

Issues for Hong Kong: securities market reform

David M. Webb
Editor, Webb-site.com

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Corporate regulatory structure

- HKEX is a for-profit regulator. That's a conflict of interests, once again exposed during the battle over listing second-class shares, or "weighted voting rights"
- HK corporate governance is bad enough without reducing investors' rights
- In 2003, the Government-appointed Expert Group recommended moving listing regulation to the SFC, which already regulates takeovers. After briefly accepting this, the Government U-turned under tycoon pressure.
- 13 years later: "SFC and the Hong Kong Exchanges and Clearing Limited are planning to conduct shortly a joint public consultation exercise on enhancing the regulatory structure in respect of listing matters" – Financial Secretary, Budget Speech, 24-Feb-2016

Listing v Trading

- HK should separate corporate regulation from securities trading.
- If SEHK (owned by HKEX) is relieved of its regulatory role, then it can focus on being a better exchange
- SEHK has a statutory monopoly on running a “stock market” in HK.
- The competition ordinance is now operating – so if we are pro-competition, then why is there a statutory monopoly?
- And even if it is a monopoly, why has the Government exempted HKEX and its subsidiaries from the Competition Ordinance?
- The statutory monopoly and the exemption should be abolished

One Board, One Regulator

- We need a unified approach to corporate regulation, and a single listing board, not a third board
- Listings and takeovers should be under one roof at the SFC
- Market entry should be based on disclosure, not irrelevant criteria
- We don't and shouldn't delist loss-making companies, so why do we require main board entrants to have made a profit?
- Why do we require main board listings to have a public offer tranche? Is applying for IPOs a human right?
- Why set a minimum on market cap, when it can shrink as soon as it is listed?
- Why set minimum float %, when 25% provides no more legal protection than 10%?
- Why set a minimum number of holders when they can always be arranged?
- Big stocks can still get cornered (Hanergy?), so entry criteria are not a cure for market manipulation or speculation

Unifying Main Board and GEM

- Allow issuer to choose whether to have a public offer or just a placement
- If there is a public offer, don't require the A/B pool system for applications under/over HK\$5m
- No profit criterion
- 3 years of unqualified audited track record
- No minimum size, no minimum float, no minimum number of holders, but full disclosure of the distribution of the issue
- Quarterly financial reporting – all GEM and Shanghai/Shenzhen Cos have been doing it, so why can't the main board?

Listing rule: boards must have 3 Independent Non-Executive Directors



INEDs

- Most markets require independent non-executive directors, but only in name
- If the controlling shareholder can vote on INED elections, then the INEDs are dependent on the controller, not independent of it
- Consequently INEDs are often just rubber stamps
- Independent directors should be elected by independent shareholders. Controlling shareholders and other directors should be required to abstain
- Boards could still nominate candidates, but candidates would have to be acceptable to independent shareholders
- INEDs would have a mandate, and be held accountable at the next election
- Failing that, we should scrap the requirement for INEDs rather than provide false comfort. Boards would either be credible or not
- With no controller, the system works – I was elected to HKEX in 2003 on a 2-share nomination and 3 incumbents were ejected

Retail shareholder engagement

- SFC does not require banks and brokers to see voting instructions from clients whose shares they hold
- Client agreements often exclude this: “we don’t have to tell you about meetings or seek your voting instructions”
- Lots of online brokers, but none of them provides online voting
- So retail investors hardly ever vote, resulting in low turnouts and bad proposals being passed
- SFC could change this by mandating change to the client agreements, as it has with suitability requirements
- Brokers could use CCASS Stock Segregated Account Service and let clients vote directly, avoiding any extra work.

