

20 May 2021

Joint statement on IPO-related misconduct

This statement sets out the general approach taken by the Securities and Futures Commission (SFC) and The Stock Exchange of Hong Kong Limited (SEHK) to some regulatory issues noted in recent new listings and how they may deploy their respective powers under the Securities and Futures Ordinance (SFO), the Securities and Futures (Stock Market Listing) Rules (SMLR), the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited and the Rules Governing the Listing of Securities on GEM of The Stock Exchange of Hong Kong Limited (Listing Rules) to tackle these issues in the future.

These issues mainly involve suspected arrangements to artificially satisfy the initial listing requirements or facilitate market manipulation of the shares at a later date. This may undermine the development of an open, orderly and fair market and call into question the existence of genuine investor interest¹ in some initial public offerings (IPOs). Both the SFC and SEHK have concerns about the impact this may have on the quality and integrity of Hong Kong's capital market and its reputation as an international financial centre.

Observations and regulatory concerns

Ramp-and-dump schemes

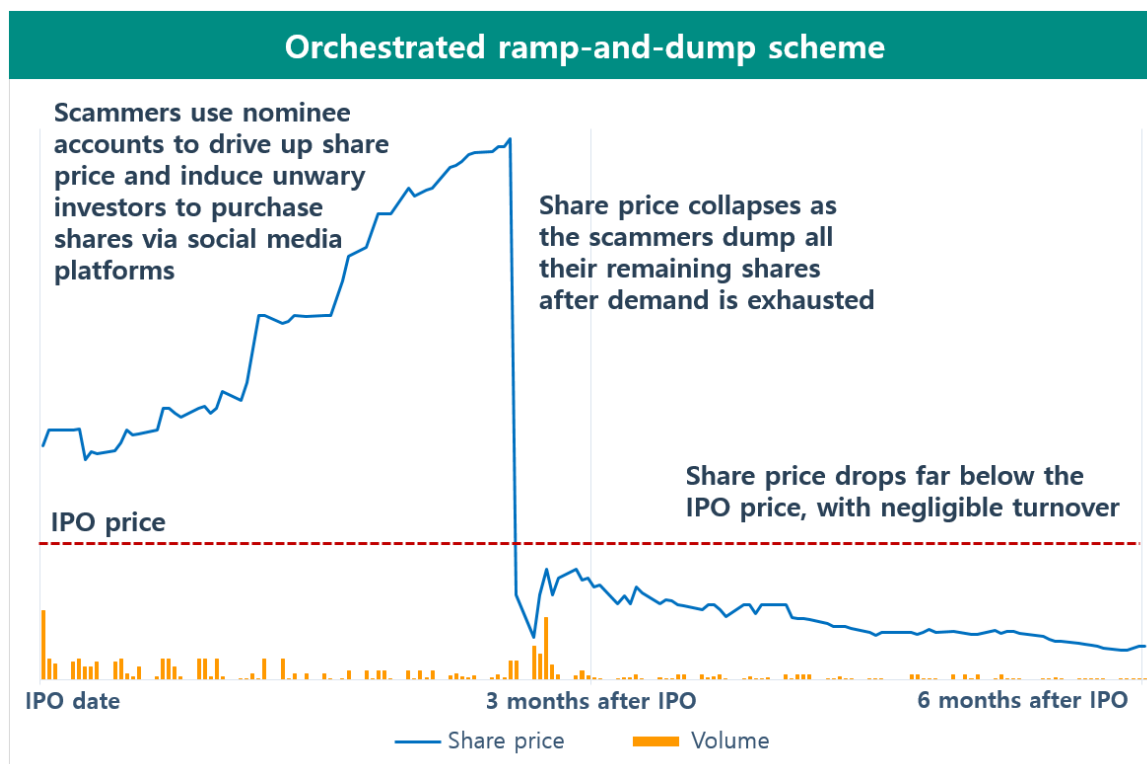
An increasing number of suspected “ramp-and-dump” schemes have been associated with IPOs launched in recent years. A ramp-and-dump scheme is a form of stock market manipulation where fraudsters use different means to “ramp” up the share price of a listed company and then induce unwary investors to purchase the shares that the fraudsters then “dump” at an artificially high price. The schemes are typically conducted using social media platforms.

