmation to the HKEX that the disclosures in a prospectus contain sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion of the shares and the financial condition and profitability of the listing applicant.

There will be many circumstances when a sponsor has to exercise judgment in determining the level of materiality to be applied in conducting due diligence on assets such as properties, machinery, produce or stock or when determining the number of distributors, suppliers or customers to interview. As the Code of Conduct states, the sponsor must exercise reasonable judgment and the sponsor should exercise its discretion in this regard on the basis of a sound understanding of the listing applicant's business, the markets within which it operates and those anticipated further developments in the applicant's business plan.

Although the main due diligence processes are likely to be very similar in the majority of cases, different industries and companies may require special focus on particular areas of due diligence. Sponsors are expected to assess whether investigations or steps beyond the typical examples provided in Practice Note 21 to the

Main Board Listing Rules are appropriate for each new listing applicant. For example, more stringent due diligence work is expected of sponsors where:

- (i) the listing applicant is engaged in mining or agricultural activities and therefore subject to higher risks;
- (ii) the listing applicant is in a highly regulated industry;
- (iii) the listing applicant operates in a country known to have a higher risk of corruption; or
- (iv) the sponsor discovers "red flags" and suggestions of irregularities during the usual due diligence process.

The HKEX also expects sponsors to have access to all information of the listing applicant, including confidential information, to enable them to complete their due diligence process, and will not accept a sponsor confirming completion of the due diligence process with a qualification that it is not provided access to the applicant's confidential information.

### **THE HONTEX CASE**

The case of *Hontex* (SFC v Hontex International Holdings Co Ltd & Ors, HCMP 630/2010) illustrated the importance of due diligence exercises conducted by corporate finance advisers and the consequences of not adhering to the requirements of the SFC and HKEX.

In this case, the amounts stated in the prospectus of the initial public offering of Hontex International Holdings Company Ltd ("**Hontex**") in respect of its turnover for the three years before its listing from 2006 to 2008 and the value of its cash and cash equivalents for the years ended 31 December 2007, 2008 and 30 June 2009 were found to be materially false and misleading. The Court of First Instance ordered Hontex to make a repurchase offer to about 7,700 investors who had subscribed for Hontex shares in the initial public offering in December 2009 or purchased them in the secondary market during the 3 months after its shares were listed.

The SFC's investigation revealed that material information about suppliers and customers (such as their transaction figures with the listing applicant) was missing from due diligence questionnaires and yet the sponsor failed to follow up on the missing information. The sponsor also rushed through a number of interviews with customers and suppliers on the day when the listing application was filed. In addition, the sponsor failed properly to verify information concerning the listing

applicant's franchisees which was provided by the listing applicant.

Following the commencement of legal proceedings by the SFC against Hontex, the SFC announced that it had revoked the licence of Mega Capital (Asia) Company Limited, the sole sponsor of the initial public offering of Hontex, to advise on corporate finance and fined Mega Capital a record high amount of HK\$42 million for its failure in discharging its duties as a sponsor, and the licence of the two sponsor principals were also revoked.

### COMPARISON BETWEEN THE DUE DILIGENCE REQUIREMENTS SET OUT IN THE NOTICE IN SINGAPORE AND THOSE IN HONG KONG

Both Hong Kong and Singapore have similar regulations for corporate finance advisers. The following is a comparison between the due diligence requirements set out in the Notice in Singapore and those in Hong Kong:

Summary of due diligence requirements set out in the Notice issued by MAS on 23 February 2023	Similar provisions in the CF Code, Code of Conduct and HKEX Listing Rules in Hong Kong
<p><b><u>Due Diligence for Transactions Generally</u></b></p> <p>A corporate finance adviser must conduct due diligence with reasonable care, skill and diligence, including in the following areas:</p> <p>(a) determining the nature and extent of due diligence work to be performed for a transaction;</p> <p>(b) making an assessment of the accuracy and completeness of material statements, confirmations, and representations made or other information given, by its customer or other persons in connection with a transaction (collectively, the "Information") and conducting appropriate</p>	<p>Under paragraph 5.1 of the CF Code, a Corporate Finance Adviser must act with due skill, care and diligence and observe proper standards of market conduct.</p> <p>Under paragraph 5.5 of the CF Code, Where information and representations are provided by a client for incorporation in a public document or submission to the Regulators, the Corporate Finance Adviser should advise its client to take all reasonable steps to ensure, and obtain confirmation from the client, that the information and representations provided are true, accurate, complete and not misleading, and that no material information or facts have been omitted or withheld.</p>

<p>verification of such Information; and</p> <p>(c) monitoring, during the transaction, other information obtained and developments in relation to the customer or transaction, that contradict or bring into question the reliability of the Information.</p>	<p>Under paragraph 17.6(d)(ix) of the Code of Conduct, a sponsor should undertake independent verification of all material information, including documents provided, and statements and representations made, by the listing applicant and its directors.</p> <p>Under paragraph 17.6(b) of the Code of Conduct, in undertaking its role a sponsor should examine with professional scepticism the accuracy and completeness of statements and representations made, or other information given, to it by a listing applicant or its directors. An attitude of professional scepticism means making a critical assessment with a questioning mind and being alert to information, including information from experts, that contradicts or brings into question the reliability of such statements, representations and information.</p>
<p><b><u>Advising the Listing Applicant on Regulatory Requirements</u></b></p> <p>A corporate finance adviser must ensure the listing applicants and its directors/management are informed of their duties and responsibilities under the Securities and Futures Act 2001 and the listing rules, relevant to its listing application and to its continuing obligations after admission to the stock exchange.</p>	<p>Under paragraph 17.11(b) of the Code of Conduct, the appointment letter of sponsors should clearly specify the listing applicant's responsibilities to facilitate the sponsor to perform its duties and to meet its obligations under the Code and the HKEX Listing Rules.</p>

