

SFC reprimands and fines Citigroup Global Markets Asia Limited \$57 million for sponsor failures

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The Securities and Futures Commission (SFC) has reprimanded and fined Citigroup Global Markets Asia Limited (Citi) \$57 million after resolving concerns with Citi over its discharge of duties as a sponsor in relation to the listing application of Real Gold Mining Limited (Real Gold) (Notes 1 & 2).

An SFC investigation revealed that Citi had failed to (i) conduct adequate and reasonable due diligence on Real Gold's customers and (ii) properly supervise its staff when carrying out the sponsor work on Real Gold's listing application.

Failure to conduct adequate and reasonable due diligence inquiries

Real Gold, established in Mainland China, owned three gold mines in Chifeng Municipality, Inner Mongolia, and specialised in the mining of gold and the processing of ore into concentrates containing gold and other minerals for subsequent sale, according to the company's 2009 prospectus (Prospectus).

The Prospectus disclosed that Real Gold's sales increased by more than twenty-fold between the year ended 31 December 2007 and the 10 months ended 31 October 2008 (being respectively the last full year and the last 10 months of the track record period).

The SFC found that information provided to Citi during its due diligence inquiries showed that apart from one customer, the customers of Real Gold for the two periods were completely different.

The Prospectus also disclosed that Real Gold had entered into a memorandum of long-term cooperation (MLC) with each of three customers who contributed to an aggregate of 35.2% of Real Gold's sales in the 10 months ended 31 October 2008. Pursuant to the MLCs, the customers were obliged to purchase whatever amount of gold or zinc concentrates Real Gold decided, in its absolute discretion, to sell them.

Citi considered that production was the key risk for early stage mining companies producing a commodity with a ready market such as gold, as in the case of Real Gold. As a result, Citi's due diligence placed emphasis on production-related diligence, such as retaining an independent technical mining expert and performing on-site validation. Citi also considered that verifying Real Gold's production was comparable to verifying its sales.

While Citi did conduct some customer-related due diligence on Real Gold, the SFC considers it inadequate and substandard (Note 3).

For instance:

- Citi conducted all customer interviews by telephone on telephone numbers provided by Real Gold, without independently verifying the identities and contact details of the representatives of the customers;
- Citi did not seek direct confirmation from the customers in regard to their transaction amounts with Real Gold; and
- Citi did not interview one of the three customers with whom Real Gold had allegedly entered into MLCs with, and when Citi did interview another one of them, no question about the MLC was asked. Citi also did not verify the authenticity of the MLCs.

Under these circumstances, the SFC considers that Citi's approach towards customer due diligence was not justified by the relevant regulatory requirements and the SFC's view is supported by the opinion of an independent market expert (Note 4).

Failure to supervise the transaction team

The SFC's investigation found that the sponsor principals did not supervise the transaction team in the manner expected of them under the Additional Fit and Proper Guidelines for Corporations and Authorized Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers

(Sponsor Guidelines) (Note 5). For instance:

- A sponsor principal was only appointed to supervise the transaction team more than four months after Citi was mandated by Real Gold to act as the listing sponsor, by which time preparation for Real Gold's listing application, including making arrangements for due diligence calls with major customers, suppliers and banks and drafting of the Prospectus, as well as due diligence on connected transactions, were well underway.
- One of the sponsor principals was a director of another investment banking team at Citi, and listing applications were not her responsibility. She thought that she was the "signing responsible officer" of Real Gold's listing application while another team member was the sponsor principal. She was not involved in conducting due diligence nor corresponding with the Stock Exchange of Hong Kong Limited (SEHK). Her involvement was limited to assisting the deal team when she was called upon to do so, for example, when the deal team needed a responsible officer to sign certain documents.
- It appeared that the transaction team was mainly supervised by a managing director who was not a sponsor principal but was nonetheless involved in the due diligence on the assets and operations of Real Gold.

