

# SFC reprimands and fines Merrill Lynch Far East Limited \$128 million for sponsor failures

14 Mar 2019

The Securities and Futures Commission (SFC) has reprimanded and fined Merrill Lynch Far East Limited (Merrill Lynch) for failing to discharge its obligations as one of the joint sponsors in relation to the listing application of Tianhe Chemicals Group Limited (Tianhe) in 2014 (Notes 1 and 2).

The SFC's investigations revealed that Merrill Lynch had failed to follow the specific guidelines on due diligence interviews under paragraph 17.6 of the Code of Conduct (Notes 3 and 4).

## **Involvement of Tianhe in due diligence interviews**

Merrill Lynch had interviewed ten customers of Tianhe: six of whom were interviewed either by telephone or at face-to-face interviews at Tianhe's offices in Jinzhou of Mainland China, and the rest of them were interviewed at the customers' own premises.

Merrill Lynch did not have direct contact with Tianhe's customers for the purpose of setting up due diligence interviews or confirming the mode and place of the interviews. On the contrary, Tianhe informed Merrill Lynch which customers were unable to attend face-to-face interviews, and which customers refused to conduct interviews at their business premises. There is no evidence that Merrill Lynch had taken any steps to check with the customers as to why they were not amenable to be interviewed at their offices.

## **Failure to address red flags in an interview**

Merrill Lynch had initially requested to interview the largest customer of Tianhe, Customer X, at its office, but eventually accepted Tianhe's explanation that since an anti-corruption campaign in Mainland China was underway, Customer X, a large state-owned enterprise, would normally turn down any third party request to visit its premises.

Merrill Lynch then agreed to interview Customer X at Tianhe's office. At the end of the interview, the representative of Customer X refused to produce his identity and business cards and stormed out of the meeting room. He told Merrill Lynch and other parties that he would not have agreed to be interviewed under Customer X's internal procedure, and he only attended the interview to help the family of Tianhe's chief executive officer (CEO).

Nonetheless, Merrill Lynch did not conduct any follow up inquiries to ascertain that the person it interviewed was the representative of Customer X and that he had the appropriate authority and knowledge for the interview.

Several months after the interview, a potential cornerstone investor of Tianhe informed Merrill Lynch of its own due diligence conducted on Customer X, noting that when trying to locate the representative interviewed by Merrill Lynch by telephoning Customer X's general line, the operator said there was no such person (Note 5).

The potential cornerstone investor's apparent inability to locate the representative of Customer X should have raised a red flag. Even if this alone was not a sufficient red flag this is all the more so when it was compounded with what happened during Merrill Lynch's interview with the individual. As such, there was no basis for Merrill Lynch to claim to be satisfied with the identity of that individual without any or any sufficient follow-up inquiries after the interview. However, the evidence shows that Merrill Lynch had not undertaken any additional due diligence to ascertain the identity of the representative of Customer X.

## **Unclear interview questions**

Tianhe conducted business with its customers through its subsidiary, Jinzhou DPF-TH Chemicals Co. Limited (Jinzhou DPF-TH), based upon the sales documents provided to Merrill Lynch.

During the customer interviews, Merrill Lynch asked the interviewees questions in relation to the

business between their companies and the “Tianhe Group”, instead of Jinzhou DPF-TH. Although the interviewees were also asked a question “which entity of the Tianhe Group and which business department do you mainly contact with”, only three out of ten customers interviewed confirmed that they had contact with Jinzhou DPF-TH. However, Merrill Lynch did not follow up with the remaining customers as to which entity of the “Tianhe Group” they had business with.

One of the purported top ten customers of Tianhe interviewed by Merrill Lynch informed the SFC that when its representative answered questions about the dealings between the customer and the “Tianhe Group” during the interview, its representative was referring to the dealings with Liaoning Tianhe Fine Chemicals, a private company wholly owned by the family of the CEO of Tianhe but no longer a part of Tianhe’s group to be listed at the material times.

As both the listed and unlisted chemical businesses of the family of the CEO of Tianhe were named “Tianhe”, the SFC considers that it was insufficient for Merrill Lynch to merely refer to the “Tianhe Group” during customer interviews and/or not to request the interviewees to identify the exact Tianhe entity with which their organisations had dealings.

