OECD, Tokyo Roundtable
November 2003

"The Penny Stocks Incident"

Ashley Alder
Hong Kong Securities and Futures Commission

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1. Overview

A political and regulatory crisis that led to a public debate about

- The quality of the bottom tier of Hong Kong's listed companies
- The "three tier" market regulatory system involving Government, the SFC and the Exchange

2. Outcomes

- First test of Hong Kong's ministerial "accountability system" (July 2002)
- Departure of the Exchange's CEO and significant changes in senior management at the Exchange (early 2003)
- Appointment of the "Expert Group" chaired by former ASIC Chairman Alan Cameron which recommended transfer of the Listing Function from the Exchange to the SFC (March 2003)
- Resistance by the Exchange to Expert Group proposals (April 2003)
- Government consultation paper on Listing Regulation (October 2003)

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3. Background

- 2000 – Exchange demutualised and self-listed. Retains front-line regulation over listed companies. SFC assumes regulation over brokers
- 2001/2002 – SFC raises concerns about market quality and small cap/low priced stocks [minimum value HK$0.01]
  - Small absolute movements in $ value lead to large percentage swings in share price
  - Insufficiency in pricing leads to price volatility
  - Facilitates manipulation on thin trading
  - Associated with poor quality companies
  - Perceived as “cheap” and “poised to rebound” “Gambling numbers”
- Overseas comparisons – e.g. NASDAQ $1 threshold.

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4. The Consultation Proposal

- First proposal (SFC) – Companies falling below a minimum price threshold must consolidate their shares
- Second proposal (Exchange) – Delisting: a necessary disciplinary backstop to force non-compliant companies to consolidate
- Result:- consultation on minimum price threshold – HK$0.50 – combined with consultation on delisting

5. What Went Wrong?

- No anticipation of a crisis
  - 26 June - 23 July – $0.50 proposal covered extensively in HK media
  - 18 July – Listing Committee approval
- Noon Thursday, 25 July 2002 – Consultation paper issued
- No market reaction in the afternoon trading session
- Friday, 26 July: Penny Stock sell-off
- Assumption – market reaction to fear that micro-cap stocks would be delisted and untradeable.

6. Statistics : 26 July 2002

- Market cap of penny stocks fell $10.9 bn
- 10% of penny stock market cap
- Penny Stocks recording declines accounted for 2.6% of total market capitalisation
- Total market cap declined by $61 bn or 1.6%. Penny Stocks contributed 0.31% to this
- Most declining stocks had recorded heavy price declines prior to 26 July

"….many penny stocks had been losing value for some time. It is …. wrong to suggest that investors in penny stocks lost all their money overnight. … While the percentage drops in the value of penny stocks that day looked dramatic, the actual losses represented by those percentages were quite small when compared with the actual losses suffered in the previous six months."

(Kotewall Report, para. 10.21)

7. A Mountain out of a Molehill?

- SFC view: "*sell-off … was primarily an over-reaction by investors to a set of proposals for market consultation that were unfortunately misunderstood by some as policy changes*" (Kotewall Report, para. 10.25)

- Paradigm stock: Dah Hua International
  - Dropped 54% on 26 July
  - Represented a price decline from $0.11 to HK$0.051
  - Turnover of HK$50,000 (US$6,500) only

7. A Mountain out of a Molehill?

Cont'd

Illiquidity contributed to volatility

- 133 stocks with a churn rate of less than 1% contributed a total loss of HK$8.35 billion on 26 July
- Turnover of only HK$145 million (0.2% of total turnover on 26 July) responsible for this loss

  "… *simplistic and inaccurate to identify the consultation paper as the single cause of what happened. Unfounded rumours about margin calls, panic reaction to dumping, an element of when fortune smiles, take advantage as well as unreflecting herd instincts played a part.*"

  (Kotewall report, para. 10.30)

- Was this really a market crash?

7. The Aftermath

- **26 July**. Government/SFC stress proposals are only part of a consultation exercise
- **27 July**. HKEx extends consultation period
- **28 July**. Consultation withdrawn.
- **31 July**. (a) Special meeting of Legislative Council.
  (b) Financial Secretary appoints Panel of Inquiry led by Robert Kotewall, QC.

Against background of new Ministerial Accountability System withdrawal of the Consultation switches the focus to blame.

