

## Corporate conduct – Two years into front-loaded regulation HKIFA 12<sup>th</sup> Annual Conference

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**26 November 2018**

In a speech to the 12th Annual Conference of the Hong Kong Investment Funds Association (HKIFA), Mr Brian Ho reviewed the state of the market nearly two years after the Securities and Futures Commission (SFC) first adopted its “front-loaded” regulatory approach and following a particularly active period of policymaking.

Hong Kong ranked first in initial public offering (IPO) fundraising five times in the past decade and assets under management in Hong Kong had also grown steadily, but there was no room for complacency, Mr Ho said. The SFC worked hard to maintain a market environment conducive to growth and stability, he added, and it aimed to instil confidence that Hong Kong’s markets remained fair, efficient, orderly, transparent and competitive.

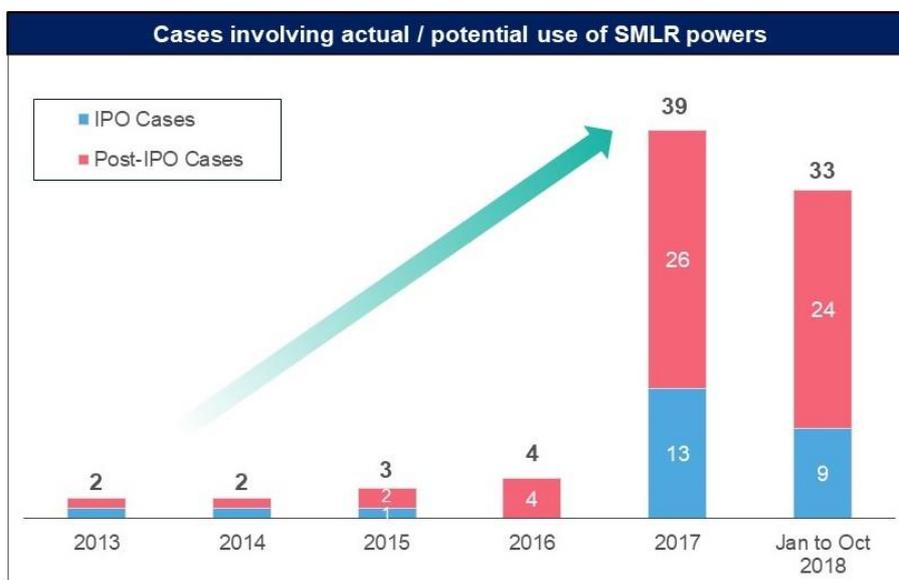
### Overview



Source: Dealogic, HKEX, SFC analysis

In the past, enforcement actions were the SFC’s primary response towards misconduct, Mr Ho continued, but since early 2017, the SFC had used its powers under the Securities and Futures (Stock Market Listing) Rules, or SMLR, to engage in targeted interventions at an early stage to prevent misconduct and harm to investors. These powers include the SFC’s discretion to object to a listing and to require the Stock Exchange of Hong Kong Limited (the Exchange) to suspend or delist a stock.

### Front-loaded action



Source: SFC analysis

*Change in how the SFC uses its SMLR powers since it adopted the “front-loaded” approach*

The majority of the SFC’s direct interventions involved companies which were already listed, Mr Ho said. In a number of cases, a listed company announced a highly dilutive share placement at an unjustifiably large discount when it had no apparent need for additional funding. The size of the issuance often meant that control would effectively be transferred from the existing controllers to a small group of new subscribers. The proceeds were often earmarked for loss-making businesses or assets that would not have made it past the IPO vetting process. Under the SFC’s new approach, it would issue enquiries directly to the company setting out its concerns and requesting an explanation.

In IPOs, the SFC would only intervene in cases involving serious issues within the scope of the Securities and Futures Ordinance (SFO), such as where fraudulent statements in the IPO prospectus were suspected, Mr Ho added.