<p><b><u>Due Diligence and Senior Management Oversight for Listing Applications</u></b></p>	<p>Under paragraph 17.4(d) of the Code of Conduct, When submitting an application on behalf of a listing applicant to the HKEX, a sponsor should ensure that all material issues known to it which, in its reasonable opinion, are necessary for the consideration of (i) whether the listing applicant is suitable for listing; and (ii) whether the listing of the applicant's securities is contrary to the interest of the investing public or to the public interest, are disclosed in writing to the HKEX.</p>	<p><b><u>Relying on Experts</u></b></p>	<p>Under paragraph 5.3 of the CF Code, a corporate finance adviser should undertake reasonableness checks to assess the relevant experience and expertise of the experts to satisfy itself that reliance could fairly be placed on their work; and review and discuss with its clients and the experts or other professionals the qualifications, bases and assumptions adopted by the experts or the other professionals in the course of their work and satisfy itself that the qualifications, bases and assumptions have been made with due care and objectivity, and on a reasonable basis.</p>
<p>A corporate finance adviser must also:</p> <ul style="list-style-type: none"> <li>(a) verify material representations</li> <li>(b) conduct background checks on the listing applicant, its listing group entities, its key executives, its directors, and its controlling shareholders, etc.</li> <li>(c) monitor any material developments and assess the impact on the suitability of the listing applicant for listing;</li> <li>(d) inspect key physical assets, and interview major business customers and other stakeholders (for example, key suppliers, creditors, counterparties or bankers); and</li> <li>(e) review relevant underlying records and supporting documents and obtain additional information from third-party sources where material issues are involved</li> </ul>	<p>Under Practice Note 21 (Due Diligence by Sponsors in respect of Initial Listing Applications) of the Main Board Listing Rules, typical due diligence on new listing applicants include, among others, background searches, review of financial statements, tax certificates, physical inspection of material assets, assessing the business development and business plan of the listing applicant, etc.</p>	<p><b><u>Admission of the Listing Applicant</u></b></p>	<p>Under paragraph 17.2(b) of the Code of Conduct, a sponsor should take reasonable due diligence steps in respect of a listing application; before submitting a listing application a sponsor should complete all reasonable due diligence on a listing applicant except in relation to matters that by their nature can only be dealt with at a later date. Under paragraph 17.4(b) of the Code of Conduct, before submitting an application on behalf of a listing applicant to the HKEX a sponsor should come to a reasonable opinion that the information in the Application Proof is substantially complete except in relation to matters that by their nature can only be dealt with at a later date.</p>
		<p>Prior to the submission of the listing application and before the listing applicant's admission to the stock exchange, a corporate finance adviser must have reasonable grounds to be satisfied, among others,</p> <ul style="list-style-type: none"> <li>(a) that all material issues identified by the due diligence performed have been, or will prior to listing be, satisfactorily resolved or clearly disclosed in the listing application or the prospectus;</li> <li>(b) the completeness of information in the listing application;</li> <li>(c) that the listing applicant is compliant with the listing rules relevant to its listing application;</li> </ul>	<p>Practice Note 21 (Due Diligence by Sponsors in</p>

<p>(d) that the listing applicant has established procedures, systems and controls to (i) enable the listing applicant to comply with the listing rules and other relevant legal and regulatory requirements; and (ii) provide a reasonable basis for directors to make proper assessment of the financial position and prospects of the listing applicant;</p> <p>(e) that the directors of the listing applicant collectively have the experience and qualifications to manage the listing applicant's business and ensure compliance with its obligations under the listing rules and other relevant legal and regulatory requirements</p>	<p>respect of Initial Listing Applications) of the Main Board Listing Rules also set out detailed requirements of due diligence steps to be taken by sponsors.</p>
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Overall, the general principles and objectives of due diligence in both Hong Kong and Singapore are the same: to ensure that advisers have taken reasonable care and skill in conducting due diligence to ensure an accurate and complete illustration of the business model and financial performance is given to the investors and regulators.

## CONCLUSION

In general, corporate finance advisers in Hong Kong or Singapore are expected to conduct thorough due diligence to ensure that they understand the business operations and financial performance of their clients thoroughly, the statements and representations made by their clients are true, accurate and complete in all material aspects, and their clients understand and comply with all relevant regulatory requirements. Cases such as Hontex have illustrated the strict position the SFC, HKEX and the courts have taken in the standard of due diligence to be taken by the corporate finance advisers and the seriousness of consequences of insufficient due diligence on the sponsors and their principals and responsible officers.

## HOW JML CAN HELP

Jeffrey Mak Law Firm is experienced in advising sponsors and corporate finance advisers on due diligence requirements and other regulatory compliance matters. We can assist with drafting and reviewing policies and procedures, engagement letters with sponsors and due diligence planning in compliance with Practice Note 21 of the Main Board Listing Rules or Practice Note 2 of the GEM Listing Rules.

Source:

- <https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/corporate-finance-adviser-code-of-conduct/corporate-finance-adviser-code-of-conduct.pdf?rev=b87d648a918d41e6a5c642a7e411884e>
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