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17 Does Hong Kong Need a Second Board?

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I am grateful for this opportunity to address a highly relevant audience on a topical subject: whether the Stock Exchange of Hong Kong should have a Second Board.

By a Second Board, I mean a separate market from the existing (or "Main") Board of the Exchange, specially for smaller, often faster-growing and more "entrepreneurial", companies that have difficulty meeting the full listing requirements of the Main Board.

I propose to review briefly the history of the debate about this question in Hong Kong, to look at the experience of Second Boards in overseas markets, to suggest possible models that could be adopted in Hong Kong and to identify the main considerations which we would need to bear in mind.

History of the Second Board Question in Hong Kong

The idea of setting up a Second Board in Hong Kong is far from new. Shortly after Unification in 1986 of the four previous Stock Exchanges, a working party was commissioned and a report was sent to Government in 1987 recommending the establishment of a "Second Market for Securities". The proposal was modelled on London's then Unlisted Securities Market (USM). Companies would be admitted to the market rather than listed on it. Thus, issuers would not have to prepare a full prospectus but they would have continuing obligations.

The Exchange's existing trading system would be used, with surveillance aimed at preventing market manipulation.

The October 1987 stock market crash occurred shortly after this report was submitted. Attention became focused on the much more fundamental reforms needed to get the main market back on its feet and to repair the damage to the reputation of Hong Kong's regulatory regime. The 1988 report of the Review Committee, chaired by Ian Davison, did touch on the idea of a second board, but found market opinion divided and expressed concern that such a board could become a "second rate" market with poor quality stocks and low standards of disclosure and surveillance. Despite this, another Advisory Group was commissioned in 1990 and supported in principle the establishment of a board for young and growing companies (with a two-year track record, versus the five years then required by the Main Board). However concern was expressed about the likely costs of listing as a proportion of the capital to be raised; further study was proposed to recommend how costs could be cut. Events then overtook the initiative when the Main Board listing rules were extensively revised (the track record requirement being reduced to three years) and the resources of the Exchange became devoted to the higher priority of developing what became the "H" share market for Mainland enterprises.

In 1994, in preparing its strategic plan (entitled The Way Forward), the Exchange conducted a public consultation exercise in the course of which the idea of a Second Board was floated again. The response from practitioners was, frankly, quite lukewarm. This lack of enthusiasm reflected partly, I think, concerns at the time about the quality of a number of third line stocks which had been admitted to the Main Board. However, the Strategic Plan, when it was finally published in early 1995 (just after I became Chairman), did contain a commitment to "review again the desirability and potential market demand for a second board or "Growth Market" for smaller companies with growth potential."

Tentative proposals for a Second Board were again circulated to market practitioners in July 1995 and again drew a response which

would have to be described, at best, as mixed. Certainly it was not felt by the Executive of the Exchange that the market reaction justified giving a high priority to the proposal. However, the concept was kept alive by being included in the brief of the New Market Working Group formed in June 1996, and that is where it presently rests. So far the Working Group has devoted its time to considering mainly the potential for a secondary market trading facility for regional stocks and financial instruments (a different but related idea which is receiving serious attention). However the Secondary Market Survey conducted by the Exchange last year raised again the question of a Second Board and elicited a somewhat more positive response - 42% of the Exchange members, fund managers and custodian banks surveyed supported the idea, though 25% of fund managers still disagreed.

More recently I have received letters from several organisations, including the Federation of Hong Kong Industries, the Hong Kong members of the APEC Business Advisory Council, and the Small and Medium Enterprises Committee, suggesting that some form of special market for small and growing companies should be considered; one suggestion was that this should be modelled on the US NASDAQ.

Thus, despite several initiatives over the past 10 years, based on somewhat varying "Second Board" concepts, we still do not have such a Board and the views of market practitioners still seem to be divided on the desirability of establishing one. However, I believe the time has come where the Exchange should finally either drop the idea or decide to go ahead with it despite the real risk that the new market could fail. And the issue is not only whether we should have a second board but, if we do, what form it should take - what should differentiate it from the Main Board in terms of rules and regulations and what kind of companies it should seek to cater specially for?

