

## Recent Trends in Corporate Conduct – An SFC Angle Presentation at Companies Registry Corporate Governance Roundtable

Mr Brian Ho, Corporate Finance Division  
Executive Director

13 March 2017

During a panel discussion entitled “Update on Corporate Governance Reforms” at the Companies Registry’s Corporate Governance Roundtable, the SFC’s Executive Director of Corporate Finance Mr Brian Ho gave a presentation on recent SFC initiatives to improve market quality and preserve Hong Kong’s competitiveness as a listing venue.

Mr Ho began by noting that Hong Kong was the leading centre for raising initial public offering (IPO) equity funds in 2016, when US\$25 billion was raised through 126 new listings, of which 81 were on the Main Board and 45 on the Growth Enterprise Market (GEM).

He added that in the past few years, the SFC has noted an increase in complaints against listed companies exhibiting patterns of problematic behaviour, such as deep-discounted, highly dilutive rights issues, placings and over-valued acquisitions. Although the majority of our listed companies are not involved in this behaviour, the SFC, as a market regulator, is obliged to be quick to identify and deal with problems before they become widespread, he added.

Consequently, the SFC has been working on a number of fronts to address these issues, Mr Ho explained. Together with The Stock Exchange of Hong Kong Limited (the Exchange), the SFC issued a joint statement on the price volatility of GEM IPOs in January 2017 as well as a joint statement on two listing decisions on highly dilutive rights issues and open offers in December 2016. In addition, the SFC continues to work with the Exchange on initiatives to address backdoor listings and “shell” activities.

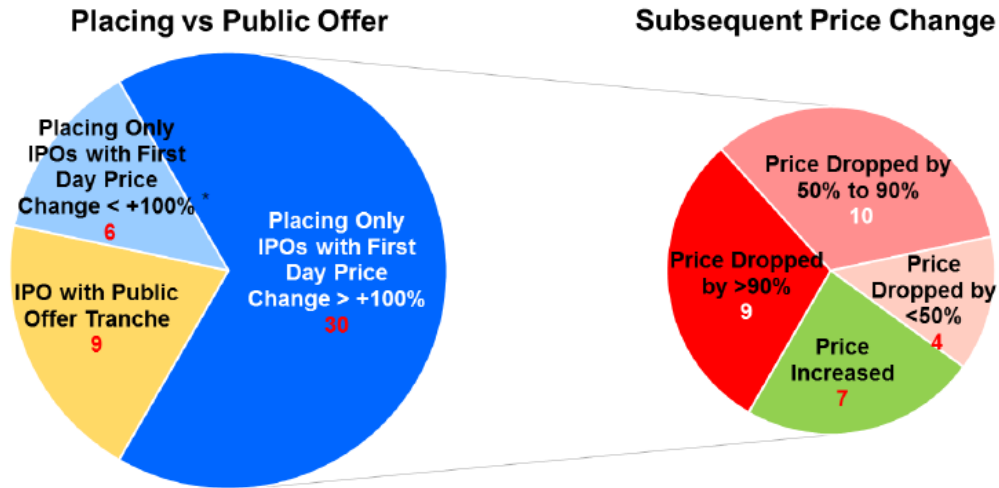
### **GEM**

Many new GEM listings have exhibited unusual price volatility and there are concerns that certain market practices may not enable an orderly, informed and efficient market for securities to develop, Mr Ho continued. For example, many new GEM listings exhibited highly concentrated shareholdings and a small shareholder base. Shares were placed in small quantities (usually one or two board lots) to a significant number of placees in order to meet the minimum requirement under the Listing Rules. In addition, repeated placees were seen in otherwise unconnected GEM IPOs.

Mr Ho cited some statistics which illustrate the share-price volatility in newly listed GEM stocks. In 2016, the average first-day price increase (when compared with the initial offer price) was 530%, with the most extreme being an increase of 20 times. Thirty-six out of 45 listings were placing-only. Amongst these, 30 saw a price increase of 100% or more at the end of the first day trading. The share price of nine out of these 30 stocks subsequently dropped by more than 90% and 10 experienced a price drop by 50%-90%.