The SFC's investigation also found that the due diligence work conducted on Real Gold's customers was handled by junior and inexperienced staff members of Citi with little supervision. For instance:

- The telephone interviews with Real Gold's customers were organised and attended by an analyst and a senior analyst, who were the most junior members of the transaction team, with apparently little supervision, notwithstanding the participation in these calls by external legal counsel.
- The deal team captain had assigned the workstream involving due diligence on Real Gold's customers to the senior analyst, the second most junior member of the transaction team, and expected him to raise any significant issue for discussion.

In view of the deficiencies in Citi's due diligence work identified above, notwithstanding Citi's view that its approach to due diligence was the result of a reasoned weighting of production-related concerns over customer-related concerns, it appeared that Citi was in breach of its undertaking and declaration to SEHK (Note 6).

In reaching this resolution, the SFC took into account all circumstances, including:

- this is the first and only listing application in which the SFC has had concerns over Citi's work as a listing sponsor;
- the breaches and deficiencies identified above related to a limited portion of the due diligence conducted by Citi in the course of Real Gold's listing application;
- the SFC found no evidence that the breaches and deficiencies identified above were deliberate, intentional or reckless;
- Citi's approach to due diligence reflected a reasoned weighting of production-related concerns over customer-related concerns, albeit one that the SFC does not consider to be compliant with the relevant regulatory requirements;
- Citi's early engagement of its senior management and an external counsel to address the SFC's regulatory concerns;
- Citi has taken action to strengthen its internal controls and systems in respect of its sponsor work since Real Gold's listing; and
- Citi's full cooperation with the SFC to resolve the SFC's regulatory concerns.

End

Notes:

1. Citi is licensed to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts), Type 6 (advising on corporate finance) and Type 7 (providing automated trading services) regulated activities under the Securities and Futures Ordinance.
2. Real Gold was listed on the Main Board of the Stock Exchange of Hong Kong Limited (SEHK) on 23 February 2009 with Citi as its sole sponsor. At the request of the company, trading in the shares of Real Gold was suspended on 27 May 2011. On 28 June 2016, the SFC directed the suspension of the company's shares under Rule 8(1) of the Securities and Futures (Stock Market Listing) Rules.
3. The customer-related due diligence carried out by Citi included collecting materials (such as shipment records and sales contracts) from Real Gold during its on-site diligence; conducting customer interviews; relying on Real Gold's reporting accountant and auditor to verify customer revenues; as well as obtaining a legal opinion as to the validity and enforceability of the memorandums.
4. Details of the relevant regulatory requirements are set out in the Statement of Disciplinary Action.
5. Paragraph 1.3.3 of the Sponsor Guidelines provides that, "As a general guidance, a Principal is expected to be in charge of the supervision of the Transaction Team(s). The Principal should be involved in the making of the key decisions relating to the work carried out by the Transaction Team and must be aware of the key risks in such work and responsible for the measures to address them."
6. As is relevant here, a sponsor is required to submit an undertaking and a declaration to the SEHK that it

would/has made reasonable due diligence inquiries.

A copy of the Statement of Disciplinary Action is available on the SFC website

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STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has reprimanded and fined Citigroup Global Markets Asia Limited (**Citi**) \$57 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 16 May 2018 in relation to Citi's failures in discharging its duties as a sponsor in relation to the listing application of Real Gold Mining Limited (**Real Gold or the Company**).
3. Citi is licensed to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts), Type 6 (advising on corporate finance) and Type 7 (providing automated trading services) regulated activities under the SFO.

