

Regulation for an Evolving Market Sixth Annual Institute on Corporate & Securities Law in Hong Kong 2018

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17 May 2018

Good morning. Thank you for the introduction.

A key part of what the Securities and Futures Commission (SFC) does is to ensure that our markets operate in an open, competitive, efficient and fair manner. Deciding on the right policy for the listed market and ensuring that the regulatory regime is appropriate for our ever-evolving market is one of the SFC's key objectives.

Today, I would like to give you a snapshot of two different but interconnected policy initiatives for the listed market which are based on this overarching objective. The first is how regulation has evolved in light of market developments, in particular the growth of the technology sector. Regulation plays a key part in ensuring that investors are protected whilst giving the public a wider choice of investment options.

The second is our regulatory approach which aims to improve the quality of our listed market through changing behaviour – and this could mean issuers' behaviour, intermediaries' behaviour or even investors' behaviour. Tackling market misconduct is at the heart of the SFC's role. We have achieved some success with a more front-loaded regulatory approach and I will briefly touch on that later.

How regulation has evolved

Last month, the Stock Exchange of Hong Kong (Exchange) issued conclusions to its consultation on "A Listing Regime for Companies from Emerging and Innovative Sectors". As a result, two chapters were added to the "Red Book". These new rules are significant – not only because they allow companies with weighted voting rights (WVR) structures and pre-revenue biotech companies to list in Hong Kong, but also because they are the first set of rules in Hong Kong and other major markets that seek to regulate WVR. In other words, Hong Kong is the first major jurisdiction to have its own regulations for WVR.

These new rules are also the culmination of discussions which began a few years ago between the Exchange and the SFC on the introduction of a WVR regime. So what prompted these discussions?

Note: This is a drafted version and may differ from the one delivered.



If we look back to the turn of the millennium, in 2001, the top five US listed companies by market cap included General Electric, Exxon, Citibank and Walmart, and Microsoft was the only tech company. In 2016, Microsoft was still on the list, but the others were replaced by Apple, Alphabet, Amazon and Facebook, two of which have a WVR structure. Let's look at some more statistics about China-based tech companies. As at end of last year, eight Chinese tech companies have reached a market cap of US\$10 billion and seven of these are US-listed. These include, for example, Alibaba, Baidu and JD.com. Out of these seven issuers, five have a WVR structure. The remaining Chinese tech company which is listed in Hong Kong is, of course, Tencent. The introduction of a WVR regime in Hong Kong therefore reflects the growing importance of the technology and other innovative sectors to our securities markets, their business need for WVR and our mandate to ensure that Hong Kong remains competitive amongst other securities markets.

While we need to foster a capital market which caters for a wider range of issuers and provides more choice for our investors, it is equally important that we focus on safeguarding the interests of the investing public. Balancing these two objectives which sometimes pull us in different directions is not an easy task. That's why we and the Exchange worked diligently over the past few years to come up with a set of rules to address business needs whilst imposing investor protection standards.

I am not going to go into every feature of the new rules today – I am sure your clients have asked many of you to explain these already so you must be familiar with them by now! What I want to share with you instead are a few highlights from a regulator's point of view.

WVR

First on WVR. I was told that almost all of you here today are lawyers. So you should all know that WVR is a departure from the long-standing principle of One Share One Vote, which is a standard of good corporate governance.

Given that WVR represents a dilution of One Share One Vote, it is important to come up with a set of ring-fencing measures so that WVR does not become commonplace in our market. In other words, WVR should be the exception rather than the norm. To achieve this, the new regime included filters such as a minimum market cap, a requirement that the issuer must be innovative in nature and that only founders who are able to demonstrate indispensable contribution are entitled to WVR. Let's take a look at some of these requirements.

Imposing a minimum market cap requirement means that only sizeable companies are allowed. Whilst size is not an indicator of quality, this requirement is intended to limit applicants to established companies that have already received a meaningful investment from sophisticated investors.

Now let's consider the question – what is an innovative company? The consultation conclusions provided some descriptions such as “research and development being a significant contributor of its expected value”. Innovation is a fluid concept that changes over time.