Overseas Experience of Second Boards

To have an informed discussion of these issues, we should obviously take a look at experience in other markets. As a generalisation, the

majority of developed overseas stock markets do have more than one listing venue. Within Asia, Singapore's SESDAQ and Kuala Lumpur's Second Board have performed rather well over the last year or two. London's USM was closed down in 1996 but replaced shortly thereafter with the Alternative Investment Market (AIM). This seems to have got off to good start, as has Paris's Nouveau Marché.

Overseas alternative listing venues are of different types. In some cases, the exchange's Main Board is divided into sections for different types of companies. Examples of this are Thailand and Taiwan. In both Singapore and Kuala Lumpur there is a Second Board with different quantitative requirements for listing but it is managed by mainly the same exchange personnel and under similar rules and culture to the main board.

London's AIM is a different model. The UK's former second board (the USM) was run in a similar manner to the main board, being distinguished by its lower listing requirements. When the track record requirements for a main board listing were reduced, the USM declined in importance. When AIM was conceived, every effort was therefore made to develop for it a distinct culture and role. AIM was set up as a subsidiary of the Exchange with its own Chief Executive, its own order-driven trading system (in contrast to the then quote-driven main board), simplified and low-cost rules and nominated advisers to help issuers with compliance and support in post-IPO trading. AIM has now been functioning for just over a year. It has over 200 listings, with a market capitalisation of over US$5 billion and a total turnover in the past year of approximately US$1.6 billion. This is generally considered a very successful start, even allowing for the fact that AIM inherited some USM listings and benefited from some technical measures such as the abolition of former section 4.2 listings on the main exchange.

France has also adopted the approach of a separate market with its own management structure and systems. The Nouveau Marché, launched in 1996, now has 12 listings and a market capitalisation of US$850 million.

The most successful market in the world for smaller or growth companies is undoubtedly NASDAQ in the US, although this could hardly be described as a second board. It was launched in 1971 and now has a market capitalisation of US$1.4 trillion. Daily average turnover, at $12 billion, approaches that of the New York Stock Exchange. NASDAQ is not just a place for smaller companies to list until they qualify for New York's Big Board. It has become a large and rival market. Several major US companies such as Microsoft, as well as international issuers such as Reuters and Volvo, have kept their listings on Nasdaq, although they could easily obtain a New York listing if they chose to.

In Japan there is also a separate market in the form of the OTC Exchange which has enjoyed considerable success in recent years. It has a market capitalisation of $125 billion, 780 listed companies and an average turnover in 1996 of $230 million per day; there were 114 new listings in 1996.

Based on this quick review of overseas experience, I would suggest that there are two possible models for Hong Kong, from the point of view of market structure:

- First, there is the true "Second Board" model - a board with lower and simpler requirements than our existing main board, but otherwise managed in a similar way by the same people, and using our existing (order-driven) trading system. This was the model proposed by the Exchange Working Groups in 1987 and 1990. Its obvious advantage is that it would be a low cost option, requiring relatively little investment to implement.
- Second, there is the separate market model, best exemplified perhaps by London's AIM. This would be separately managed, though still under the control of the Exchange Council. It would have its own CEO and staff, its own marketing function and possibly a different trading mechanism. It would not be a "nursery" for the main board, though transfer from it would be possible. There might be some special ongoing role for the sponsor to the issue.

The second of these approaches is clearly the bolder one. It would involve a significant investment in people and technology which would probably not be recovered for a long time. If the full cost were imposed on users of the new market, it might never take off. The only way of mitigating the cost would appear to be some form of subsidy (such as was in practice given to AIM). If successful, such a new market would probably affect, and might even offer some competition to, the Main Board (I do not, incidentally, regard this as necessarily a bad thing). It would certainly open a new dimension for the Hong Kong capital market.

Issues in the Hong Kong Context

Let me now try to address some of the more particular issues which arise in the Hong Kong context when considering a Second Board.