Pre-emptive rights

- In 2003 I launched Project VAMPIRE – Vote Against Mandate for Placings, Issues by Rights Excepted
- Independent shareholders still vote more than 2:1 against the 20% general mandate (at up to 20% discount), but controllers carry the day
- UK best practice for non-pre-emptive issues is 5% in 1 year, 7.5% in 3 years, and maximum discount of 5%
- HKEX “consulted” the market in 2009 and decided to do nothing
- HKEX also allows “open offers”: a non-transferable rights issue at any discount, extorting shareholders to either put in cash or get massively diluted. UK limits discount to 10%.
- UK requires unsubscribed rights to be sold at market for benefit of owners, protecting them
- HK says “you snooze, you lose” and either puts the discounted shares into an “excess application” lottery, or allows the underwriter to take the shares and pocket the premium

Non-existent listed bond market

- Hundreds of bonds and notes in USD, CNH, HKD and other currencies are “listed” on SEHK
- This is a farce – none of them settles in CCASS or trades on SEHK (except HKSAR iBonds)
- HKMA protects banks, which have no obligation to provide best execution for retail bond issues, so wide spreads and no centralised market. Prevents competition for retail deposits.
- HK is missing a huge potential market for retail investors to park short/medium-term money in notes and bonds rather than banks at 0.01%. Certainly not more risky than equities or derivatives, so why not?
- Instead, Government deflects attention with Islamic finance and fintech stunts

