Reasonable Enquiries with Due Diligence

by Eileen Tan Yuh Wen

Last year, the Securities Commission Malaysia (SC) commenced a review of its 2008 Due Diligence Guidelines.[1] The review, which involves collaboration with various industry participants, is intended to enhance the effectiveness of due diligence processes carried out for corporate proposals.

History

The first form of guidance resembling what we have presently, the Due Diligence Practices, was released by the SC in August 1996. This was a shift from a merit-based to a disclosure-based regime. The onus of assessing the merit of any securities would then rest with the investors, the public, while the SC regulates the disclosure of material information.

In preparing information to be disclosed to the public, a due diligence exercise is undertaken to verify and ensure that the information is accurate. The exercise also applies to information that is submitted to the SC in connection with the corporate proposals. In the absence of a due diligence exercise, persons responsible for submission of the corporate proposals to the SC will be vulnerable to criminal liabilities under the then s 32 of the Securities Commission Act 1993.

Over the years, the different sectors of the capital markets represented by the merchant banks, accountants and company secretaries have issued periodic updates on due diligence standards and practices. Eventually, these evolved into the 2008 Guidelines issued by the SC.

Legal requirement

The Capital Markets and Services Act 2007 (CMSA)[2] and the Main Market Listing Requirements of Bursa Malaysia[3] require the applicant, and those involved in preparing the corporate proposals, to ensure that any statement or information to be submitted to the regulators is not false or misleading and does not contain any material omission.

The CMSA makes it an offence to submit information that is false or misleading, or contains any material omission. The statutory defence against a charge for such an offence is available if it can be shown that enquiries as were reasonable in the circumstances had been made, and the accused had reasonable grounds to believe, and did believe until the time of the statement or submission was made, that the statement or information submitted to the regulators was not false or misleading and did not contain any material omission.[4]

The 2008 Guidelines

The existing 26-page Due Diligence Guidelines set out the obligations and standards expected of the due diligence working group (DDWG)[5] in broad terms. The DDWG is responsible for conducting reasonable enquiries to ensure that information submitted to the regulators or the public is not false, misleading or contains any material omission.

In particular:

(a) The principal adviser must exercise its own judgment in determining the scope and extent of due diligence for the corporate proposal in its entirety; and

(b) The advisers/experts must exercise their own judgment in determining the scope and extent of due diligence required under their agreed terms

1 "Guidelines on Due Diligence Conduct for Corporate Proposals" issued by the SC, which have been in effect from 1 February 2008
2 Section 215(1)
3 Paragraphs 2.18, 9.16 and 9.32(1)
4 *Supra* n 2,, s 215(2)
5 The DDWG would include the issuer or the listing applicant (represented by member(s) of its board, senior management and company secretary), the merchant banks as the principal adviser (PA) and other adviser or expert in relation to the corporate proposal such as lawyers, reporting accountants, property valuers and independent market researchers.

of reference and capacity as advisers/experts after having regard to the corporate proposal in its entirety.[6]

New direction

It is anticipated that the current review will see the 2008 Guidelines expanding into a set of specific prescriptions and steps to be taken in the due diligence process. Although these are loosely referred to as a set of recommended steps, they should not be taken as minimum requirements for compliance by the DDWG with their obligations, which will likely remain cast in broad terms and principles.

Areas of enquiries for the DDWG will include, as has been the case, background information of the issuer or listing applicant and its subsidiaries or intended subsidiaries ("Group"), material and key contracts, litigation and regulatory compliance proceedings and disputes, business overview, interviews of major suppliers and customers, related party transactions and conflict of interest, financial due diligence, internal controls and site inspection.

Areas of Enquiries

Material and key contracts

Relevant contracts are usually considered under two heads:

(a) Material contracts, being contracts (including contracts not reduced into writing) not in the ordinary course of business made within two years (or such other period as may be prescribed in the relevant statutes, rules, regulations or guidelines) preceding the date of the relevant documents;[7] and

(b) Key contracts, or contracts which the Group is highly dependent on.

Material contracts and key contracts are reviewed to consider any legal issues arising in relation to the corporate proposal.

What is deemed "material" is not prescribed in the CMSA, the Listing Requirements or the SC guidelines. The qualitative and quantitative threshold to determine whether a contract is "material" or not would be set out by the DDWG before commencement of the due diligence exercise.