The first is: what focus should such a board have? What kind of issuers should it aim to attract? One possibility is "high-tech" stocks. I have heard concerns about the decline in Hong Kong's industrial base, coupled with calls for fresh initiatives to develop high-tech industry here, in the way that Singapore has done. I have also heard suggestions that we should concentrate more on encouraging the development of small service industry firms. An obvious target for a second board would be potentially high-growth Mainland-based companies (or Hong Kong companies whose business is on the Mainland), including joint ventures. This could require some quite special rules to cater for circumstances on the Mainland. There is now a substantial volume of money in private equity funds managed from Hong Kong investing in unlisted Mainland companies. A second board in Hong Kong might provide an attractive potential exit for such investors. Another possible focus for second board listings would be companies in the S.E. Asian region who do not have a market at home (e.g. Vietnam or Myanmar), or who have a regional focus, or who are looking for an alternative to their domestic market.

The second issue is regulatory philosophy. This is perhaps the most tricky aspect, and the one which has aroused greatest concern in previous public consultation exercises. By definition, companies listed on a second board will tend to be smaller and riskier than Main Board companies, and they will generally have less resources available for ensuring regulatory compliance. The risk of market manipulation and insider trading is also higher. Even in relation to third-tier stocks on our Main Board, this is seen to be a problem. The concern is that a second board could turn into a casino, with the result that it fails and damages the reputation of the Exchange in the process.

It has to be admitted that this is a difficult concern to dispel. Hong Kong's listing regime does rely quite heavily on self-regulation and on the integrity of listed company managements. There are no statutory penalties for breaches of the listing rules. The enforcement measures available to the regulators are considerably less extensive than in the more mature markets which have second boards. There is thus a real risk that a second board could attract unscrupulous operators. The question is: how could we deal with this? It is theoretically possible to conceive of a second board with lower listing qualifications but a tougher enforcement regime. But I do not see how this could work in practice. I think we just have to take a view as to how likely it is that a second board could degenerate in this way, and weigh this against the extent of the need for such a new market in Hong Kong. Some additional health warnings could be attached to the second board, to try to ensure that investors were made aware of the higher risk involved. It would be vital that there were no misconceptions among investors about the responsibility carried by the SEHK in relation to the behaviour of companies listed in any second board.

One possible alternative would be to go quite consciously to the extreme of having a pure "*caveat emptor*" second market - i.e. the Exchange would not pretend to provide more than a rudimentary regulatory function, and would confine itself to providing a trading facility for such stocks. It would then be left entirely to the market to assess or discover which companies were incompetently managed or

run by crooks. There is a case for this approach, provided the nature of such a market is properly understood and accepted by investors. However, it would be a major departure from the way we operate our main market. And we would need to assess very carefully the potential impact on the reputation of the Exchange, however many health warnings we hung over the door.

The third issue I see is whether any second board should have a different trading mechanism from the Main Board. We have in the past considered the introduction of market makers for smaller stocks or a single-price auction system such as that which is used in some emerging markets. We concluded that this would not be right for our Main Board. However, the answer in relation to a Second Board might well be different. Making a market for a given period of time might also be made one of the obligations of the sponsor of second board issues.

A fourth issue to consider is whether the establishment of a second board should be accompanied by any restructuring of our existing Main Board. Our present "one-size-fits-all" system already encompasses an unusually wide spectrum of companies in terms of size, experience and quality.

Finally, there is the very important question of costs. A second board, by definition, will contribute only a small amount of additional trading, at least in the initial years. The additional costs of a second board for our Exchange could be considerable, especially if a disproportionate amount of regulatory resources has to be directed at it. A second board run on a purely commercial basis would almost certainly not be viable; the costs of issuing would be prohibitive for potential listing candidates. Therefore, if we were to get a second board off the ground in Hong Kong, we would certainly have to subsidise it for a number of years from the other revenues of the SEHK. I do not suggest this is necessarily inappropriate. If there is a genuine market need for a second board, and if the regulatory risks I mentioned can be accepted, then the Exchange should in my view be willing to bear the cost aspect, provided it is not out of all proportion to the benefits.