There is a reasonable suspicion that some of these schemes were orchestrated at an early stage in the IPO process with the aim of later manipulating the share price. In some cases, shares were apparently allocated in the placing tranche to controlled accounts which were seemingly financed in part by funds diverted from the unusually high underwriting commissions or other listing expenses paid as part of the IPO process. Following an initial surge after listing, the share price often fell well below the IPO price,

¹ Main Board Rule 8.07 and GEM Rule 11.22A require an adequate market in the securities for which listing is sought. This means that SEHK must be satisfied that there will be sufficient public interest in the business of the issuer and in the securities. Main Board Rule 8.08(1) and GEM Rule 11.23(7) set out public float requirements specifying that at least 25% of the issuer's total number of issued shares must at all times be held by the public.

causing substantial losses for many investors, and afterwards trading turnover usually shrank to a negligible level.

Example:



Whilst these schemes more commonly involve IPOs of companies with small market capitalisations (particularly those which barely meet the minimum market capitalisation threshold under the Listing Rules)², the regulatory approach set out in this statement targets IPO-related misconduct regardless of the size of the companies concerned.

Lack of a robust and transparent share placement and price discovery process

In some problematic cases, there was reason to suspect that the perpetrators used the IPO placing tranche to allocate shares to controlled placees in order to (i) artificially satisfy the initial listing requirements under the Listing Rules, creating a false market for the shares, or (ii) corner the shares to better enable market manipulation after the shares were listed.

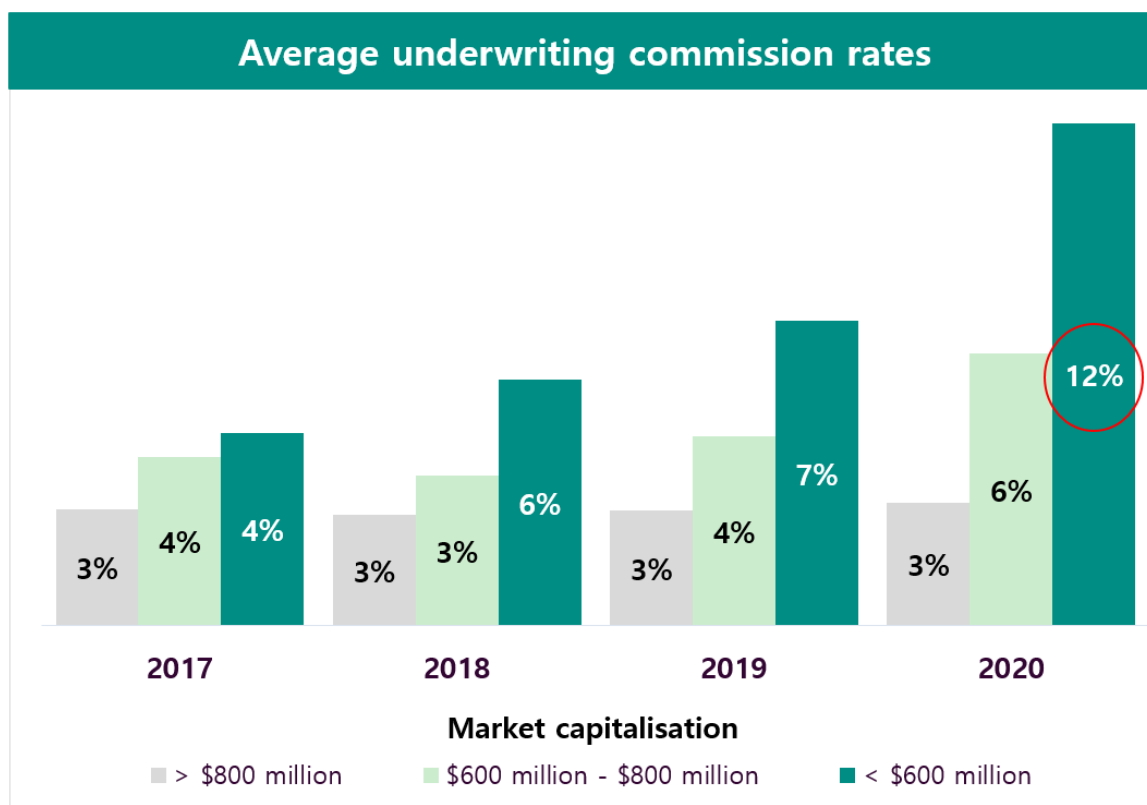
Another concern is that, in some cases, the lack of a robust and transparent share placement and price discovery process makes it difficult to understand how the placees were identified, the basis for allocating shares in the placing tranche and how the IPO price was determined.