At a minimum, it can be expected that the DDWG will be required to consider the following:

(a) The value of the contract — in particular, the contract value relative to the net assets, net profit, total assets or total revenue of the Group;

(b) The degree of reliance or dependency of the Group on the contract;

(c) Contracts which impose onerous or restrictive covenants that must be observed by the Group.

Material litigation

The DDWG, with the assistance of its lawyers, has the task of identifying any legal proceedings and disputes that could have a material adverse effect on the listing applicant. Normally, it will be sufficient to rely on the confirmation and summaries of the lawyers involved in the legal proceedings. However, with cases of exceptional significance, the due diligence exercise may involve delving into the pleadings and other relevant documents relating to the proceedings or dispute.

Malaysia does not have a public database of litigation cases, so the current practice is to use such private databases as may be available.

6 Paragraph 3.02 of the 2008 Guidelines
7 Paragraph 5.04 of Division 1 (Equity) of the SC's Prospectus Guidelines issued on 28 December 2012 and revised on 19 September 2018

The guidelines are unlikely to depart very far from what is commonly undertaken today in the review of litigation.

Regulatory compliance

Common areas of review for compliance will include licensing, foreign exchange administration rules, environmental compliance, land use, employment, competition and personal data protection. Compliance requirements specific to the business of the corporation will need to be identified.

Where any material non-compliance is found, it falls upon the DDWG to determine whether such non-compliance will render the applicant unsuitable for listing or whether the issue can be addressed with appropriate disclosure in the proposal document.

The disclosure will need to address:

(a) the nature and extent of the breach;

(b) whether the corporation has been charged or penalised;

(c) enhanced internal controls to prevent their recurrence; and

(d) if rectification actions were taken or will be taken.

Major suppliers and customers

Major suppliers and customers of the applicant are often interviewed as part of the due diligence exercise:

(a) to derive a better understanding of the listing applicant's business; and

(b) to establish the existence of such supplier and customer as represented by the listed applicant and assess the relationship between them, and in particular, any area of constraints, and whether the listing applicant is heavily dependent on any of them or if there is any material change since the previous disclosure.

In order to avoid any influence from the listing applicant, the suppliers and customers to be interviewed will be selected by the principal adviser and interviews conducted in the absence of the listing applicant.

The interview should cover:

(a) Background information and whether they are related parties or persons connected to the listing applicant;

(b) In relation to major suppliers, costs incurred by the listing applicant or the Group during the relevant period covered in the proposal document;

(c) In relation to major customers, revenue contributed to the listing applicant or the Group during the relevant period covered in the proposal document;

(d) Salient terms of their arrangements such as any minimum purchase commitment, duration, option for renewal, termination and penalty provisions; and

(e) Future plans with the listing applicant.

Ideally, the interviews should be conducted face-to-face in a physical meeting or alternatively by way of telephone or video conference and, as a last resort (if refused by the interviewee), by written interview questionnaires.

Related party transactions

Related party transactions (RPTs) are reviewed to ascertain whether a business may be over-reliant on dealings with related parties, which may compromise the independent sustainability required for listing. RPTs may also involve a conflict of interest of a director, promoter, management company, trustee, major shareholder, or person connected with any of these persons, the aforesaid persons which may affect proper decision-making in the business or entity.

Since the main source of information on RPTs will be the listing applicant or its promoters, the principal adviser must satisfy itself that these key persons in the business have sufficient understanding to identify RPTs according to the rules.

Efforts to ensure proper disclosure can be complemented by requiring the directors and officers of the applicant to attend courses or training run by trainers or individuals with sufficient experience in conducting such training before the start of the due diligence exercise, unless the principal adviser is satisfied that they have attended such courses or training or are otherwise qualified to identify RPTs.

Conclusion

The aim of the due diligence exercise is to pre-empt the possibility of personal liability and to enable the members of the DDWG and others involved with the issue of the proposal documents to be satisfied that the proposal documents comply with the legal regulatory requirements and to prevent breaches of the law from arising.

Any guidelines issued in the form of prescribed steps and procedures should not be viewed as the minimum due diligence steps that must be followed. A DDWG member should not assume that complying with such steps will be a sufficient discharge of its responsibilities under the regulatory framework in Malaysia. The substance and the principles underlying the due diligence exercise must still be heeded if it is to meet the statutory requirement for reasonable enquiries under the circumstances. **LH-AG**

About the author

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