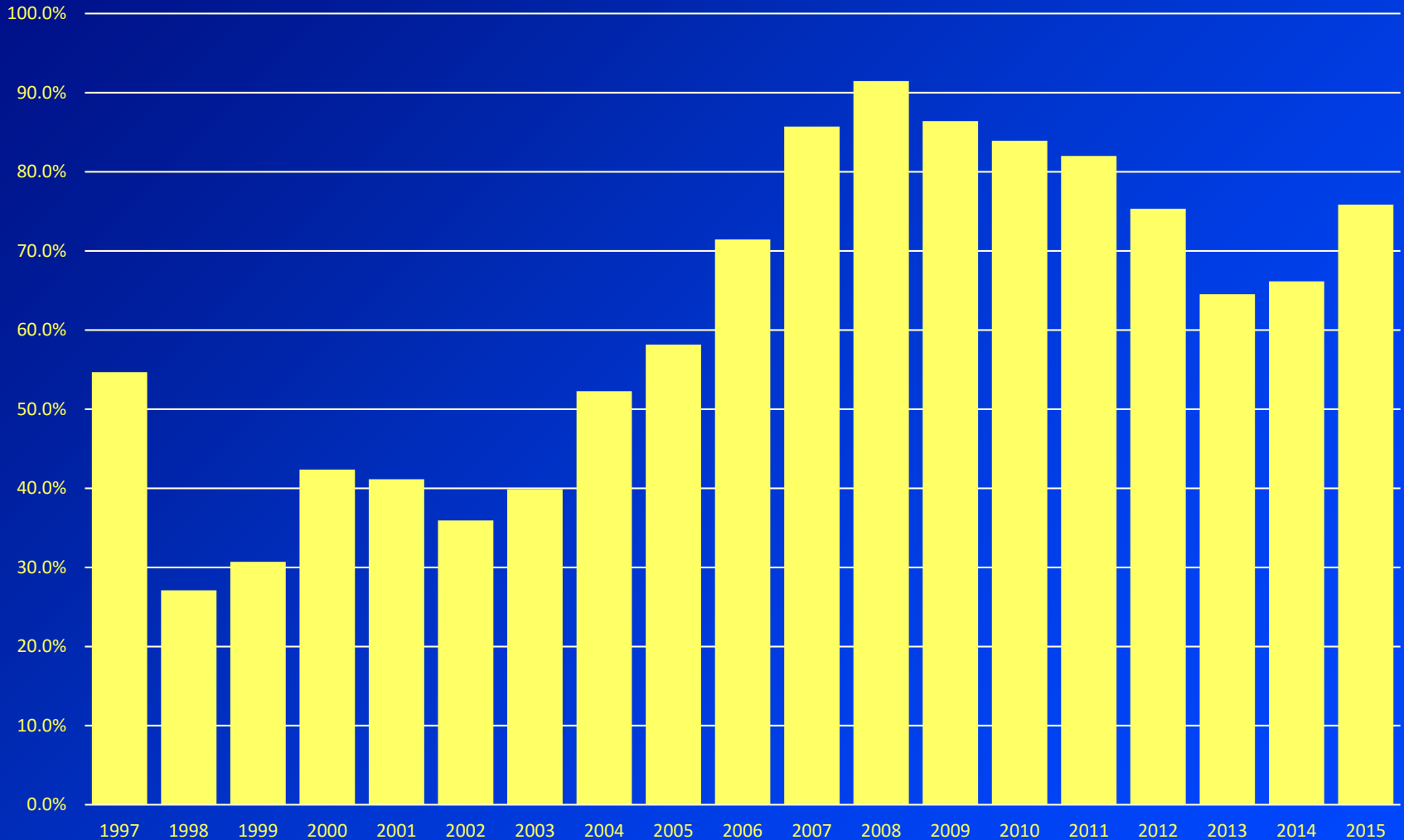
Short selling

- Only “designated securities” can be short-sold, a nanny approach
- There is a regulatory bias against shorting. Short positions of 0.02% (or HK\$30m if lower) must be reported to the SFC weekly. No systemic risk comes from such positions – for every short position there is a long position somewhere else. Long minus short = 100%.
- Total short positions are now about 1.25% of market cap
- Long positions must be disclosed at 5%
- The law does not require disclosure of share pledges: banks and brokers are exempt from disclosing security interests – that’s a greater threat to stock price stability and can lead to change of control in foreclosure
- The action against Moody’s for its “Red Flags” report betrays a bias against negative research. The SFC has never acted against overly-bullish analysts – and anyway, 4 out of 6 “negative outliers” defaulted within 4 years of the report
- HK sits on the doorstep of a country which stamps out all forms of criticism. We need to strengthen and encourage, not weaken, freedom of debate and criticism of companies

Behaviour of a monopoly: HKEX

- Slow to innovate – trading hours, trading spreads, etc.
- Collects rent from other platforms – e.g. Alternative Trading Systems, dark or lit pools must report trades to HKEx and pay fees
- When you're the only exchange, you're too big to fail - so all systems must be built with multiple redundancies
- High fees and massive profit margins