Unusually high underwriting commissions and suspicious arrangements

We also noted that over the past two years, unusually high commissions were paid to the underwriters in some of these problematic IPOs. For example, the average underwriting commission rate for IPOs with market capitalisations below \$600 million increased substantially from about 4% in 2017 to 12% in 2020. These high underwriting commissions, along with other listing expenses, were disproportionate to the net IPO funds raised. In the most extreme cases, the overall underwriting commission rates paid

² Main Board Rule 8.09(2) requires the expected market capitalisation of a new applicant at the time of listing to be at least \$500,000,000. GEM Rule 11.23(6) requires the expected total market capitalisation of a GEM applicant to be at least \$150,000,000.

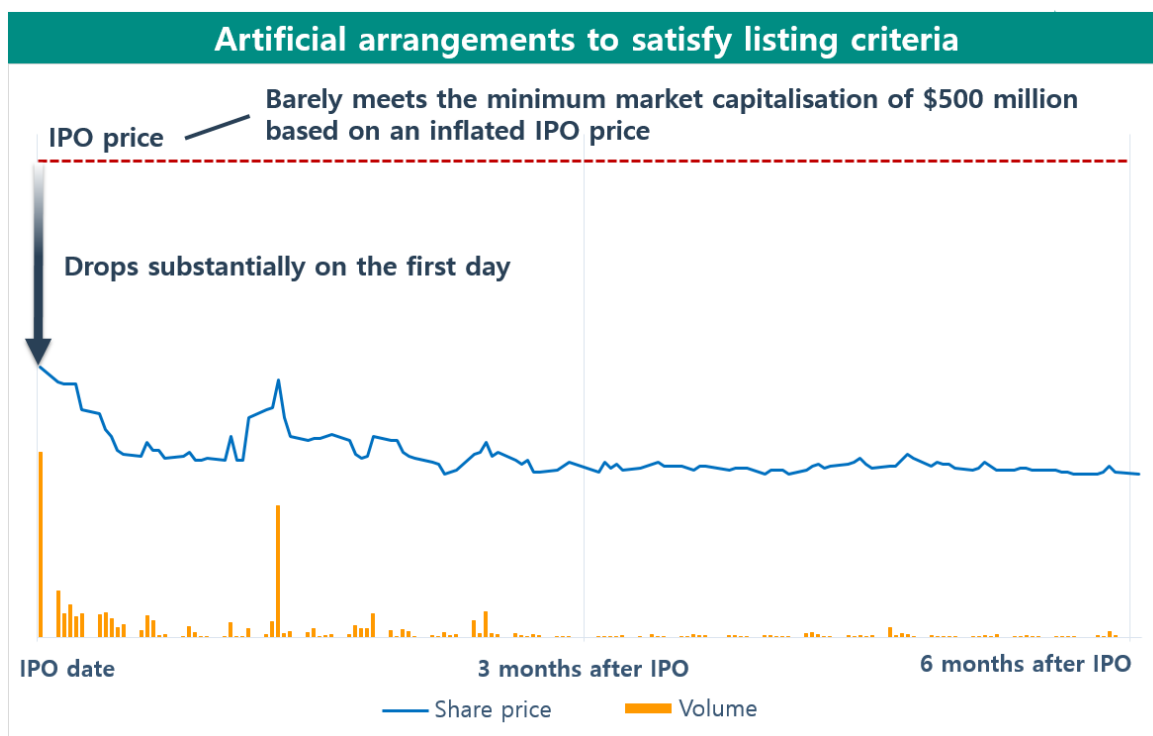
to the brokers in an IPO exceeded 20%, with some of the brokers receiving an even higher rate from the commission pool.



There is reason to suspect that, in some cases, a portion of the underwriting commissions and other listing expenses was used to partially finance arrangements intended to (i) artificially satisfy the initial listing requirements under the Listing Rules regarding sufficient investor interest, minimum market capitalisation and adequate spread of shareholders or (ii) perpetrate ramp-and-dump schemes. For example, to compensate the controlled placees for creating a “market” or to subsidise the placees to subscribe for the shares at an inflated price, part of the listing expenses may have been funnelled to them in the form of rebates. We also noticed instances where the listing applicant paid out a material amount of additional “discretionary” listing expenses post-listing, without explaining the basis for doing so. In many instances, the resulting reduction to the net proceeds available to the applicant as compared to that disclosed in the prospectus was significant.