It was important to note that the SFC’s direct interventions were highly targeted at the most serious forms of misconduct, Mr Ho emphasised. In a majority of the cases where the SFC made direct enquiries under this “front-loaded” approach in 2017, companies were unable to provide a reasonable explanation and the related transactions were either aborted or restructured.

Furthermore, this approach complemented, rather than replaced, the SFC’s traditional enforcement actions. The SFC would continue to investigate wrongdoing and deter misconduct, Mr Ho said.

*Listing policy changes*

The SFC and the Exchange proactively worked together on listing policy changes over the past two to three years, Mr Ho explained, including to tackle a proliferation of shell company-related activities, extreme price swings on GEM and highly dilutive capital raisings.

Policy initiatives to discourage shell-related activities included tightening the listing “suitability” standard, prohibiting “cash companies” and other companies with minimal operations and more efficiently delisting long-suspended companies. The Exchange’s proposal in its consultation on backdoor listings, if adopted, would tighten the existing rules for reverse takeovers to discourage backdoor listing.

**Regulatory initiatives**

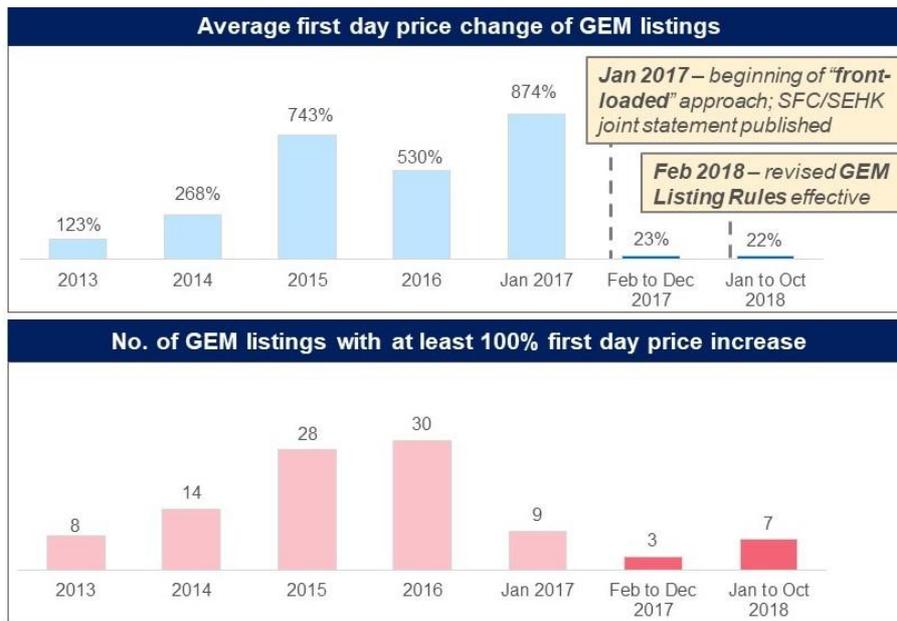


Mr Ho also noted that the impact of the SFC’s new regulatory approach has been evident on GEM. In January 2017, the SFC issued a joint statement with the Exchange on abusive practices in GEM IPOs and how the application of the listing rules would be tightened. At the same time, an SFC circular was issued setting out guidelines for placing agents of GEM IPOs.

In a number of subsequent GEM IPOs, the SFC wrote to sponsors and issuers to examine whether a sufficiently open market, which was a pre-requisite for listing, had been established. This led to a number of GEM IPOs being restructured or withdrawn, Mr Ho noted.

In addition, the SFC and the Exchange conducted a holistic review of the GEM listing regime, including the policy objectives behind setting up GEM and whether those objectives remain relevant in today’s markets. This review led to the introduction of higher eligibility requirements, a mandatory public offer tranche and more stringent vetting for transfers from GEM to the Main Board.