- The market value of HKEx is about 1% of the whole market, or about 2% of the free float. That's a proxy for how much value will be extracted from trading these stocks and their derivatives

HKEX group pre-tax profit margin



The spread table

Price		Stocks					Market cap \$bn		
from \$	Spread \$	High	Low	Main Bd	GEM	Total	Main Bd	GEM	Total
0.01	0.001	10.00%	0.40%	199	80	279	265	34	299
0.25	0.005	2.00%	1.01%	181	49	230	276	33	310
0.50	0.01	2.00%	1.01%	267	43	310	546	44	591
1.00	0.01	1.00%	0.50%	318	25	343	933	40	973
2.00	0.01	0.50%	0.20%	373	18	391	4,643	50	4,693
5.00	0.01	0.20%	0.10%	153	13	166	3,198	57	3,254
10.00	0.02	0.20%	0.10%	93	3	96	2,978	12	2,990
20.00	0.05	0.25%	0.10%	53	-	53	4,329	-	4,329
50.00	0.05	0.10%	0.05%	16	-	16	3,428	-	3,428
100.00	0.1	0.10%	0.05%	5	-	5	2,324	-	2,324
200.00	0.2	0.10%	0.04%						
500.00	0.5	0.10%	0.05%						
1,000.00				1,658	231	1,889	22,920	270	23,190

Stock prices at 13-May-2016, primary listings only

Spread table issues

- If you have a wide minimum bid-offer spread, then you get a race to get “pole position” on the top of the bid/offer queue and wait for someone to blink
- This impedes volume – willing buyers and sellers cannot meet in the middle, except off-market. This reduces liquidity and increases effective transaction costs for at-market orders
- When I was on the HKEX board, in 2005 and 2006 we cut the spread table at the high end, but small brokers lobbied against the low-end, and the result is great inefficiency below \$5 and a double-width spread between \$5 and \$50.
- Only 21 stocks trade above \$50 in the most efficient part of the table, and HKEX itself is currently the highest-priced stock.

