



Hong Kong Needs a Vibrant SME Fundraising Board, says SFC's Julia Leung

Speaking about a "[Sustainable and Healthy Ecosystem for the Small-cap Stock Segment of Hong Kong Market](#)",¹ SFC Chief Executive Officer, Ms. Julia Leung, emphasised the need for Hong Kong to develop a sustainable small-cap stock market to meet the needs of small and medium-sized enterprises (**SMEs**) and investors. Noting the commitment in this year's [Budget](#) to put forward reform recommendations for GEM this year² to address the funding needs of SMEs and start-ups, Ms Leung expressed the need for Hong Kong to "*restore investor confidence and the original intent of a junior board for quality growth enterprises*".

Tackling Market Misconduct in the Hong Kong Market

Ms Leung noted the damage that market misconduct can have on investor confidence, pointing in particular to "ramp and dump scams" where fraudsters ramp up share prices and entice unwary investors via social media to invest in illiquid stocks before dumping the stock. The SFC froze assets worth around HK\$0.9 billion in ramp and dump scams in the period starting January 2020 and ending in December 2022.³ Its investigations found the schemes to be highly sophisticated and orchestrated.

Although only a small number of small-cap stocks are involved, ramp and dump schemes cause significant losses for the investors involved and undermine investor confidence in the Hong Kong market, adversely affecting the liquidity and valuation of small-cap companies.

Lack of Liquidity in Hong Kong Small-Cap Stocks

The Hong Kong stock market's total market capitalisation grew 62% over the past decade, while the average daily market turnover more than doubled.⁴ The number of listed companies rose to about 2,600 from 1,500,⁵ while record fundraising positioned the HKEX at the top of global IPO fundraising rankings with the HKEX ranking as the world's largest IPO fund-raising market for four of the past 10 years.

However, despite the HKEX's success in attracting primary listings, secondary market trading and liquidity remains concentrated among the top 250 stocks by market capitalisation. Despite growth in the small-cap stock segment in terms of the number of stocks and market capitalisation, their share of market turnover declined over the past decade. As of the end of 2022, approximately 1,100 listed companies, accounting for 40% of the total, had a market capitalisation of less than HK\$500 million. The vast majority of these companies had daily turnover below HK\$100,000.⁶

While institutional holdings of small-cap stocks tend to be low, the situation in Hong Kong is particularly pronounced and has been exacerbated by the lack of growth in retail participation in the Hong Kong stock market in the last ten years. According to the HKEX's Cash Market Transaction Surveys, trading turnover attributable to retail investors remained relatively stagnant in dollar value over the past decade, while its share of total market turnover dropped from 25.8% in 2010⁷ to 15.5% in 2020.⁸

Meanwhile, the last decade has seen a drastic increase in the number of small-cap stocks, leading to a larger pool of small caps sharing and competing for the same pool of liquidity from retail investors.

Increase in the Number of HKEX Small Caps 2015-2018

The rate of increase in the number of small cap companies was particularly fast between 2015 and 2018. The SFC attributes this in part to "shell manufacturing" noting that around half of the companies that listed in that period had an initial market capitalisation of less than HK\$500 million. Many businesses that met the minimum cash flow requirement for what was then the Growth Enterprise Market or the Main Board's minimum profit requirement were apparently willing to bear the substantial costs of listing to have their companies listed. These expenses sometimes exceeded half of the IPO funds raised. Ms Leung noted that, in some cases, the newly-listed company would then sell its business back to its controlling shareholder creating a "shell" which would be acquired by a third party which would inject its own business into the shell as a means to circumventing the requirements for new listings, including the eligibility, sponsor due diligence and disclosure requirements. This backdoor listing process was often conducted in several stages to avoid being classified as a new listing under the reverse takeover rules. For example, the injection of assets was sometimes delayed, while the company sought to preserve its listing status by investing in financial assets, including the shares of other shell companies.

As pointed out by Ms. Leung, the incentive for some market participants to engage in "shell manufacturing" was the high trading value of listed shells at that time. Shells were reportedly traded for over half a billion Hong Kong dollars at the peak, an amount which often exceeded the value of the actual business. Given the lower entry requirements, it was easier to "manufacture" a shell on GEM, where the impact of shell activities was particularly noticeable. Ms. Leung did not point out in her speech that the HKEX re-positioned GEM in 2008 from "an alternative board for emerging and growth companies to a 'stepping stone' to the Main Board with the introduction of new quantitative admission criteria for GEM and a streamlined process for transfer to the Main Board on meeting the Main Board listing requirements. This resulted in the number of annual GEM listings increasing from zero in the second half of 2008 to 45 IPOs in 2016 which raised HK\$4.6 billion.⁹

Market Misconduct on Hong Kong's GEM

Ms. Leung noted that shell manufacturing was often associated with various forms of market misconduct. As shell companies were often unattractive to investors, unscrupulous individuals would arrange for nominee places to subscribe for IPO shares, artificially inflating the valuation and creating a wider spread of shareholders in the company in order to meet the minimum market capitalisation and number of shareholders required for listing.