In deciding on the sanctions, the SFC took into account that:

- Merrill Lynch allowed Tianhe to control the due diligence process and failed to take appropriate steps to address the red flags raised in and after the customer interviews;
- the breaches and deficiencies identified above related to the due diligence conducted on Tianhe’s top customers, including its largest customer, during the track record period;
- Merrill Lynch cooperated with the SFC in accepting the disciplinary action and the SFC’s findings and regulatory concerns; and
- Merrill Lynch agreed to engage an independent reviewer to review its policies, procedures and practices in relation to the conduct of its sponsor business.

End

Notes:

1. Merrill Lynch is licensed under the Securities and Futures Ordinance to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities) and Type 6 (advising on corporate finance) regulated activities.
2. Tianhe was listed on the Main Board of Stock Exchange of Hong Kong Limited (SEHK) on 20 June 2014, and was engaged in the manufacture and sale of chemical products. At Tianhe’s request, trading in the shares of the company was suspended on 26 March 2015. On 24 May 2017, the SFC issued a notice under section 8(1) of the Securities and Futures (Stock Market Listing) Rules directing the SEHK to suspend all dealings in the shares of Tianhe effective from 9 am on 25 May 2017. Trading in Tianhe’s shares remains suspended as of today.
3. Code of Conduct for Persons Licensed by or Registered with the SFC.
4. Paragraph 17.6(f) of the Code of Conduct provides that, in conducting interviews, the sponsor should, among other things:
  - carry out the interview directly with the person or entity selected for interview with minimal involvement of the listing applicant;
  - confirm the bona fides of the interviewee (including establishing the identity of the interviewee and other relevant information) to satisfy itself that the interviewee has the appropriate authority and knowledge for the interview; and
  - identify any irregularities noted during the interview (e.g. interview not taking place at the registered or business address of the person or entity selected for interview, reluctance on the part of the interviewee to cooperate) and ensure any irregularities are adequately explained and resolved.
5. It does not appear from the evidence that the other co-sponsors were aware that a potential cornerstone investor of Tianhe had conducted its own due diligence on Customer X.

[A copy of the Statement of Disciplinary Action is available on the SFC website](#)

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## STATEMENT OF DISCIPLINARY ACTION

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### The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has reprimanded and fined Merrill Lynch Far East Limited<sup>1</sup> (**Merrill Lynch**) a sum of HK\$128 million, pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).
2. The disciplinary action is taken according to an agreement pursuant to section 201 of the SFO dated 13 March 2019 in relation to Merrill Lynch's failures in discharging its duties as one of the joint sponsors in relation to the listing application of Tianhe Chemicals Group Limited (**Tianhe**) in 2014.

### Regulatory requirements

3. A sponsor is required to conduct reasonable due diligence inquiries so as to put itself into a position to ensure that the disclosure in the listing document and all information provided to the Stock Exchange of Hong Kong Limited (**SEHK**) during the listing application process are true in all material respects and do not omit any material information.
4. Specifically, a sponsor is required by:
  - (a) Paragraph 17.6(f) (Interview practices) of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) to adopt effective and adequate measures to ensure that the records of interviews are reasonably accurate, complete and reliable in all material respects, including to (i) carry out the interview directly with the person or entity selected for interview with minimal involvement of the listing applicant; (ii) confirm the bona fides of the interviewee to satisfy itself that the interviewee has the appropriate authority and knowledge for the interview; and (iii) identify and ensure any irregularities noted during the interview are adequately explained and resolved.
  - (b) Paragraph 17.6(c) (Appropriate verification) of the Code of Conduct to undertake additional due diligence to ascertain the truth and completeness of the information provided by the listing applicant, after it becomes aware of circumstances that may cast doubt on such information or otherwise indicate a potential problem or risk.

### Summary of facts

#### *Background*

5. Tianhe was an investment holding company which indirectly wholly owned its key operational arm in Mainland China known as Jinzhou DPF-TH Chemicals Co. Limited (**Jinzhou DPF-TH**).

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<sup>1</sup> Merrill Lynch is licensed under the SFO to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities) and Type 6 (advising on corporate finance) regulated activities.

