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# Has Hong Kong tightened GEM rules far enough?

By: Wing Cheung and Matthew Wong

Hong Kong's stock exchange and securities regulator are jointly warning market participants that they are ready to crack down on suspected rule-breaking with respect to listings and share placements on the Growth Enterprise Market (GEM).

On January 20, 2017, the Securities & Futures Commission (SFC) and the Hong Kong Exchanges & Clearing (the Exchange) jointly issued a strongly worded statement that criticised the second board's sponsors and underwriters for the price volatility of their clients' public listings. The SFC also issued a guideline to sponsors and placing agents to provide guidance on the standards of conduct that is expected of them when conducting a GEM IPO.

"The SFC or the Exchange will, where appropriate, take action against applicants, sponsors, underwriters or placing agents who fail to have appropriate policies and procedures in place to ensure the placing is conducted in a fair and orderly manner," the regulator said in its statement.

The SFC and the Exchange have identified a number of instances in which shares were placed with a small number of shareholders and that these concentrations of ownership had led to extreme volatility among some stocks on GEM; share prices surged or plunged by 10 times on their trading debut.

According to their joint statement, "The SFC and the Exchange consider that some market practices may not enable an orderly, informed and efficient market for such securities to develop."

## The Guideline

The guideline issued by the SFC is 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 (IPO) stocks.

The two regulators said new GEM listing applicants need to comply with all relevant GEM listing rules including ensuring their offerings are "for an open market as well as orderly, informed and fair trading to develop at the time of listing."

- New applicants seeking to list on GEM should ensure compliance with all relevant GEM Listing Rules including ensuring that in relation to their securities for which listing is sought the conditions exist for an open market as well as orderly, informed and fair trading to develop at the time of listing.
- The SFC or the Exchange will, where appropriate, take action against applicants, sponsors, underwriters or placing agents who fail to have appropriate policies and procedures in place to ensure the placing is conducted in a fair and orderly manner.

"Sponsors should advise the new applicant on the overall strategy and allocation basis to achieve an open market and an adequate spread of shareholders," said Julia Leung, Executive Director of intermediaries division at the SFC. She added that placing agents "should put in place appropriate policies and procedures to avoid any undue concentration of shareholding."

## Volatility in GEM-listed stocks

- In 2015, the average first-day price gain was 743 percent for GEM stocks listed, and 454 percent for those listed in the first half of 2016 (Source: SFC).
- Most new listings on GEM are offered to 135 shareholders on average, just slightly higher than the minimum of 100 to qualify.
- Shareholdings in some companies drop to 30 or 40 soon after their listings.
- A high concentration of shares in the hands of a few can cause prices to be highly volatile.
- Investors need to be aware that GEM is designed to accommodate companies that involve a higher investment risk than other companies listed on the main exchange.

## Conclusion

Sponsors, underwriters or placing agents should expect tighter scrutiny over their conduct in GEM IPOs. They should all review their internal control system to ensure proper procedures are in place to ensure compliance with the new guideline.

For instance, sponsors should ensure that they advise a new applicant to retain proper documentation to demonstrate that due care has been taken to decide the method of listing; the target investor type and place mix; the overall strategy and allocation basis of the placing; and any preferential treatment afforded to the places.

Placing agents should ensure that, among other things, there are appropriate policies and procedures to avoid any undue concentration of shareholdings. Placing agents must also conduct robust KYC procedures and establish a client’s source of funds before accepting its subscription in the placing.

Brokers and lawmakers representing the city’s financial services industry suggest that to address the problem, the Exchange and the SFC should immediately increase the minimum number of shareholders on GEM to 300, from the current 100, the same level as on the main board; and that the regulators must also make it mandatory for GEM-listed companies to disclose their shareholding allocations to increase transparency.

The January 20 joint statement was an initial step to address current concerns with GEM IPO placings while the SFC and the Exchange continue to work on a broader GEM reform. While it remains to be seen how the SFC and the Exchange will enforce the measures set out in the joint statement and the guidance, it is clear that the regulators are placing a heavy burden on the intermediaries. Sponsors and brokers who are active in the GEM IPO market should be prepared for that.

For more information on the matters discussed in this Locke Lord QuickStudy, please contact the authors.

**Wing Cheung** | +852 3465 0688 | wcheung@lockelord.com
**Matthew Wong** | +852 3465 0622 | mwong@lockelord.com