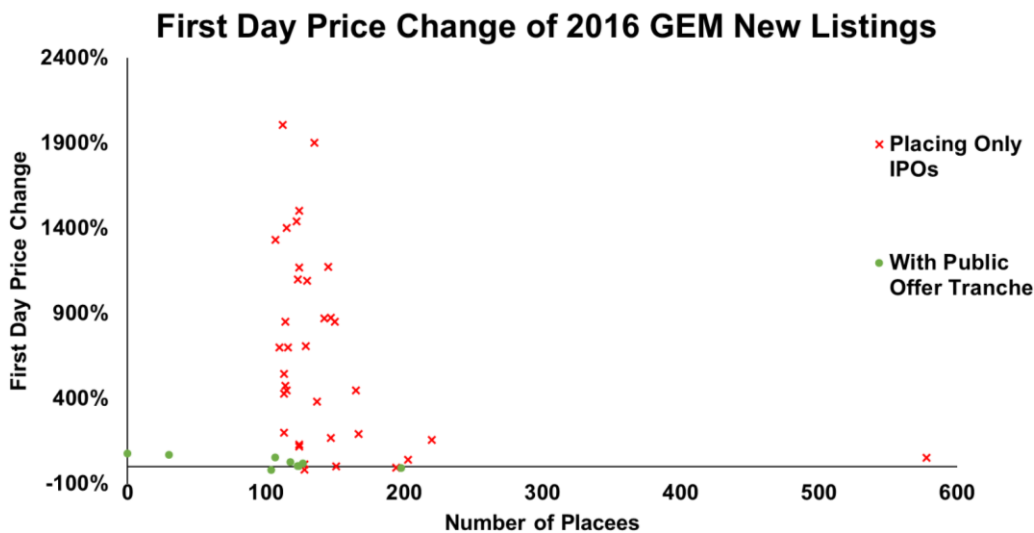


## 2016 GEM IPOs Price Change from First Day to 31 Jan 2017



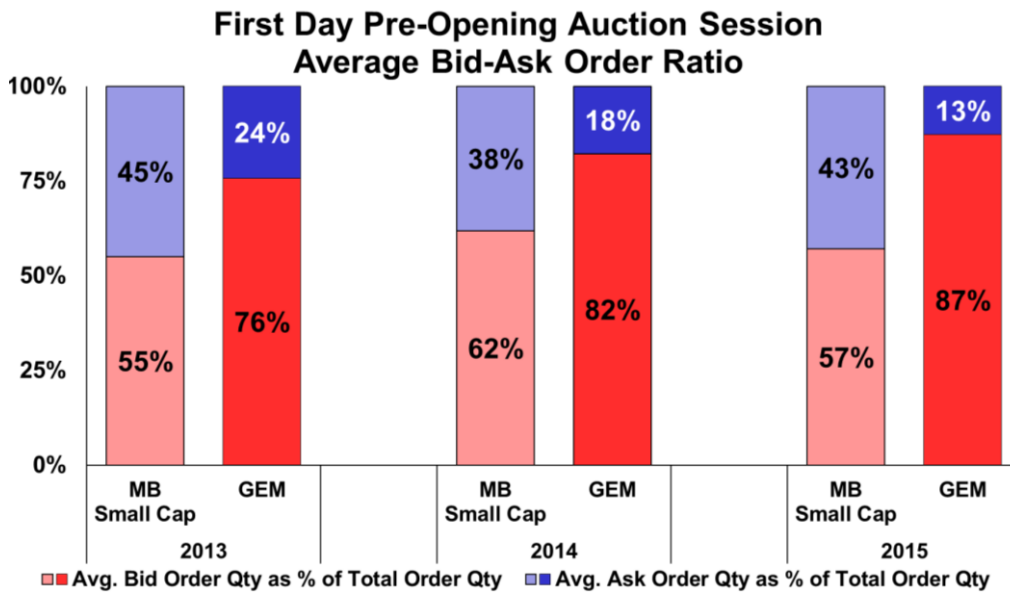
\*Including two stocks with price drops of 8% and 19%.

In contrast, Mr Ho noted, where a GEM listing involved a public offer tranche, the average first-day price increase was only 22%. Also, for these IPOs, there were over 2,500 public shareholders on average, a stark contrast to the placing-only IPOs with an average of only 100-200.