### Effect of combining our regulatory tools on GEM



Source: HKEX, Capital IQ, SFC analysis

*The average first-day price increase for GEM stocks was much less volatile after the SFC’s policy actions*

Next, Mr Ho explained how the SFC distinguished between healthy market risk-taking and harmful speculative activities. The cases that were of concern to the SFC often displayed one or more of the following characteristics: (i) a company’s market capitalisation increased exponentially over an unusually short period of time and traded at an inexplicably high valuation; (ii) a company’s controllers or associates were associated with shell-related activities; (iii) there were indications that the company belonged to or was associated with a network of companies with a complex pattern of cross-holdings; or (iv) there were other indicators pointing to suspected market manipulation.

These cases posed significant potential risks to the stability and orderliness of our markets, Mr Ho pointed out. In some cases, the company’s market capitalisation grew to the extent that its stock was included as an index constituent, forcing more institutional investors to buy it. In other cases, the surging market capitalisation enabled the company to transfer from GEM to the Main Board.

### Stocks with surging market capitalisation



(1) based on month-end market capitalisation  
Source: Bloomberg, SFC analysis

*The number of stocks that surged more than 10 times within a six-month period has fallen noticeably*

Mr Ho pointed to the noticeable decrease in the number of stocks surging more than 10 times as evidence that fewer “new stock bubbles” were being created. Fewer stocks traded at a price-to-sales (P/S) ratio of more than 10 times, but still more than the SFC would like to see. The Hang Seng Index average was closer to 1.5 times. It was fair to say that the SFC’s coordinated policy actions with the Exchange, and its direct interventions, made it more difficult for listed companies to be used as vehicles for improper market activities, he said.

### Stocks with extreme valuations



(1) excluding stocks with Price-to-Earnings (P/E) ratio below 30 or Price-to-Book (P/B) ratio below 2  
Source: Capital IQ, SFC analysis

### *Fewer stocks traded at an extreme P/S ratio*

Noting that the Hong Kong media has used the number of listings by construction companies as a reflection of the overall demand for shell companies, Mr Ho emphasised that many companies from this sector sought listings for genuine reasons and were good candidates for listing. Nonetheless, there was a sudden surge in listings by construction companies between 2016 and 2017. Many of these listed companies changed hands or saw injections of significant new businesses or assets shortly after their IPOs, and these activities were rumoured in the press to be attributable to the prevailing “market price” for a shell.

Mr Ho added that it was difficult to measure shell-related activities in the market, but it did appear that the number of construction sector listings decreased following actions by the SFC and the Exchange to discourage shell-related market activities.

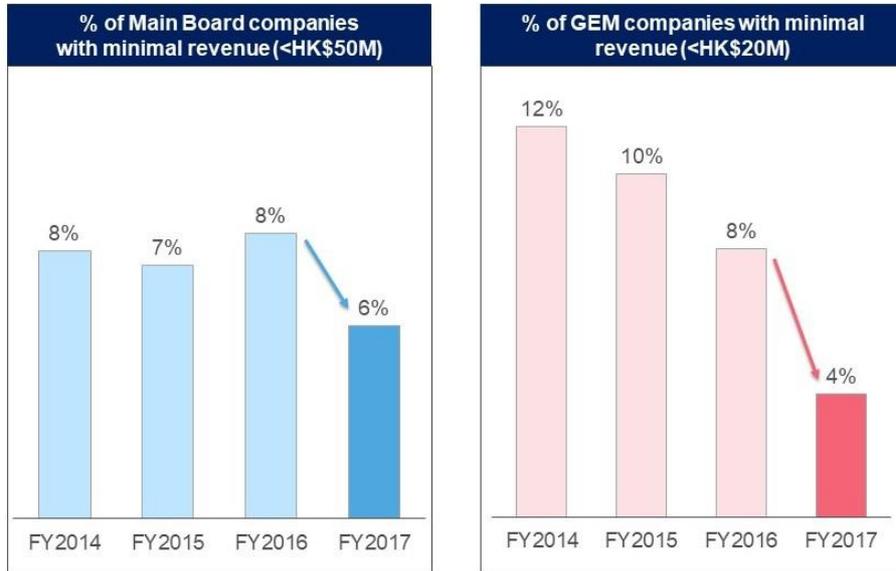
### New listed companies – construction sector



Source: SFC analysis

One policy action to combat shell-related activities was to significantly tighten the practice for listed companies with minimal operations, Mr Ho continued. A few years ago, there was an increase in “cash companies” as well as companies engaged predominantly in small-scale money lending activities. These companies often became “cash companies” after a large portion of their assets were sold, and they would be recycled as “shell companies” for trading. The Exchange issued guidance which effectively disallowed listed companies from converting their business and operations in this manner.