3-zone spread table summary

Price from \$	Main Bd	GEM	Total	Main Bd	GEM	Total
			Stocks			
0.01	1,338	215	1,553	80.7%	93.1%	82.2%
5.00	299	16	315	18.0%	6.9%	16.7%
50.00	21	-	21	1.3%	0.0%	1.1%
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	1,658	231	1,889			
			Market cap \$bn			
0.01	6,663	201	6,864	29.1%	74.7%	29.6%
5.00	10,505	68	10,573	45.8%	25.3%	45.6%
50.00	5,752	-	5,752	25.1%	0.0%	24.8%
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	22,920	270	23,190			

Trading hours

- Stock Exchange is open 5.5 hours/day, 5 days/week. Until Mar-2011 it was 4 hours/day, then 5 hours until Mar-2012.
- 2-hour broker siesta has been reduced to 1-hour lunch break from 12:00-13:00.
- If HK had competing exchanges like the USA, would SEHK still close for lunch?
- Opening the futures exchanges after hours was easier, as fewer small brokers are involved.

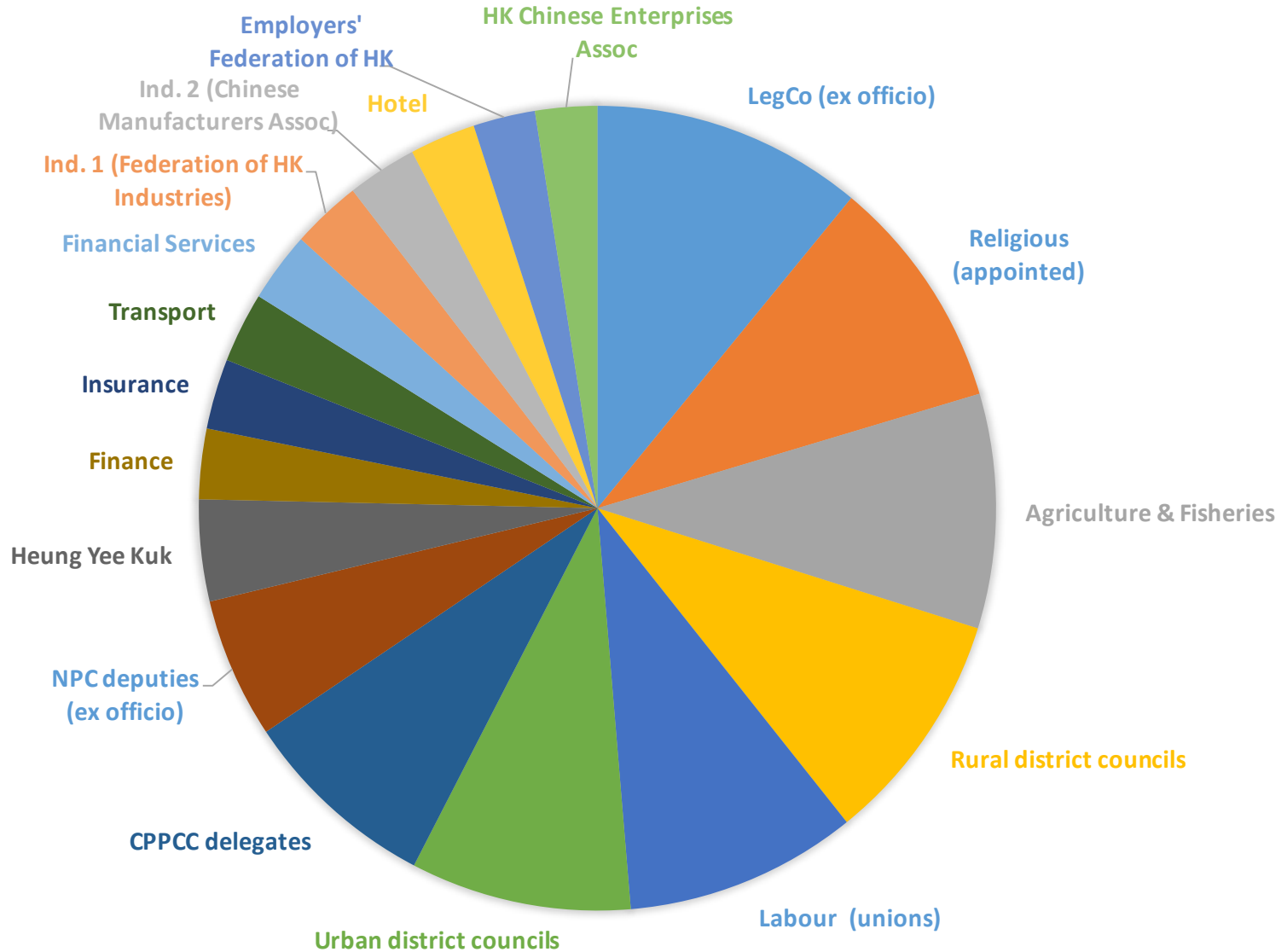
Ah yes, the small brokers

- Top 14 brokers have 57% of the market turnover
- Next 51 brokers have 33%
- About 500 others have 10%
- Each registered firm can vote in elections for:
 - the election for the Legislative Council “Financial Services” (small brokers) seat
 - 18 seats in the Election Committee Subsector Elections
- Also, members of the Chinese Gold and Silver Exchange each have a vote
- Total Financial Services electorate in 2011: 568 firms, no individuals
- Anyone else who works in financial services has no vote.
- So it is really the “small brokers” constituency

