



Hong Kong

June 2021

## SFC AND HKEX ISSUE JOINT STATEMENT ON IPO-RELATED MISCONDUCT

On 20 May 2021, the Securities and Futures Commission (**SFC**) and the Stock Exchange of Hong Kong Limited (**HKEX**) issued their joint statement on IPO-related misconduct<sup>1</sup> setting out issues detected in recent new listings and the regulators' proposed approach to dealing with them. These issues mainly involve arrangements to artificially satisfy the initial listing requirements under the HKEX's Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong (**HKEX Listing Rules**) or facilitate market manipulation of the shares after the initial public offerings (**IPOs**).

Simultaneously with the joint statement, the HKEX published its Consultation Conclusions on the Main Board Profit Requirement<sup>2</sup> setting out its decision to increase the amount of profit required of new listing applicants by 60% to HK\$80 million over three financial years (with profit of HK\$35 million in the most recent year and an aggregate of HK\$45 million for the two preceding years) from 1 January 2022. The increase in the profit requirement is aimed at combatting misconduct observed by the regulators following the 2018 increase in the market capitalisation requirement for profit test listing applicants to HK\$500 million. For listing applicants which only just met the minimum thresholds, the 2018 increase effectively increased their implied historical price-to-earnings (**P/E**) ratio from 10 to 25. According to the HKEX, this led to a surge in the number of listing applicants which only just met

the profit threshold and only satisfied the market capitalisation requirement with very high historical P/E ratios. These listing applicants typically justified their high valuations by reference to potential growth which they supported with profit forecasts, but many of them failed to meet their profit forecasts and/or experienced falls in their share prices and market capitalisation post-listing. This gave rise to concerns on the part of the regulators that listing applicants' valuations were artificially inflated to meet the market capitalisation requirement. Please see Charltons' newsletter "HKEX to Raise Main Board Profit Requirement from 1 January 2022"<sup>3</sup> for further details.

### HKEX IPOs – Regulators' Concerns

#### Hong Kong "ramp-and-dump" schemes

The SFC and HKEX have observed an increasing number of "ramp-and-dump" schemes in recent IPOs, particularly in IPOs of companies with smaller market capitalisations. Ramp-and-dump schemes are a form of market manipulation often conducted via social media where fraudsters use various methods to inflate the share price to induce investors to buy the shares and subsequently dump the shares at an artificially high price before the share price eventually drops far below its IPO price.

The Hong Kong regulators suspect that some of these schemes were initiated at the IPO stage with a view to manipulating the

1 SFC/HKEX. Joint statement on IPO-related misconduct. 20 May 2021. Available at: [https://www.sfc.hk/-/media/EN/files/COM/Statements/SFC-HKEX\\_Joint-Statement\\_EN.pdf](https://www.sfc.hk/-/media/EN/files/COM/Statements/SFC-HKEX_Joint-Statement_EN.pdf)

2 HKEX. Consultation Conclusions on The Main Board Profit Requirement. May 2021. Available at: [https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Conclusions-\(May-2021\)/cp202011cc.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Conclusions-(May-2021)/cp202011cc.pdf?la=en)

3 Charltons' newsletter. HKEX to Raise Main Board Profit Requirement from 1 January 2022. Available at: <https://www.charltonslaw.com/hkex-to-raise-main-board-profit-requirement-from-1-january-2022/>

share price later. Shares are often allocated in the placing tranche to controlled accounts funded by unusually high underwriting commissions or other listing expenses. After an initial rise in the share price after listing, the share price often dropped significantly.

The SFC notes that the placing tranche is also used to allocate IPO shares to controlled placees in order to artificially meet the HKEX listing requirements or to corner the shares to facilitate market manipulation post listing. It also points to the lack of a robust and transparent share placement and price discovery process as contributing to the difficulty in identifying suspicious cases.

## HKEX IPOs – Unusually high underwriting commissions

The SFC observes that the payment of unusually high underwriting commissions was often a feature of problematic IPOs in the last two years. The average underwriting commission rate for IPOs with a market capitalisation of less than HK\$600 million reportedly rose to 12% in 2020 from around 4% in 2017. The SFC suspects that high underwriting commissions were used to fund arrangements aimed at satisfying the HKEX's Listing Rule requirements (including the minimum market capitalisation, sufficient investor interest and adequate spread of shareholders requirements) or perpetrating ramp-and-dump schemes. Commissions may, for example, have been used to fund rebates paid to controlled placees for having subscribed for shares at an inflated price. Listing applicants' payment of substantial amounts of additional "discretionary" listing expenses after listing is also highlighted as suspicious.