6. According to Tianhe's prospectus dated 9 June 2014 (**Prospectus**), Jinzhou DPF-TH manufactured and sold chemical products, i.e. lubricant additives and specialty fluorochemicals.
7. On 10 March 2014, Tianhe submitted its listing application to the SEHK, whereby:
  - (a) Merrill Lynch and two other sponsors were the joint sponsors, and they or their associated companies were the joint global coordinators, joint bookrunners and joint lead managers; and
  - (b) its track record period was the three years ended 31 December 2011, 2012 and 2013 (**Track Record Period**).
8. On 20 June 2014, Tianhe was listed on the Main Board of the SEHK.
9. At Tianhe's request, trading in the shares of the company was suspended on 26 March 2015. This was because Tianhe required additional time to provide further information to fully address its auditors' concerns, which caused delay in the publication of its 2014 Annual Results.
10. On 24 May 2017, the SFC issued a notice under section 8(1) of the Securities and Futures (Stock Market Listing) Rules directing the SEHK to suspend all dealings in the shares of Tianhe effective from 9 am on 25 May 2017.
11. Trading in Tianhe's shares remains suspended as of today.

*Involvement of Tianhe in due diligence interviews*

12. The SFC's investigations revealed that for the purpose of their due diligence interviews, Merrill Lynch, the other joint sponsors and their legal counsel initially requested to:
  - (a) conduct face-to-face due diligence interviews at the customers' business premises; and
  - (b) verify the interviewees' identity and authority, during the interviews, by:
    - (i) obtaining an authorization letter from their companies;
    - (ii) reviewing their business licences;
    - (iii) obtaining their business cards; and
    - (iv) reviewing their personal identity documents.
13. It is apparent that Merrill Lynch was fully cognizant of its due diligence duties (for example, to effectively verify the identities of the interviewees from major customers). However, Merrill Lynch agreed to change the due diligence plan, apparently due to the resistance of Tianhe.
14. Out of the ten customers of Tianhe interviewed by Merrill Lynch, six of whom were interviewed either by telephone or at face-to-face interviews at Tianhe's offices in Jinzhou of Mainland China, and the rest of them were interviewed at the customers' own premises.

15. Further, the SFC noted that the customer due diligence interviews were arranged by Tianhe:
  - (a) Tianhe contacted the relevant customers directly.
  - (b) The name and contact details of the representatives of the customers were provided to Merrill Lynch by Tianhe.
  - (c) Tianhe informed Merrill Lynch which customers were unable to attend face-to-face due diligence interviews at Tianhe's premises and which customers refused to conduct interviews at their respective business premises.
16. The SFC is concerned that:
  - (a) Merrill Lynch did not have direct contact with Tianhe's customers for the purpose of setting up due diligence interviews or confirming the mode and place of the interviews.
  - (b) There is no evidence that Merrill Lynch had taken any steps to verify directly with the relevant customers as to the reason(s) why they could not attend face-to-face interviews or refused to conduct onsite interviews.
17. The SFC also found that, upon the request of Tianhe, Merrill Lynch agreed not to request the interviewees' companies to provide an authorization letter and not to review their business licences as planned. Merrill Lynch agreed that they would only check the identity/staff card of the interviewees and ask the interviewees to provide business cards.

*Failure to address red flags in an interview*

18. While Merrill Lynch had requested to conduct face-to-face due diligence interview with the largest customer of Tianhe, Customer X, at its business premises, Merrill Lynch eventually agreed to interview Customer X at Tianhe's office after Tianhe informed them that since an anti-corruption campaign in Mainland China was underway, Customer X, a large state-owned enterprise, would normally turn down any third party request to visit its premises.
19. At the end of the interview, the representative of Customer X refused to produce his identity and business cards and stormed out of the meeting room. He told Merrill Lynch and other parties he would not have agreed to be interviewed under Customer X's internal procedure, and he only attended the interview to help the family of Tianhe's chief executive officer (CEO).
20. Nonetheless, Merrill Lynch did not conduct any follow-up inquiries to ascertain that the person it interviewed was an authorised representative of Customer X and that he had the appropriate authority and knowledge for the interview.
21. Several months after the interview, a potential cornerstone investor of Tianhe informed Merrill Lynch of its own due diligence conducted on Customer X, noting that when trying to locate the representative interviewed by Merrill Lynch by telephoning Customer X's general line, the operator said there was no such person<sup>2</sup>.