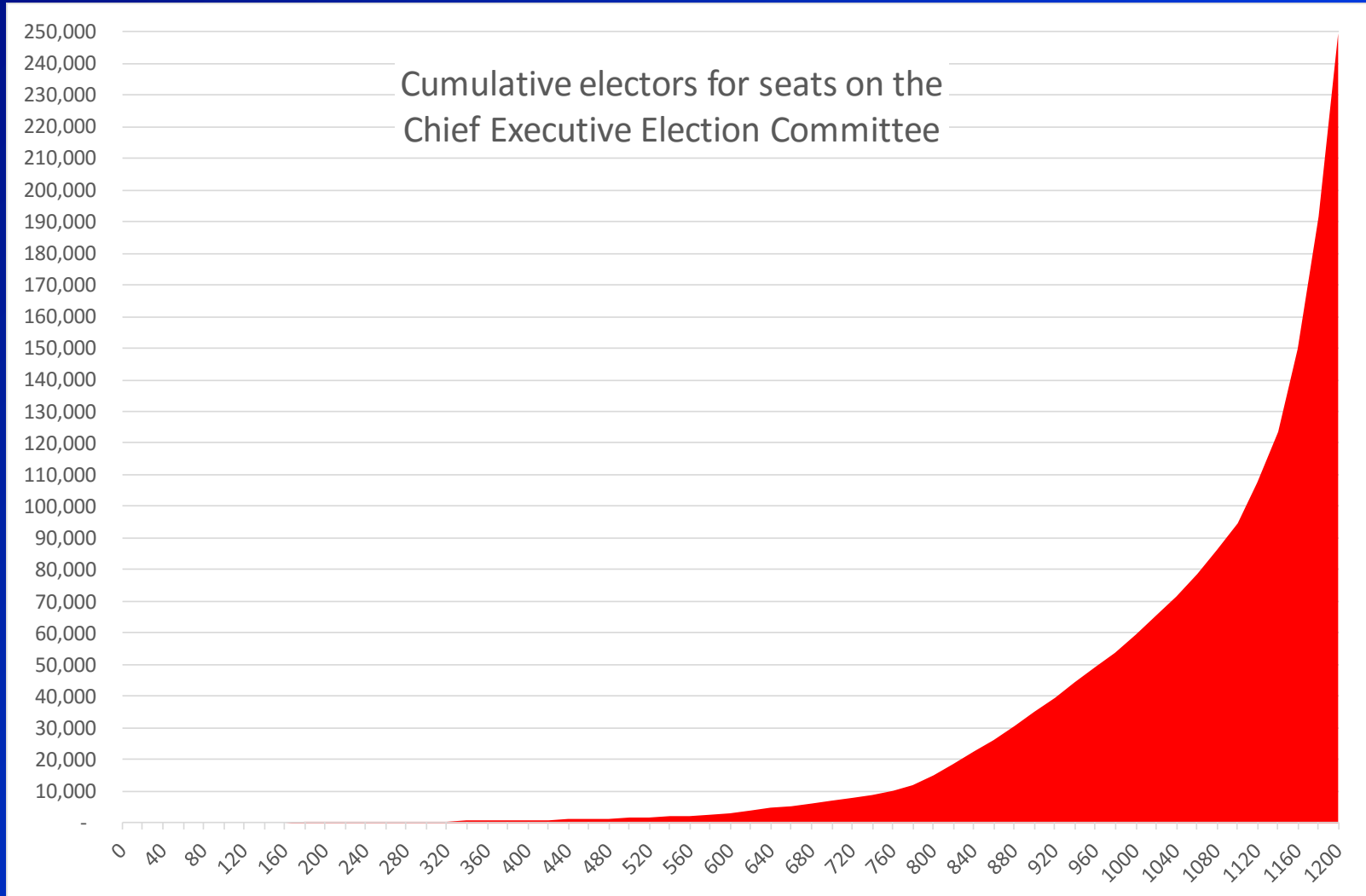
The 4 sectors of the Election Committee

Sector	Seats	Registered voters 2011		
		Bodies	Humans	Total
1 Industrial, commercial and financial sectors	300	12,369	14,459	26,828
2 The professions	300	347	204,052	204,399
3 Labour, social services, religious and other	300	3,211	14,361	17,572
4 LegCo, DCs, NPC, CPPCC	300	-	700	700
Total	1,200	15,927	233,572	249,499