In the absence of such arrangements, some listing applicants may not satisfy certain initial listing requirements under the Listing Rules and the IPO price and valuation may be substantially lower than what was stated in the prospectus. In some cases, the share price dropped substantially on the first trading day to a level which more closely reflected the company’s true market value.

Example:



Features of problematic IPOs which may lead to enquiries by regulators

The SFC, as the statutory regulator, administers the SFO and the SMLR and supervises and monitors SEHK's performance of its listing function. SEHK administers the Listing Rules and is the primary front-line regulator and contact point for all listing applications except those where concerns have been raised by the SFC under the SMLR.

In light of the concerns identified in this joint statement, where a listing application displays one or more of the following features, the SFC and SEHK will make enquiries to ascertain whether there is sufficient genuine investor interest in the applicant and its securities and an adequate spread of shareholders to enable an open, fair and orderly market for the securities to develop after listing.

- (i) The applicant's market capitalisation barely meets the minimum threshold under the Listing Rules³.
- (ii) Very high price-to-earnings (P/E) ratio taking into account the applicant's fundamentals (including its profit forecast) and the valuations of its peers.
- (iii) Unusually high underwriting or placing commissions or other listing expenses⁴.

³ This is also a characteristic of shell companies identified in the "Guidance on IPO Vetting and Suitability for Listing" (HKEX-GL68-13A) – (i) small market capitalisation.

⁴ This is also a characteristic of shell companies identified in the "Guidance on IPO Vetting and Suitability for Listing" (HKEX-GL68-13A) – (iii) involve fund raising disproportionate to listing expenses (ie, a high proportion of the listing proceeds were used to pay listing expenses).

- (iv) Shareholding is highly concentrated in a limited number of shareholders, particularly where the value of the public float is small and the spread of shareholders barely meets the minimum thresholds set out in the Listing Rules⁵.

The above list is non-exhaustive and the SFC and SEHK in their review of listing applications and subsequent investigations may identify other features which entail heightened scrutiny by the regulators.

During the IPO vetting process, the SFC and SEHK may request a listing applicant to provide compelling evidence to demonstrate genuine investor demand to satisfy the Listing Rules requirements⁶ and the reasonableness of the expected valuation having regard to the valuation multiples of comparable listed companies. In addition, a listing applicant may be required to demonstrate that the IPO price has been or will be determined through a robust and transparent price discovery exercise, including its strategies for investor targeting, marketing, pricing and allocation. The listing applicant should be prepared to explain any departure from these strategies.

Where (i) unusually high underwriting commissions or other listing expenses or (ii) material amounts of discretionary listing expenses might be paid by the listing applicant or its connected persons, the listing applicant is expected to provide the complete details of these expenses for the regulators' scrutiny and disclose relevant information in the listing document. SEHK will continue to closely monitor the use of proceeds after listing.

Regulators' power to object to a new listing

SEHK may exercise its discretion to reject a listing application if questions raised regarding the share placement and price discovery process are not satisfactorily addressed, or the basic conditions for listing under the Listing Rules are not met. These conditions include, but are not limited to, sufficient public interest⁷, an open market in the shares and an adequate spread of shareholders⁸. SEHK will also focus on whether an IPO raises suitability concerns as elaborated in the "Guidance on IPO Vetting and Suitability for Listing" (HKEX-GL68-13A) regarding potential "shell companies".

The SFC is empowered under section 6(2) of the SMLR to object to a listing application if it appears to the SFC that, among other grounds:

- (i) the application does not comply with the Listing Rules⁹; or
- (ii) it would not be in the interest of the investing public or in the public interest for the securities to be listed¹⁰.

For example, if SEHK views that a listing application does not comply with Main Board Rule 8.07 (ie, there is insufficient public interest in the shares of the listing applicant) based on the specific facts of the case, SEHK may reject the listing application. The SFC may also object to the application under section 6(2)(a) of the SMLR on the ground that the application does not comply with the Listing Rules.

⁵ 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 places) and their equivalents in the GEM Listing Rules.

⁶ Main Board Rule 8.07 and GEM Rule 11.22A.

