Sustainable and Healthy Ecosystem for the Small-cap Stock Segment of Hong Kong Market

Speech at HKSI Institute Regulatory Luncheon

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Good afternoon, ladies and gentlemen. It's my pleasure to speak to you at this event organised by the Hong Kong Securities and Investment Institute. Today, I will touch on a range of topics relating to the structure of our stock market, our efforts to rid the market of practices harmful to retail investors, and our vision to build a healthy ecosystem for the sustainable development of the small-cap stock segment.

Sustainable development of stock market

I have spoken on different occasions about climate change and sustainability in the context of green finance, including our efforts to develop an effective regulatory and disclosure regime for sustainable products in Hong Kong and our support of the inaugural standards for corporate sustainability disclosures launched by the International Sustainability Standards Board (ISSB). In fact, many of the climate-related concepts are also pertinent to the sustainable development of the stock market.

An important lesson we learn from climate change is the need to properly manage pollutants in the environment we live and breathe in. These include not only the toxic substances that directly harm our health but also various carbon emissions and other greenhouse gases, which exacerbate global warming and disrupt the balance of the ecosystem. In our stock market, it is equally important for us to control and minimise "pollutants" in order to maintain a healthy ecosystem, which is essential to the market's sustainable development. Such "pollutants" can exist in different forms of market and corporate misconduct, and they can be highly toxic and detrimental to the market.

Ramp and dump scams

One major pollutant is ramp and dump scams, where fraudsters ramp up share prices by various means and then use social media platforms to lure unwary investors to buy illiquid stocks before dumping them.

Although it is difficult to quantify the true scale and gravity of this problem, the amount of frozen assets involved in ramp and dump cases can provide some insight – about HK$1.8 billion worth of assets have been frozen under restriction notices issued by the SFC since 2020, involving 10 stocks targeted by ramp and dump scams. These assets primarily consist of funds and securities in the fraudsters' accounts, including the sale proceeds from dumping

Note: This is the text of the speech as drafted, which may differ from the delivered version.

stocks to investors. We believe this figure might just be the tip of the iceberg, and actual losses suffered by investors could be much higher.

Our investigations reveal that these scams are highly sophisticated. They are orchestrated by syndicates of fraudsters with clear division of labour. These may include:

(i) an "IPO cornering team" (上市圍飛團隊), responsible for sourcing nominee placees to subscribe for IPO shares and arranging funding for the subscriptions;

(ii) a "market manipulation team" (造市團隊), responsible for creating an illusion of active trading to lure investors and ramping up share prices by controlling the nominees' securities accounts; and

(iii) an "off-loading team" (散貨團隊), responsible for operating social media accounts, including fake accounts with photos of investment experts or KOLs, or WeChat girls to induce investors to buy the stocks from the syndicate at an inflated price and executing the offloading process in an "orderly" manner, until the final dumping of shares.

We have identified a number of common features in the stocks targeted by these ramp and dump syndicates including low trading turnover and small market capitalisation[1], as it is much easier and less costly for the "market manipulation team" to ramp up the prices of these stocks. We also note that a significant portion of these cases involved newly listed stocks, where the "IPO cornering team" started to corner the shares at the IPO stage by arranging nominee placees to subscribe for shares in the placing tranche.

Even though only a minority of small-cap stocks in our market are involved in ramp and dump cases under investigation, these scams have caused substantial financial losses to investors and could also affect investor confidence. As the saying goes, "once bitten, twice shy", or in Chinese "一朝被蛇咬，十年怕井繩". Investors who get burnt once may not return to the market. This, in turn, can hurt market liquidity and valuation, particularly for the small-cap segment.

Structure of our stock market

Market misconduct keeps evolving and appears in different forms over time. Whilst we take a very targeted approach in our enforcement actions, it is equally important to understand the current structure of our stock market.

Over the past 10 years, the total market capitalisation of the Hong Kong stock market has grown by 62%, while the average daily market turnover has more than doubled. The number of listed companies has also grown from about 1,500 to about 2,600[2], turbocharged by fundraising records that put Hong Kong at the top in the world IPO league table[3].

The success in primary listings masks a phenomenon that warrants closer attention. In common with many other markets, secondary market trading and liquidity are skewed towards the largest stocks. The top 250 stocks in market capitalisation account for the predominant share of total market turnover. Though the small-cap stock segment is growing

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[1] before the ramping of these stocks
[2] As at 31 December 2022
[3] Hong Kong has been ranked the number one IPO venue globally (in terms of IPO funds raised) for four of the past 10 years

in terms of number of stocks and market capitalisation, they account for a declining share of market turnover over the last decade.

As at the end of 2022, around 1,100 listed companies or 40% of the total number had a market capitalisation of below HK$500 million. Of these, the great majority had daily turnover of below HK$100,000[4]. This phenomenon gives us food for thought – what are the underlying reasons for this? And what are the implications for our market, our issuers and our investors?