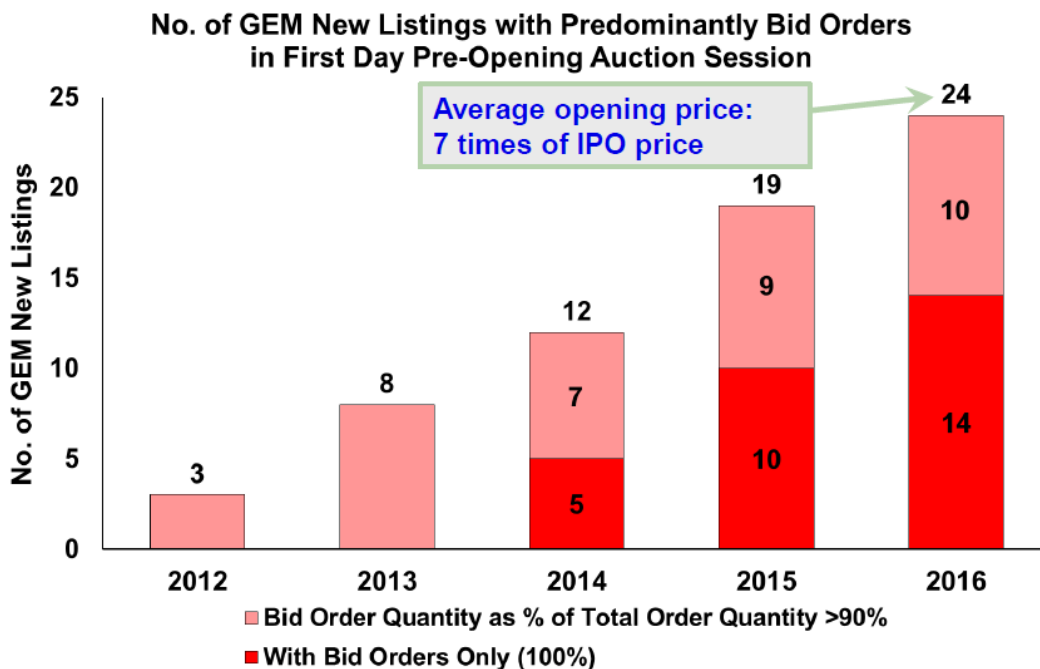


These observations show a correlation between the method of listing and price volatility, Mr Ho explained. It is apparent that new listings with a public offer tranche experienced less share-price volatility when compared with their placing-only counterparts. Moreover, the substantial price increase and subsequent decrease for placing-only GEM stocks could be indicative of potential regulatory concerns.

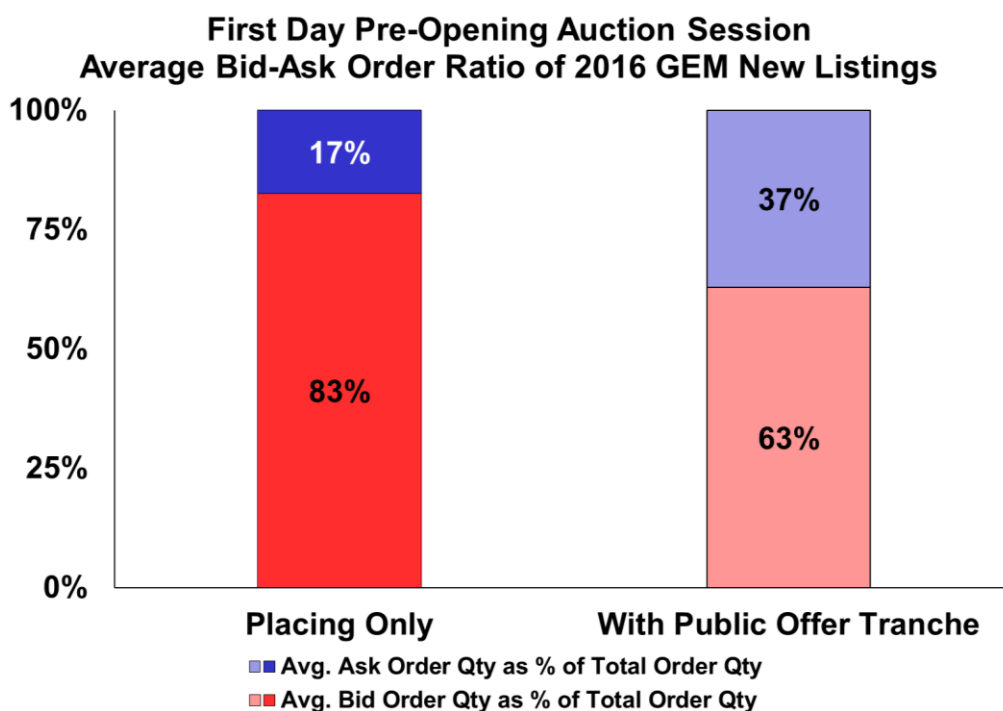
The SFC studied the bid and ask orders at the pre-opening sessions in recent years and observed that, as compared with the Main Board, orders for GEM listings were predominantly bid orders, indicating a significant imbalance between supply and demand, Mr Ho stated.