## Features of Problematic IPOs and Heightened Scrutiny of HKEX Listing Applications

The SFC and HKEX will make enquiries to ascertain whether there is sufficient genuine investor interest in a listing applicant's shares and an adequate spread of shareholders if the listing applicant displays one or more of the following non-exhaustive features:

- The applicant's market capitalisation barely meets the minimum requirement under the HKEX Listing Rules.<sup>4</sup>
- A very high P/E ratio taking into account the applicant's fundamentals (including its profit forecast) and the valuations of its peers.

<sup>4</sup> Main Board Listing Rule 8.09(2) requires the expected market capitalisation of a new listing applicant at the time of listing to be at least HK\$500 million. GEM Rule 11.23(6) requires the expected total market capitalisation of a GEM applicant to be at least HK\$150 million.

- Unusually high underwriting or placing commissions or other listing expenses.
- Highly concentrated shareholders, particularly where the value of the public float is small and the spread of shareholders barely meets the minimum thresholds under the HKEX Listing Rules.<sup>5</sup>

The SFC and HKEX may request a listing applicant to provide evidence to demonstrate genuine investor demand and the reasonableness of the expected valuation. Listing applicants may also be required to demonstrate that the IPO price has been or will be determined through a robust and transparent price discovery process. Where there are unusually high underwriting commissions or other listing expenses or material amounts of discretionary expenses, applicants should be prepared to provide details of those expenses in the listing document.

## HKEX and SFC Regulatory Powers

### Power to object to a new listing

The HKEX may reject a listing application where:

- questions raised regarding the share placement and price discovery process are not satisfactorily answered;
- the applicant does not meet the basic conditions for listing, including the requirements for sufficient public interest in the applicant and its shares, an open market in the shares and an adequate spread of shareholders;
- the HKEX considers the applicant and its business to be unsuitable for listing. The grounds on which an applicant may be considered unsuitable for listing include concern that the applicant is listing as a potential shell (as elaborated on in the HKEX's Guidance Letter 68-13A<sup>6</sup> on IPO vetting and suitability for listing).

The SFC can object to a listing application under section 6(2) of the Securities and Futures (Stock Market Listing) Rules (**SMLR**) if it considers that the application does not comply with the HKEX Listing Rules or that the listing would not be in the interest of the investing public or the public interest. According to the joint statement on IPO-related misconduct, the SFC can object on the

<sup>5</sup> These are: (a) Main Board Rule 8.08(2) (at least 300 shareholders); (b) Main Board Rule 8.08(3) (not more than 50% of the securities in public hands at the time of listing beneficially owned by the three largest public shareholders); and (c) Appendix 6 to the Main Board Listing Rules (at least 100 placees)

<sup>6</sup> HKEX. HKEX GL68-13A. Available at [https://en-rules.hkex.com.hk/sites/default/files/net\\_file\\_store/gl6813a.pdf](https://en-rules.hkex.com.hk/sites/default/files/net_file_store/gl6813a.pdf)

basis of the “public interest or interest of the investing public” ground where it appears to the SFC that:

- conditions do not exist for the development of an orderly and fair market in the listing applicant’s shares on listing, having regard to: the background and number of the investors who have indicated an interest in the shares, the pattern of distribution of the shares and the number of shareholders on listing; or
- the listing applicant’s structure, financial condition, governance arrangements, board or management may not be appropriate for it to be listed on the HKEX. Examples of relevant circumstances include where the applicant’s board or management is found to have been involved in a ramp-and-dump scheme or a scheme intended to mislead the regulators or the investing public, or to circumvent the HKEX Listing Rules.

## Suspension of dealings in HKEX-listed shares

The SFC and HKEX will investigate and take appropriate regulatory action against relevant parties if:

- there are unusual movements in the share price or trading volume;
- there is a high concentration of shareholdings after listing;
- it appears that a listing document may have included false, incomplete or misleading information; or
- there is evidence of other misconduct.

Where there is evidence that at the time of listing a significant number of placees were not genuine investors and there was not sufficient genuine investor interest in the shares, the SFC may exercise its power under section 8(1) of the SMLR to direct the HKEX to suspend trading of a listed company’s shares.

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