Poor liquidity for small-cap stocks

Low liquidity of small-cap stocks suggests a lack of investor demand. While institutional holdings of small-cap stocks are generally low in Hong Kong and elsewhere, the situation seems more pronounced in Hong Kong. This isn't helped by the fact that participation by retail investors in the stock market has not grown in dollar value in the past decade.

According to the Cash Market Transaction Survey conducted by the Exchange, over the past decade, trading turnover attributable to retail investors[5] has been largely stagnant in terms of dollar value, whilst its contribution to total market turnover decreased from *25.8%* in 2010[6] to *15.5%* in 2020[7]. Based on the latest data obtained from the Hong Kong Investor ID regime launched in March 2023, retail investors seem to contribute about 12% of total market turnover.

Meanwhile, the number of small-cap stock listings has risen sharply in the past decade, resulting in a bigger pool of small caps primarily sharing, and competing for, the same pool of liquidity from retail investors. Their growth during 2015-18 was particularly rapid. There were 290 IPOs[8] of companies with an initial market capitalisation of below HK$500 million, representing about 48% of the total number of IPOs from 2015 to 2018.

Extraordinary growth of small caps during 2015-18

One of the drivers for the extraordinary growth was "shell manufacturing". Some business owners whose firm met the minimum cashflow requirement on GEM or the minimum profit requirement on the Main Board were willing to incur significant listing expenses to get their companies listed. These expenses could amount to more than half of the amount raised from an IPO. After listing, the company sold its business back to the controlling shareholder within a relatively short period to create "a shell."

A new controlling shareholder bought the shell to inject its own business to circumvent new listing requirements, including eligibility, sponsor due diligence and disclosure requirements. This backdoor listing process was often done in multiple steps to avoid being deemed as a new listing under the reverse takeover rules, and they might be structured in different sequences. For example, injection of assets into the shell might be deferred to a later date, and in the interim, it might seek to maintain its listing status by investing in financial assets, including the shares of fellow shell companies.

The incentives for listing were distorted by the value of listed shells during that period. At the peak, shells were reportedly traded at more than half a billion dollars, often more than the

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[4] Based on average daily turnover in 2022
[5] In the survey, retail investors are defined as investors who trade on their personal account
[6] 12 months ended September 2010
[7] 12 months ended December 2020 (the survey period of the last published report)
[8] Of the total, 227 were listed on GEM and 63 on the Main Board)

value of the businesses themselves. This incentivised some people in the market to engage in the so-called “shell manufacturing” business.

The effect of shell activities was more pronounced on the GEM board as it was easier to “manufacture” a GEM shell given its lower entry requirements. As such listings were not driven by investor demand in the first place, naturally trading in these stocks would not be active after listing.

Market misconduct

Shell manufacturing was often associated with a range of market misconduct issues. As these companies might not be very appealing to investors, some bad actors would arrange nominee placees to subscribe for the IPO shares, creating an artificial valuation and spread of shareholders in the company, in order to meet the minimum market capitalisation and number of shareholders at listing.

Moreover, as GEM IPOs were not required to have a public subscription tranche back in those days, the shareholdings were often highly concentrated in the hands of a limited number of shareholders, including suspected nominee placees in some cases. As such, stock prices could be highly volatile and susceptible to market abuse. In 2015 and 2016, the share prices of newly listed GEM stocks increased by about 6 times on average from their IPO price on the first trading day. However, a large majority of these stocks subsequently saw their prices drop below their IPO prices, resulting in substantial losses to investors, especially for those who bought the shares in the secondary market at high prices.

While we fully recognise that the bad actors comprised only a very small part of the market participants, such misconduct has caused substantial losses for investors and harmed the health of our ecosystem. Whatever constraints and rules are put in place, it is impossible to prevent all misconduct. Bad actors will always find a way. And it is important not to try to prevent all possible misconduct because such a regime would likely become a serious impediment for legitimate activities and development. It is therefore a question of balance. The evidence of those years suggested that the balance needed to be adjusted.

Ridding market of bad practices and harm

As my predecessor Ashley Alder had mentioned at the HKSI roundtable before, the SFC formed in 2016 a cross-divisional working group code-named “ICE” which stands for “Intermediaries, Corporate Finance and Enforcement”, combining the expertise from these divisions to develop and implement an organisation-wide strategy to tackle corporate misconduct in a holistic manner.

Let me recap some of the outcome following several years of hard work. A huge amount of work has been done on the policy front through amendments made by HKEX to the Listing Rules to address market quality issues and mitigate the risk of corporate misconduct and market abuse. Some examples are as follows:

- GEM IPOs are now required to include a public tranche to reduce the risk of use of nominees to secure high concentration at IPO;
- The reverse takeover requirements have been tightened to deter backdoor listing. As well, highly dilutive capital raising is made more difficult;

- The initial listing criteria for both the Main Board and GEM have been raised in 2018 and 2022, including the increase in the minimum market capitalisation for the Main Board from HK$200 million to HK$500 million to position it closer to the main overseas markets.