Summary of facts

Background

4. On 26 May 2008, Citi, on behalf of the Company, submitted the Company's listing application to the Stock Exchange of Hong Kong (**SEHK**). On 31 December 2008, the Company re-submitted a listing application due to the lapse of more than six months from the first application. The track record period was the three years ended 31 December 2007 and the ten months ended 31 October 2008 (**Track Record Period**).
5. The Company was listed on the Main Board of the SEHK on 23 February 2009. According to the Company's 2009 annual report, around RMB549.8 million, net of listing expenses, was raised by the initial public offering of the Company.
6. According to the Company's prospectus dated 10 February 2009 (**Prospectus**), it owned a 97.14% shareholding in three gold mines in Chifeng Municipality, Inner Mongolia, namely, the Shirengou Gold Mine, the Nantaizi Gold Mine and the Luotuochang Gold Mine, and specialized in the mining of gold and the processing of ore into concentrates containing gold and other minerals for subsequent sale.
7. At the request of the Company, trading in the shares of the Company was suspended since 27 May 2011. On 28 June 2016, the SFC has, under Rule 8(1) of the Rules Governing the Listing of Securities on the SEHK (**Listing Rules**), directed the SEHK to suspend all dealings in the shares of the Company.

Regulatory requirements¹

8. A sponsor is required to conduct reasonable due diligence inquiries so as to put itself in a position to ensure that the disclosure in the listing document and all information provided to the SEHK during the listing application process are true in all material respects and do not omit any material information.

¹ References to codes and guidelines in this Statement of Disciplinary Action are references to the codes and guidelines that were current at the time of the listing of Real Gold.

9. Specifically, a sponsor is required by:

- (a) General Principle 2 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) and paragraph 5.1 of the Corporate Finance Adviser Code of Conduct (**CFA Code of Conduct**) to act with due skill, care and diligence and observe proper standards of market conduct, in the best interests of its clients and the integrity of the market;
- (b) paragraph 5.8 of the CFA Code of Conduct to use all reasonable efforts to assist its client in ensuring any document for public dissemination is prepared to the required standard and no relevant information has been omitted;
- (c) paragraphs 2 and 3 of Practice Note 21 to the Listing Rules (Due Diligence by Sponsors in respect of Initial Listing Applications) (**PN 21**) to examine the information/documents provided by the listing applicant with professional skepticism;
- (d) rule 3A.06 of the Listing Rules and paragraph 4.4 of the CFA Code of Conduct to act impartially; and
- (e) General Principle 7 and paragraph 12.1 of the Code of Conduct and paragraph 1.5.1(3) of the Additional Fit and Proper Guidelines for Corporations and Authorized Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers (**Sponsor Guidelines**) to comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of clients and the integrity of the market.

10. In terms of supervision of its sponsor work, a sponsor is required by paragraph 4.2 of the Code of Conduct, paragraph 2.4 of the CFA Code of Conduct and paragraph 1.5.1(1) of the Sponsor Guidelines to ensure that it has adequate resources to supervise diligently and does supervise diligently its staff members, to ensure that supervisory and reporting responsibilities are assigned to the more experienced staff members, and to have effective systems and controls to ensure adequate supervision and management of its employees.

11. Further, General Principal 9 of the Code of Conduct and paragraph 1.2.4 of the Sponsor Guidelines make it clear that the management of a sponsor is ultimately responsible for the supervision of the sponsor work undertaken by the firm and compliance with all relevant rules, regulations, codes and guidelines. While the management may delegate the operational functions to the staff of a sponsor, the management remains responsible for the discharge of these functions and such responsibilities cannot be delegated.

12. Paragraph 1.3.3 of the Sponsor Guidelines puts the sponsor principal in charge of the supervision of the transaction team. The sponsor principal is expected to be responsible for the overall due diligence planning, involved in the making of the key decisions relating to the work carried out by the deal team and be aware of the key risks in such work.

Failure to conduct adequate and reasonable due diligence inquiries

13. The Prospectus disclosed that:

- (a) only the 50 tpd ore processing facility located at the Shirengou Gold Mine was in operation in 2007 and the Nantaizi Gold Mine and the Luotuochang Gold Mine commenced commercial production in July and September 2008 respectively;