Some of you who are around 20 years ago might have remembered a global wave of new listings which we call the “dot com” boom. “New-media and internet portals” (in other words, websites) were the hottest things in town and their IPOs easily were oversubscribed by hundreds of times. Snaking queues of investors who yearned for a white form would appear at the receiving banks' branches before the banks opened. Were these companies



innovative at the time? Probably. No one had listed websites in Hong Kong before. Would it be innovative now?

The point is, what is innovative today might not be so tomorrow. A bright line test is therefore not applicable. Determining what is innovative relies on the application of a set of standards which inevitably involves a degree of subjectivity, a comment also raised by some investors during the market consultation. However, I believe that the SFC and the Exchange would be prudent to apply these standards and be as objective as possible to avoid arbitrary outcomes in regulation.

Biotech

Next on biotech. Not many of you are scientists, I suppose. But it does not take a molecular biologist to tell us that, if a company is still developing a pharmaceutical product which has not gone through the necessary regulatory approval and it is now seeking a listing, this presents heightened risks for the public. There is no track record to serve as a benchmark. And investors can't rely on the traditional methods of valuation like price-to-earnings or price-to-revenue ratios to value the worth of a company.

On top of this, we worry that if a product fails to make it through the regulatory process, the company could become an easy target for backdoor listing and shell activities, which I will touch on later. Therefore, the biotech regime includes rules that aim to prevent this from happening. These include an expedited delisting procedure, a prohibition on a material change in business and enhanced disclosure requirements. There are other requirements too, such as a minimum market capitalisation, a public float and higher working capital. They all aim to raise the bar so that we could see good quality biotech listings.

Corporate behaviour

Let's now turn to something more local. I want to talk about how regulation can hopefully change corporate behaviour so that we have a better quality market in Hong Kong.

Look up the term "con stock" or "老千股" and you will find hundreds or thousands of entries, some containing lists of stock codes of "untouchable" stocks, and others describing how controllers of listed companies were able to make money through "deceiving" public investors.

Many of you would have read about or heard of networks of companies which use cross holdings of assets and shares to try to create higher valuations for the listed companies within the network. Undeniably, there are companies or persons who engage in misbehaviour at the expense of public shareholders. Misconduct is like a disease that spreads, and Hong Kong's market will be further contaminated. This can only have a negative impact on the reputation of our market.

In circumstances where misconduct has been identified or suspected, we will have to use our enforcement tools. However, enforcement comes at a later stage where losses could have already been incurred, and it could take a long time for the wrong to be redressed. It is particularly important that our rules and regulations prevent misconduct and change corporate behaviour, and also that the rules create sufficient disincentives for corporate misbehaviour.



Let me give you two examples of how corporate conduct has changed for the better through regulatory intervention.

GEM companies

The first is our approach to GEM companies. Three years ago, newly listed GEM stocks exhibited a high degree of volatility as shown by their first-day price increase. In 2015, the average first-day price increase was seven times, with the most extreme being an increase of more than 20 times. Many new GEM listings had highly concentrated shareholdings and a small shareholder base. Shares were placed in small quantities (usually one or two board lots) to most of these places in order to meet the minimum requirement under the Listing Rules. In addition, the same places were seen in otherwise unconnected GEM initial public offerings (IPOs). These market practices may not be conducive to the development of an orderly, informed and efficient market for securities.

This prompted the SFC, together with the Exchange, to issue a joint statement regarding the price volatility of GEM stocks in January 2017. On the same day, the SFC issued guidance to sponsors, underwriters and placing agents on the standards of conduct that are expected of them in the listing and placing of GEM IPO stocks. We specifically explained what we expect of them in terms of ensuring an adequate spread of shareholders at listing. Subsequently, we saw substantially less volatility – first-day price increases averaged only 23% between February and December 2017, when all GEM IPOs included a public offer tranche and shareholding was less concentrated.

Around this time, the Exchange and the SFC also conducted a review of GEM listings which led to a consultation proposing tighter eligibility requirements for GEM listings. This consultation was concluded in December 2017 and most of the proposals were adopted.