Market surveillance and enforcement actions have been stepped up to focus on ramp and dump cases, and investigation widened to unveil mastermind syndicates, as illustrated in the beginning of this speech. Collaboration with the Independent Commission Against Corruption (ICAC), the Commercial Crime Bureau (CCB) of Hong Kong Police Force as well as overseas regulators have been enhanced to ensure that bad actors have nowhere to hide. Arrests have been made and assets frozen.

Licensed corporations have been reminded of their obligations under the Code of Conduct to report any suspected market misconduct to the SFC immediately, such as nominee placees' account opening. Prompt reporting of suspicious activities is crucial to enable the SFC to investigate and take swift action to contain the damage, for example, by preventing the proceeds of potential crime from being siphoned away.

Following a series of regulatory actions and rule changes, the inexplicable first-day price surge of GEM listings has now become history, and it has become much more difficult and costly for backdoor listings to take place. As a result, demand for shell companies has decreased, leading to a sharp drop in shell prices. Together with the heightened scrutiny by the regulators in vetting listing applications with red flags, this has led to fewer IPOs of companies with shell features. The SFC is also prepared to apply its full regulatory toolkit to reduce the risk that small-cap, illiquid companies can be used to facilitate market misconduct and cause investor harm. There may be more to be done, but the balance has certainly moved towards a fairer and better informed market.

A vibrant small-cap ecosystem

With that episode of distorted incentives firmly behind us, it is time to reset and refocus on attracting quality small-cap companies and achieving sustainable growth of the sector. First, it is useful to consider this in the context of the market forces driving changes in the past decade. The introduction of a number of new chapters in the Listing Rules, tailored for the listing of innovative companies with weighted voting rights, biotech companies and, more recently, specialist technology companies, has resulted in a stock market with more new economy stocks with high growth potential. New economy companies now account for more than one third of our total market capitalisation and more than 40% of our total market turnover, compared to less than 20% five years ago. Hong Kong has also become the largest biotech listing centre in Asia.

We see a clear need to improve the quality of the small-cap stocks on our market to recapture the interests of both institutional and retail investors. It is a challenging task, given the recent history and current macro environment, but our stock market's fundraising function must be revitalised for SMEs. We need to go back to the basics, restore investor confidence and the original intent of a junior board for quality growth enterprises. The Budget included an announcement about the reform of GEM and HKEX will launch a public consultation in the second half.

Any measures taken to revitalise GEM should best be accompanied by a vision and a roadmap to develop a vibrant small-cap ecosystem to support liquidity of small caps in the Main Board market as well. It may also need to address upfront the issue of investor demand

and liquidity, because adding more companies with little investor interest and low liquidity is unlikely to make HK's listing market better.

Market participants, including both the buy side and the sell side, have important roles to play. To develop a critical mass of quality issuers that will restore investor appetite for small caps, intermediaries, in particular sponsors and underwriters, should serve as gatekeepers of quality and help screen out problematic companies with their expertise in due diligence.

Investors, in particular investment managers seeking to deliver superior investment returns for their funds or clients, would follow wherever there are good companies and attractive investment opportunities. Institutional investors' participation would lead to improvements in liquidity and valuation, which in turn attract more quality issuers to list on our market. In addition, they can provide capital to support the growth of SMEs at both the pre-IPO stage and after their listing. Their participation would also drive the demand for research coverage, which is virtually non-existent for the small-cap segment. This would help improve transparency and efficiency in the market.

Last but not least, investor culture has to improve through education. Unwary investors have been lured into the "ramp" stage because they believe in the tips provided by influencers who impersonate well-known stock analysts or by WeChat girls who claim to know somebody in the know. Working closely with our subsidiary, the Investor and Financial Education Council (IFEC), we have been educating retail investors not to blindly follow influencers or hearsay tips in making investment decisions. With the ever-increasing popularity of social media platforms, this task has become even more challenging. Apart from what we have done in the past, we have brought this battle to the social media platforms where fraudsters spread investment tips to lure investors, and we are sharing anti-scam information through these channels. These include the SFC's official Facebook page and WeChat account. We have also conducted an online campaign which simulated the experience of being drawn into social media investment scams.

Conclusion

Ladies and gentlemen, I mentioned earlier that the trading turnover attributable to retail investors has been stagnant over the past decade, while the number of small-cap stocks has grown rapidly. That has contributed to a relatively low level of liquidity for small-cap stocks.

There are various reasons behind this phenomenon, but a key to winning retail investors back is to ensure our listed or to-be-listed small-cap stocks are free from scams and worthy of investment. To this end, it is important for us to continue our efforts to maintain a clean environment to foster investor confidence. We will continue to engage with the industry to explore how we can better support the sustainable development of our market.

Thank you.