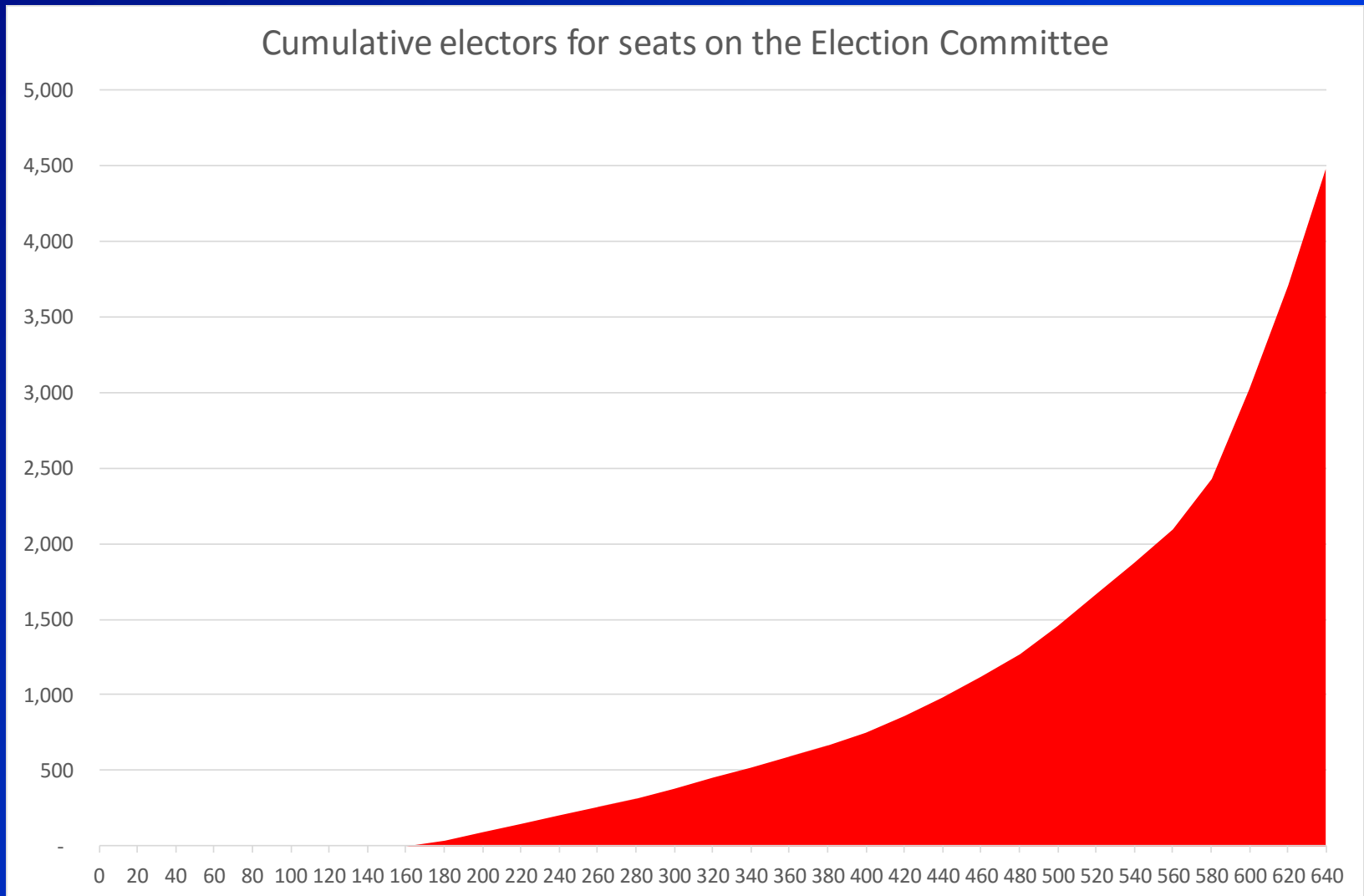
637 Seats with fewest electors per seat



How many votes does it take to elect the majority of the Election Committee?



Need to zoom in...



Political reality

- If you are an accountant, teacher, doctor, nurse or lawyer, you may feel like you have a say in the CE election as a “professional”. You don’t. The small-circle constituencies are enough to determine the majority of the committee. You are just window-dressing.
- 637 seats had a combined electorate of 4,363 in 2011: 3,648 bodies and 715 humans. Many of the corporate voters have common controlling shareholders, so in reality there are even fewer independent decision-makers.
- Any candidate just needs the support of the smallest circles to be sure of election. No wonder then that the CE panders to them. He or she has to. Small brokers are one of those sectors. Banks and Insurers are two others, each with a seat in the Legislative Council.
- The Government owns 5.5% of HKEx but appoints the majority of its board. Shareholders elect 6/13. The Chairman has always been a member of the HK Executive Council (cabinet) and is approved by the Chief Executive

About Webb-site

- Founded in 1998. Not-for-profit, partly funded by speaker fees, but mostly funded by me. The site and related activity takes about half my time.
- The other half, I research and invest in HK small-caps, currently holding >5% of 15 listed companies
- Corporate horror stories end up in *Webb-site Reports* (time permitting), while under-valued well-governed companies go into my portfolio, and hopefully not *vice versa*
- Over 22,000 subscribers to a free newsletter, opt-in/out
- Opinion polling
- Hall of Shame for jailed directors, CCB watch, SFC watch, ICAC watch
- Site also covers economic governance, advocating transparency, accountability, civil liberties, tax reform, land lease reform, minimal intervention and economically-rational policy-making
- *Webb-site Who's Who* covers all HK-listed directors, auditors, advisers since 1990; legislators, district councils, statutory/advisory bodies, CE election committee, relationships between them
- Frequent news flow from courts, tribunals, ICAC, HKICPA, SEHK, SFC and others, often with commentaries
- *Webb-site Total Returns* series – since 1994, all HK stocks including delisted
- Tracking all SFC-licensees, and all HK-registered companies (over 1 million live)
- CCASS Analysis System for stock movements
- Directors' share dealings since 2003

Thank you!