- (b) Real Gold's sales increased by more than twenty-fold between the year ended 31 December 2007 and the 10 months ended 31 October 2008 (being respectively the last full year and last 10 months of the Track Record Period);
 - (c) sales to the Company's top five customers represented 100% and 95.4% of total sales for the year ended 31 December 2007 and the 10 months ended 31 October 2008 respectively; and
 - (d) Real Gold had entered into a memorandum of long-term cooperation (**MLC**) with each of three customers who contributed to an aggregate of 35.2% of Real Gold's sales for the 10 months ended 31 October 2008; pursuant to the MLCs, the customers were obliged to purchase whatever amount of gold or zinc concentrates Real Gold decided, in its absolute discretion, to sell them.
14. The SFC found that information provided to Citi during its due diligence inquiries showed that apart from one customer, which was Real Gold's largest customer for the year ended 31 December 2007 and third largest customer for the 10 months ended 31 October 2008, the customers of Real Gold for the two periods were completely different.
15. Citi's due diligence in respect of Real Gold's customers comprised:
- (a) conducting on-site diligence, including collecting materials from Real Gold's records (for example, warehouse and shipment records, sales contracts and settlement records with Real Gold's customers);
 - (b) conducting customer interviews;
 - (c) relying on the work of Deloitte Touche Tohmatsu (**Deloitte**), which acted both as the reporting accountant and auditor, to verify customer revenues, and reviewing and commenting on Deloitte's work; and
 - (d) obtaining a legal opinion as to the validity and enforceability of the MLCs.
16. In particular, Citi considered it reasonable to rely on Deloitte's work, taking into account a number of factors, including the fact that Deloitte gave an unqualified opinion as to Real Gold's total revenue figures for the year ended 31 December 2008, audited and provided comfort as to sales, trade receivables, bank balances and cash, each of which acts as a proxy for customer revenues, and did not identify any red flags.
17. However, the SFC considers that Citi's due diligence on Real Gold's customers was inadequate and sub-standard. For instance:
- (a) Citi conducted all customer interviews by telephone on telephone numbers provided by Real Gold, but there is no evidence that Citi had independently verified the identities and contact details of the representatives of the customers. The only verification was a confirmation of identity with the interviewee at the start of an interview. Further, of all the customers interviewed, Citi only has a record of the business licence of one of them, and it is not clear whether or not internet or other background searches had been conducted on Real Gold's customers.
 - (b) Citi did not seek direct confirmation from the customers in regard to their transaction amounts with Real Gold.
 - (c) Confirmations that were obtained from the top 5 customers of Real Gold for the ten months ended 30 October 2008 were provided to Citi by a director of Real Gold, and they only confirmed that the customers had had "a business relationship" with

the Company and/or its subsidiaries for more than 7 months, and that it was expected that the relationship would continue.

- (d) Citi did not interview one of the three customers with whom Real Gold had allegedly entered into MLCs with, and when Citi did interview another one of them, no question about the MLC was asked. Citi also did not verify the authenticity of the MLCs.
18. Citi explained that the weighting of its due diligence plan reflected its assessment, which in turn reflected the prevailing view in the market, that for early stage mining companies which produces a commodity with a ready market such as gold, as in the case of Real Gold, the key risk area is production – namely, the accuracy of reported resources and estimated reserves, the nature of mining rights, operating capacity, etc. As a result, it placed emphasis on production-related diligence, for example, by retaining an independent technical mining expert and performing on-site validation. Citi also considered that verifying Real Gold's production was comparable to verifying its sales.
19. The SFC disagrees with Citi's view that there is a necessary correlation between the existence of resources / reserves in the Company's mines and the Company's ability to sell the concentrates it produces from processing the ore mined, and that verifying production is comparable to verifying sales. The Prospectus, in fact, discloses the Company's reliance on major customers as one of the risk factors, and states that "*given that most of our revenue is derived from the sale of concentrates to our five largest customers, any adverse effect on their ability to purchase our concentrates will have a material adverse effect on our results of operations.*"
20. The SFC therefore considers that Citi's approach towards customer due diligence was not justified by the relevant regulatory requirements, as summarized in paragraph 9 above. **The SFC's view is supported by the opinion of an independent market expert.**