Capital raising

The other example would be the policy changes made in respect of highly dilutive capital raisings, which have been more frequent in recent years. The typical patterns of problematic behaviour can be seen in transactions involving securities issuance, such as deeply discounted fund raisings, share consolidations and subdivisions. These transactions materially dilute the voting rights and value of public shareholders' investments, and some result in a transfer of value to the new subscribers.

In some cases, we have also seen an increase in share price volatility. There are cases of so-called "downward share price manipulation" where insiders were suspected of selling shares on the market and then subscribing for new shares at very low prices. Transactions such as these often lacked a commercial rationale, raising questions about whether they really benefit the company and its shareholders.

These concerns led to the publication of the Exchange's consultation paper on "Capital Raisings by Issuers" in September 2017, which proposed to ban highly dilutive rights issues and open offers altogether and impose conditions on underwriting. The market supported the changes. This was concluded a week ago and all the proposals were adopted.

Shell companies

This leaves the difficult issue of backdoor listing and shell activities. At our Regulatory Forum in March this year, we spent quite some time discussing this during a panel which Teresa



moderated. A summary of discussions is available on our website so please take a look. I will not repeat what was discussed in detail. But I do want to share with you some statistics.

Consider that 45% of new listing applicants in 2017 recorded declining profits in the financial year immediately before listing, while only 10% did in 2007. Also consider the number of construction companies being listed; there were 38 in 2017, but only one in 2007. Of the 61 construction companies listed between 2013 and 2016, 30% already underwent a change of control or of their major shareholders. Do these numbers tell us something about the incentive for seeking a listing? Are companies trying to list now because of the so-called “shell value”?

In order to understand why listed shells exist and why a listing status is valuable, we need to look into the phenomenon of backdoor listing. In a backdoor listing, the requirements for a new listing are circumvented and assets are injected into a listed company without going through proper sponsor due diligence and the appropriate vetting process. Usually, very limited disclosure is made about the new business. This often leaves public shareholders in the dark as to the company’s true intentions, strategy and future prospects.

In my view, the reason why backdoor listings are difficult to tackle is because our rules were drawn up at a time when market conditions were quite different. We are now working with the Exchange to come up with a regulatory response which deals with the reality we are facing now.

Front-loaded regulation

On a final note, I want to touch briefly on the front-loaded approach which the SFC has implemented over the past two years. For those of you who are not familiar with it, the SFC’s front-loaded regulatory approach emphasises earlier and more targeted intervention, with an aim to deliver a faster response and maximise the impact of our actions.

We have usually adopted this front-loaded approach in dealing with post-IPO transactions, but recently we stepped up our front-loaded approach to IPO cases. This approach is premised on the Securities and Futures (Stock Market Listing) Rules, or SMLR. In particular, Section 6 of the SMLR gives us the power to object to a listing application and Section 8 gives us the power to direct a trading suspension.

In 2017, the number of cases involving the potential or actual exercise of SMLR powers increased substantially to around 40 from only two or three cases per year in the past. The use of our statutory powers is combined with investigation and other enforcement tools. Some of you might have heard of or received our investigatory section 179 enquiries or letters of concern relating to your client’s proposed transactions. These all form part of our approach to intervene appropriately at an earlier stage.

This means that issuers, sponsors and other parties involved in an IPO process can be investigated at the application stage where we have grounds to suspect that the SMLR provisions are triggered. There will be enforcement consequences if breaches of the SFO are identified, irrespective of whether the listing application is withdrawn.



Conclusion

So what does this all mean? Let me attempt to pull these strands together.

Good regulation should provide an appropriate framework within which companies conduct their business, whilst at the same time cater for public interests. That is the reason why regulation must keep up with market developments and business needs.

On the other hand, regulation should provide the correct incentives and drive corporate behaviour to foster a better market. Regulatory approaches should not stand still. Whereas the regulators design the framework, we need your cooperation and feedback. Most important of all, we need to see a good compliance culture amongst everyone involved in the listing process.

A quality market benefits all of us. I hope what I have said today helps make it clear that regulation is not a roadblock – it is a tool to create a better market.

Thank you.