### Companies with minimal revenue

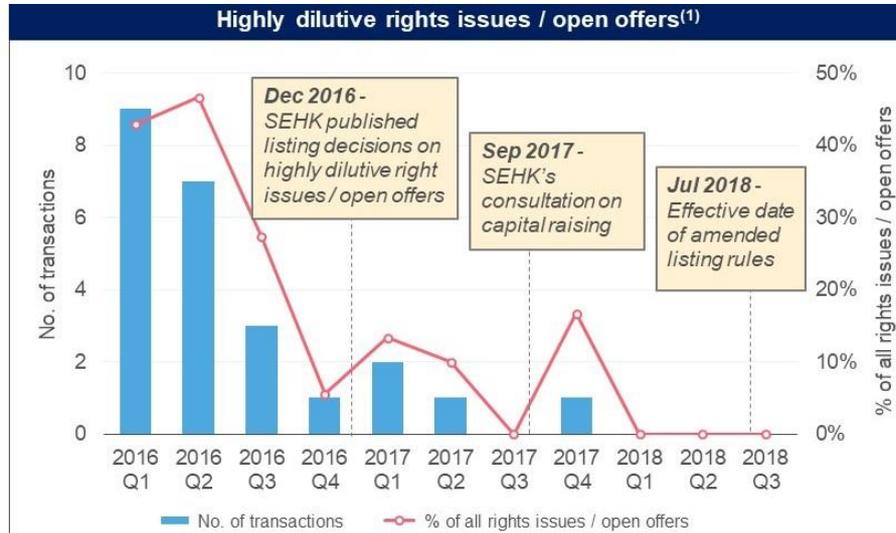


Source: Capital IQ, SFC analysis

*Significantly fewer Main Board and GEM companies had minimal revenue in 2017*

Between 2015 and 2016, Mr Ho saw many highly dilutive rights issues and open offers were structured or conducted in a manner which appeared to be against the interests of minority shareholders, even though they were given the opportunity to buy the offered securities. After more than a year of collaboration with the SFC, the Exchange introduced a series of measures to tackle these types of transactions, and the number of highly dilutive rights issues and open offers dropped substantially since early 2016.

## Rights issues and open offers



- “Highly dilutive” means a value dilution impact which is larger than 25%, calculated by reference to offer size and price discount

(1) Excluding open offers / rights issues involved in restructuring proposals or reverse takeovers  
Source: Dealogic

*The number of highly dilutive rights issues and open offers dropped substantially*

The number of deeply-discounted share placements also decreased, Mr Ho noted. This was one area where the SFC often directly intervened.

## Deeply-discounted share placements



(1) Issuance of new shares for cash  
Source: HKEX, SFC analysis

### Negative research or short seller reports



Source: HKEX, SFC analysis

*The number of companies targeted by short seller reports declined and these reports appear to have less of an impact on stock prices*

The SFC was encouraged by the early signs of improvement over the past 18 months, Mr Ho said. It would continue to closely monitor conduct in the listing market and intervene directly or through policy actions when necessary. In the near term, the SFC intended to step up efforts to combat backdoor listings and to target arrangements which were commonly used for improper purposes, including “warehousing” and highly-concentrated shareholding structures.

Mr Ho concluded by saying that only through the joint efforts of the regulators and market players can markets thrive in a healthy, sustainable manner. The SFC welcomes feedback and ideas from the market and invites the industry to proactively contribute to developing policy initiatives which enhance market quality and investor protection.