In the past, new companies listing on GEM were not required to offer shares to the public, and their ownership was often concentrated among a small number of shareholders, some of whom were suspected to be nominee places. This made the stock prices of these companies volatile and highly susceptible to market manipulation. In 2015 and 2016, stock prices of newly listed GEM companies rose an average of about six times their IPO price on the first day of trading only then to drop below the IPO price in many cases resulting in substantial losses for investors who bought the shares at high prices in the secondary market.

SFC's Efforts to Combat Market Misconduct in the Hong Kong Market

To tackle market misconduct, in 2016, the SFC formed a cross-divisional working group code named "ICE" (standing for Intermediaries, Corporate Finance and Enforcement) that brought together experts to collaborate and implement an organisation-wide strategy to deal with market abuse issues.

A number of policy measures were implemented to address market quality issues and reduce the risk of corporate misconduct and market abuse, involving various amendments to the HKEX Listing Rules including:

- a requirement for GEM IPOs to include a public tranche to mitigate the risk of nominees being used to achieve high concentration at IPO;
- the reverse takeovers requirements were strengthened to discourage backdoor listing, while highly dilutive capital raising was made more difficult; and

- the initial listing criteria for both the Main Board and GEM were raised in 2018 and 2022, increasing the minimum market capitalisation for Main Board listing applicants from HK\$200 million to HK\$500 million.

The SFC also increased market surveillance of ramp and dump cases and brought more enforcement actions. Investigations were also expanded to uncover the bad actors behind these activities, and cooperation with the Independent Commission Against Corruption (ICAC), the Commercial Crime Bureau (CCB) and overseas regulators was strengthened to prevent wrongdoers from evading liability.

Vision for a Vibrant Small-Cap Ecosystem for Hong Kong

Having addressed the various issues that impacted the GEM market, the SFC now wants to refocus on attracting quality small-cap companies and promote sustainable growth in the sector. Due to the market forces driving changes in the past decade, such as the listing reforms tailored to the listing of innovative companies with weighted voting rights, biotech companies and specialist technology companies, the Hong Kong stock market is now populated with more new economy stocks with high growth potential. In 2022, 62 of the IPOs were of new economy companies which accounted for 65% of the capital raised that year.¹⁰ Since pre-revenue biotech companies were first allowed to list in 2018, Hong Kong has also become Asia's largest biotech fundraising venue.¹¹

To recapture the interest of institutional and retail investors, Ms. Leung emphasised the need to raise the quality of small-cap stocks listing in Hong Kong by revitalising the market's fundraising function for SMEs. The SFC aims to achieve this by restoring investor confidence and re-establishing the original intent of a junior board as a fund-raising venue for quality growth enterprises. In revitalising the GEM, Ms Leung stressed the need for a clear roadmap for developing a vibrant small-cap ecosystem to also support the liquidity of small-cap stocks listed on Hong Kong's Main Board. She pointed to the need for the involvement of both the buy side and the sell side. Institutional investors' participation in the small-cap market can enhance liquidity and valuation, in turn attracting more quality issuers to list on the market. Investors can also provide capital to support the growth of SMEs before and after listing. Intermediaries, particularly sponsors and underwriters, can assist in maintaining quality by screening out problematic companies in the due diligence process.

Finally, Ms. Leung highlighted the significance of education in improving investor culture. With the increasing prevalence of technology, many inexperienced investors have fallen into the "ramp" stage by following tips provided by online influencers impersonating reputable stock analysts or by social media fraudsters claiming to have inside information. In light of this, the HKEX has been working closely with its subsidiary, the Investor and Financial Education Council (IFEC), to educate retail investors to not blindly follow influencers or hearsay tips when making investment decisions, and in sharing anti-scam information through social media channels to raise investor awareness and combat scams in listed or to-be-listed small-cap stocks.

[1] Available at: https://www.sfc.hk/-/media/EN/files/COM/Speech/HKSI-Luncheon_English.pdf?rev=bdc98a7ef6d748b8a18d09b14355df82&hash=84C7508CE1357E09877CA268FCE8F603

[2] 2023-2024 Budget Speech at paragraph 89

[3] Data available at [Securities and Futures Commission Annual Report 2020-21 \(sfc.hk\)](#)

[4] Data available at [Annual Market Statistics \(hkex.com.hk\)](#)

[5] As at June 2023, [HKEX Monthly Market Highlights](#)

[6] Based on average daily turnover in 2022

[7] Data available at [Cash Market Transaction Survey 2010](#)

[8] Data available at [Cash Market Transaction Survey 2020](#)

[9] HKEX (June 2017) '[Consultation Paper: Review of the Growth Enterprise Market \(GEM\) and Changes to the GEM and Main Board Listing Rules](#)'.

[10] Data available at [2022 Annual Report \(hkexnews.hk\)](#)

[11] As at October 2020, [HKEXBIOTECH_Newsletter_issue4_eng.pdf](#)

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