⁷ Main Board Rule 8.07.

⁸ Main Board Rule 8.08.

⁹ Sections 3(a) and 6(2)(a) of the SMLR.

¹⁰ Section 6(2)(d) of the SMLR.

Separately, the SFC will take into account any issue raising public interest concerns in assessing whether it should exercise its power to object to a listing application. Set out below are non-exhaustive examples of circumstances under which the SFC may invoke the “public interest or interest of the investing public” ground to object to a listing application under section 6(2)(d) of the SMLR.

- (i) Where it appears to the SFC that conditions do not exist for an orderly and fair market in the applicant’s securities to develop upon listing, having regard to the background and number of investors who have indicated an interest in the applicant’s securities, the pattern of distribution of the applicant’s securities and the number of persons who would hold the applicant’s securities immediately upon listing; or
- (ii) where it appears to the SFC that the applicant’s structure, business, financial condition, governance arrangements, board or management may not be appropriate for it to be listed in Hong Kong. For example, where the board or management of the listing applicant is found to be involved in a ramp-and-dump scheme or a scheme designed to mislead regulators or the investing public or to circumvent applicable rules.

In addition, in considering whether to invoke the “public interest or interest of the investing public” ground to object to a listing, the SFC may also take into account whether the listing would put at risk the reputation of Hong Kong’s capital market as fair, efficient, competitive, transparent and orderly.

The SFC is also empowered under section 6(3)(b) of the SMLR to impose conditions on a listing application¹¹.

Suspension of dealings and other regulatory action

The SFC and SEHK will investigate and take appropriate action against the parties involved under the SFO, the SMLR or the Listing Rules, if:

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

In addition to SEHK’s regulation of listed issuers based on the Listing Rules, the SFC will not hesitate to use its statutory powers, including its investigation powers, in relation to issuers, directors, major shareholders and intermediaries suspected of being involved in misconduct.

¹¹ Section 6(3) of the SMLR provides that the SFC may, within the period specified in section 6(6) of the SMLR, notify an applicant and SEHK that —

- (a) it does not object to the listing of any securities to which an application relates; or
- (b) it does not object to the listing of any securities to which an application relates subject to such conditions as the SFC may think fit to impose.

The SFC may direct SEHK under section 8(1) of the SMLR¹² to suspend trading in any securities listed on SEHK. For example, where there is evidence that at the time of listing a significant number of IPO placees were not genuine investors and there was not sufficient genuine investor interest in the securities, the SFC may exercise its power under section 8(1) of the SMLR and issue a suspension notice.

Apart from the above, intermediaries involved in problematic IPOs with features discussed above (market capitalisation barely meeting the minimum threshold under the Listing Rules, very high P/E ratios, unusually high underwriting or placing commissions or high concentration of shareholders) might be prioritized for more in-depth inspection to assess their compliance with the applicable legal and regulatory requirements¹³. Upon detecting any apparent breaches and control deficiencies of a serious nature, the SFC will promptly investigate such matters. The SFC will not hesitate to take enforcement action against intermediaries for IPO-related misconduct.

The SFC and SEHK will continue to work closely and exchange information to ensure an appropriate regulatory response to address any improper behaviour.

Securities and Futures Commission
The Stock Exchange of Hong Kong Limited

¹² Section 8(1) of the SMLR provides that the SFC may direct SEHK to suspend all dealings in any securities listed on SEHK if it appears to the SFC that:

- (a) any materially false, incomplete or misleading information has been included in any document (such as a prospectus or circular) issued in connection with a listing of securities on SEHK or in any announcement, statement, circular or other document made or issued by or on behalf of an issuer in connection with its affairs;
- (b) it is necessary or expedient in the interest of maintaining an orderly and fair market in securities traded on SEHK;
- (c) it is in the interest of the investing public or in the public interest, or it is appropriate for the protection of investors generally or for the protection of investors in any listed securities on SEHK; or
- (d) there has been a failure to comply with conditions imposed by the SFC in the context of a resumption of dealings under section 9 of the SMLR following a previous suspension.

¹³ For reference, the SFC published a consultation paper on conduct requirements for capital market transactions in Hong Kong on 8 February 2021. The proposed requirements would help clarify the roles played by intermediaries in equity and debt capital raisings and set out the standards of conduct expected of them in bookbuilding, pricing, allocation and placing activities.