7. The Kotewall Report – September 2002

Key Findings

- Unclear whether the Consultation was the only factor triggering the sell-off on 26 July
- Consultation would have been better managed if more pre-consultation market soundings had been carried out
- For controversial proposals regulators should adopt a 2-stage consultation process: concept release/detailed proposals
- Expectations and debate following the Incident had much to do with the new Ministerial Accountability System. A "political hot potato"
- **Roles of Government/SFC/Exchange within a three tiered regulatory structure suffered from lack of clarity over division of responsibility.**

8. The Immediate Fallout

- Appointment of Expert Group to review three-tier regulatory structure
- Departure of Exchange CEO

9. Lessons from the Penny Stocks Incident (1)

The Consultation Process must be handled sensitively. **But**:

- Consultations are not referenda
- Respondent population biased to vested interests
- Consultations about market rules can (and should be expected to) lead to market effects
- Measures to enhance market quality will usually result in winners and losers
- Consultations should identify clearly (1) winners and losers (2) the justification for proposals notwithstanding losers
- If consultations are not to be seen as “done deals” be careful about engaging the market beforehand

10. <u>Lessons</u> (2)

- **Alternative Trading Systems for Delisted Stocks?**
  - Resisted by the Exchange: "*qualitative delisting rules would provide adequate signals to investors and afford them sufficient time to act and make investment decisions*"
  - But no ATS proposal in the consultation paper – a major criticism
  - Consultation failed to emphasise share consolidation as the likely outcome of falling below price threshold
  - But would already very thinly traded stocks trade on an ATS that
    - Deals <u>only</u> in stocks <u>ejected</u> from the Exchange; and
    - Does not subject companies to to the usual disclosure standards and other market rules?

11. Lessons (3)

The 3-tier Regulatory Structure

Kotewall Report

"The essence of this structure is that the operation of the market should rest with the market operator close to the market under the watchful eyes of an independent regulator. Government maintains a broad policy interest …"

SFC Supervision of the Exchange

- SFC has statutory duty to "supervise and monitor" the Exchange and
  - Must approve new listing and trading rules of the Exchange before implementation
  - Can serve "restriction notices" and "suspension orders" on the Exchange

11. <u>Lessons</u> (3)
cont'd

- SFC cannot in practice use its nuclear deterrent: mutually assured destruction
- Systemic tension caused by a regulator regulating a regulator, despite MOU to facilitate cooperation
- "*Implicit in the system in the belief that the SFC has … expertise … as well as the credibility and vigilance to perform its functions effectively ... Should the SFC not possess or be denied any of these attributes, the checks and balances will be undermined*" (Kotewall Report, para. 3.10)
- In other words the checks and balances hinge on "SFC knows better than the Exchange"?

12. Lessons (4)

Role of the Listing Committee

- Part-time unpaid market participants
- Insufficiently engaged in the Penny Stock consultation proposals
- A Systemic problem?
  - Listing Committee has delegated authority over all Listing matters from Exchange Board
  - Operates behind Chinese Wall segregating Exchange Business and Regulatory units post-2000 demutualisation
- Inappropriate allocation of responsibility to deal with Exchange conflicts of interest?

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13. The Expert Group Report (March 2003)

- Conflicts of interest at the Exchange between regulatory function and for-profit business answerable to public shareholders
- Overlaps/gaps between role of Exchange and role of SFC: lack of clear public accountability for listing regulation
- Insufficient enforcement "teeth" to sanction Listing Rule breaches
- Recommendation – "HKLA", based on UK model, with Listing Rules backed by law

14. Law of Unintended Consequences

Core Criticism

“*The crux of what went wrong is that the public associated the [$0.50] threshold with delisting rather than consolidation. Media discussion … also concentrated on delisting … the two issues were intertwined in a lengthy, complex and technical Consultation Paper …*”

(Kotewall Report, para. 11.35)

Core Outcome

- Moves to reform entire HK regulatory structure after the 2000 demutualisation and self-listing of the Exchange
- Latest development: Government public consultation (October 2003)

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14. Law of Unintended Consequences

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One last quote:

"*One of the reasons the Listing Division did not follow up on the options suggested by the SFC [about an ATS] was that these issues were within the purview of the HKEx's business units*."

(Kotewall Report, para. 11.38)

We are watching developments at the NYSE with interest!

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Thank you.