For example, of the 45 GEM listings in 2016, 14 had bid orders only but nil sell orders, whilst another 10 had bid orders accounting for 90% of the total orders in the pre-opening session. The average opening price of these 24 stocks was seven times their IPO prices, and all of them were listed by way of placing only. This demand and supply imbalance had increased since 2013, Mr Ho added.



However, he noted that separating the 2016 data into placing-only GEM IPOs and those with a public tranche, it became clear that those with a public offer tranche did not experience a similar imbalance of supply and demand.



Looking at the most extreme cases of order imbalance, Mr Ho noted that very few investors sold their stocks despite multifold gains. In a typical IPO, no new material information is released after the issuance of prospectus, ie, between the IPO book-building process and the listing date. The IPO book-building process is supposed to be an effective price discovery mechanism in order for a fair price to be fixed. This raises a number of questions, including why there would be such significant price differential between the offer price and the first-day opening price, whether there was something wrong in the book-building process and why there were so few willing sellers despite multifold gains. Setting aside any possible market misconduct, all these lead to the question of whether there is a structural issue in the placing-only offer mechanism as a method of listing.

Against this background, the SFC, together with the Exchange, issued a joint statement regarding the price volatility of stocks listed on GEM on 20 January 2017. On the same day, the SFC issued a guideline to provide guidance to sponsors, underwriters and placing agents on the standards of conduct that is expected of them in the listing and placing of GEM initial public offering stocks. And today, 13 March 2017, the SFC will issue a Statement in relation to recent GEM applicants.

### **Highly Dilutive Rights Issues and Open Offers**

On another issue which raises regulatory concerns, Mr Ho continued, a joint statement on highly dilutive rights issues and open offers was issued by the SFC and the Exchange in December 2016. Two listing decisions (HKEX-LD102-2016 and HKEX-LD103-2016) were also issued. The SFC, together with the Exchange, had been closely monitoring rights issues and open offers that substantially dilute the interests of non-subscribing minority shareholders.

Mr Ho related the SFC's concerns that in some cases, these fundraisings were not conducted in a manner that affords fair and equal treatment to all shareholders. These corporate actions, absent any demonstrable commercial rationale, cast doubt on whether the



directors of the listed companies have complied with the requirement to act in the best interests of shareholders. The SFC and the Exchange will continue to closely monitor such corporate conduct, he said.

### **Backdoor listings**

Mr Ho also outlined the SFC's concerns about backdoor listing – a means to circumvent the requirements for IPO applicants and avoid the IPO vetting process. The result is that due diligence which is normally undertaken by sponsors is lacking, thereby calling into question how much meaningful information is given to the public about the quality of the assets or businesses being acquired. In cases where the acquisition does not constitute a very substantial acquisition, disclosure is expected to be much more limited when compared with that of an IPO, Mr Ho pointed out. This gives rise to concerns about whether a fair and orderly market exists for all investors and whether it is in the interests of the investing public that these transactions should be allowed. In the SFC's view, a principles-based anti-avoidance approach works best to prevent backdoor listing transactions which circumvent the IPO requirements. This allows regulators to assess transactions using a purposive approach to interpret any rules or regulations, Mr Ho concluded.

### **Shell manufacturing activities and shell trading**

Pointing out that the number of takeovers cases handled by the SFC increased by about 40% over the past two years, Mr Ho stated that the rumoured "shell value" for both Main Board and GEM companies was reflected in the valuation of some takeovers transactions reviewed in 2016. However, a small number of takeovers cases were conducted at an apparently low valuation despite the rumoured shell value. This has led the SFC to look into any potential undisclosed transactions which could involve a transfer of value to certain stakeholders, and any suspected breaches of the Takeovers Code will be investigated as appropriate, he stated.

### **Conclusion**

Mr Ho wrapped up his presentation by saying that the SFC as a securities market regulator has a duty to uphold the quality and reputation of our market, and is obliged to ensure that conditions exist for its sustainable development, whilst having regard to preserving Hong Kong's competitiveness as a listing venue and reputation as an international finance centre.

A quality market is defined not only by the amount of funds raised but it is also about gaining investor trust and confidence. As such, he added, issues such as those discussed in the presentation could undermine a quality market. And whilst effective regulatory enforcement is important, it is also essential that a culture of robust corporate governance is developed to safeguard the interests of the investing public. This involves not only market regulators but is also reliant on the joint efforts of all market participants such as listing applicants, listed companies and intermediaries, Mr Ho concluded.