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<sup>2</sup> It does not appear from the evidence that the other co-sponsors were aware that a potential cornerstone investor of Tianhe had conducted its own due diligence on Customer X.

22. The potential cornerstone investor's apparent inability to locate the representative of Customer X should have raised a red flag. Even if this alone was not a sufficient red flag this is all the more so when it was compounded with what happened during Merrill Lynch's interview with the individual. As such, there was no basis for Merrill Lynch to claim to be satisfied with the identity of that individual without any or any sufficient follow-up inquiries after the interview. However, the evidence shows that Merrill Lynch had not undertaken any additional due diligence to ascertain the identity of the representative of Customer X.

#### *Unclear interview questions*

23. According to the sales documents provided by Tianhe to Merrill Lynch, Tianhe conducted business with its customers through Jinzhou DPF-TH.
24. During the customer interviews, the interviewees were asked questions in relation to the business between their companies and the "Tianhe Group", instead of Jinzhou DPF-TH. There is no evidence that Merrill Lynch or other parties have explained to the interviewees which entities did the "Tianhe Group" refer to during the customer interviews.
25. Although the interviewees were also asked a question "*which entity of the Tianhe Group and which business department do you mainly contact with*", only three out of ten customers interviewed confirmed that they had contact with Jinzhou DPF-TH. However, Merrill Lynch did not follow up with the remaining customers as to which entity of the "Tianhe Group" they had business with.
26. One of the purported top ten customers of Tianhe interviewed by Merrill Lynch informed the SFC that when its representative answered questions about the dealings between the customer and the "Tianhe Group" during the interview, its representative was referring to the dealings with Liaoning Tianhe Fine Chemicals (**Liaoning Tianhe**), a private company wholly owned by the family of the CEO of Tianhe but no longer a part of Tianhe's group to be listed at the material times.
27. The separation of Tianhe and Liaoning Tianhe was an important feature of Tianhe and disclosed in different parts of the Prospectus. As both the listed and unlisted chemical businesses of the family of the CEO of Tianhe were named "Tianhe", the SFC considers that it was insufficient for Merrill Lynch to merely refer to the "Tianhe Group" during customer interviews and/or not to request the interviewees to identify the exact Tianhe entity with which their organisations had dealings.

#### **Breaches and reasons for action**

28. In light of the matters set out above, the SFC considers that Merrill Lynch has failed to discharge its duties as a sponsor in relation to the listing application of Tianhe, in that it has failed to:
  - (a) conduct adequate and reasonable due diligence inquiries in relation to Tianhe's listing application and use all reasonable efforts to ensure that the information and representations provided in the Prospectus were true, accurate and not misleading;
  - (b) perform adequate and reasonable due diligence inquiries in relation to Tianhe's customers in that it has:
    - (i) failed to carry out customer interviews directly with the person or entity selected for interview with minimal involvement of Tianhe;

- (ii) failed to confirm the bona fides of the interviewees to satisfy themselves that the interviewees had the appropriate authority and knowledge for the interviews;
  - (iii) failed to identify and ensure any irregularities noted during the interviews were adequately explained and resolved; and
- (c) comply with all regulatory requirements applicable to the conduct of a sponsor, including the Rules Governing the Listing of Securities on the SEHK (**Listing Rules**) and Practice Note 21 to the Listing Rules (Due Diligence by Sponsors in respect of Initial Listing Applications).

## **Conclusion**

29. Having considered all the circumstances, the SFC is of the view that Merrill Lynch has breached the regulatory requirements as set out in paragraph 4 above.
30. In deciding the appropriate sanction, the SFC has taken into account all relevant considerations, including:
- (a) Merrill Lynch allowed the listing applicant to control the due diligence process and failed to take appropriate steps to address the red flags raised in and after the customer interviews.
  - (b) The breaches and deficiencies identified above related to the due diligence conducted on Tianhe's top customers, including its largest customer, during the Track Record Period.
  - (c) Merrill Lynch cooperated with the SFC in accepting the disciplinary action and the SFC's findings and regulatory concerns.
  - (d) Merrill Lynch agreed to engage an independent reviewer to review its policies, procedures and practices in relation to the conduct of its sponsor business.