Failure to supervise the transaction team

21. Citi was mandated by Real Gold in around mid-December 2007 to act as the listing sponsor. The all parties kick-off meeting took place on 15 January 2008, and preparation for the listing application, including making arrangements for due diligence calls with major customers, suppliers and banks, and drafting of the Prospectus, as well as due diligence on connected transactions, etc, commenced thereafter. The most senior banker involved at that stage was a managing director who was not a sponsor principal but was nonetheless involved in the due diligence on the assets and operations of Real Gold.
22. A sponsor principal² - one of Citi's four qualified sponsor principals at the time - was only appointed in or around late April 2008 and was a director in another team within Citi's investment banking divisions, with no responsibility otherwise for listing applications.
23. The sponsor principal thought that she was the "signing responsible officer" of Real Gold's listing application, while another team member was the sponsor principal. She was not involved in conducting due diligence nor corresponding with the SEHK. Her involvement was limited to assisting the deal team when she was called upon to do so, for example, when the deal team needed a responsible officer to sign certain documents. Before signing documents for the transaction, she asked the deal team

² Another sponsor principal took up the role in or around mid-December 2008 when the first sponsor principal took a leave of absence.

whether they had completed all the necessary work, and whether they had noticed any inconsistencies or red flag, and she was not aware that anyone had brought up any key issues.

24. The SFC's investigation also found that the due diligence work conducted on the Company's customers was handled by junior and inexperienced staff members of Citi with little supervision. For instance:
 - (a) The telephone interviews with Real Gold's customers were organized and attended by an analyst and a senior analyst, who were the most junior members of the transaction team, with apparently little supervision within Citi, although external legal counsel did participate in the interviews. Notably, the analyst, for whom the Company's listing application was the first transaction that she was involved in after joining the industry, said that she was instructed by the senior analyst to obtain contact details of the customers. She did not remember being asked to verify the identities and telephone numbers of the interviewees. She thought that her responsibility was to dial in, host the call, and take notes.
 - (b) The deal team captain had assigned the workstream involving due diligence on Real Gold's customers to the senior analyst, and expected him to raise any significant issue for discussion. The email correspondence relating to the Company's listing application provided by Citi does not record comments made or guidance given by those supervising the senior analyst on the due diligence progress, from the making of arrangements for the interviews, to the results of the interviews.
25. The SFC therefore considers that the sponsor principals did not supervise the transaction teams in the manner expected of them under the Sponsor Guidelines, and Citi failed to properly supervise its staff in carrying out the sponsor work in relation to the listing application of the Company in accordance with the requirements set out in paragraphs 10 and 11 above.
26. In view of the deficiencies in Citi's due diligence work identified above, notwithstanding Citi's view that its approach to due diligence was the result of a reasoned weighting of production-related concerns over customer-related concerns, it appeared that Citi, contrary to the undertaking and declaration that it was required to submit to the SEHK, did not make reasonable due diligence inquiries.

Conclusion

27. Having considered all the circumstances, the SFC is of the opinion that it is in the interest of the investing public and in the public interest to resolve the above concerns with Citi and take the disciplinary action as set out in paragraph 1 above.
28. In reaching this resolution, the SFC took into account all circumstances, including:
 - (a) this is the first and only listing application in which the SFC has had concerns over Citi's work as a listing sponsor;
 - (b) the breaches and deficiencies identified above related to a limited portion of the due diligence conducted by Citi in the course of Real Gold's listing application;
 - (c) the SFC found no evidence that the breaches and deficiencies identified were deliberate, intentional or reckless;

- (d) Citi's approach to due diligence reflected a reasoned weighting of production-related concerns over customer-related concerns, albeit one that the SFC does not consider to be compliant with the relevant regulatory requirements;
- (e) Citi's early engagement of its senior management and an external counsel to address the SFC's regulatory concerns;
- (f) Citi has taken action to strengthen its internal controls and systems in respect of its sponsor work since Real Gold's listing; and
- (g) Citi's full co-operation with the SFC to resolve the SFC's regulatory concerns.