2024 Policy Address Recommendations

Capital Market Reforms in Hong Kong

HKCMP

The Association of Hong Kong Capital Market Practitioners Limited, HKCMP, has been established by a group of seasoned market professionals from corporate finance, legal and accounting sectors. Its mission is to promote Hong Kong as a pre-eminent international capital market.

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Executive Summary

Policy Address Recommendations: Capital Market Reforms in Hong Kong

Introduction Hong Kong's capital market, once Asia's financial crown jewel, has faced significant struggles in recent years. These challenges stem from operational inefficiencies, regulatory rigidities, an inability to attract smaller, innovative enterprises, and lack of statutory support.

Key Issues Identified

1. **Diminished IPO Activity**: Hong Kong's IPO market, once a global leader, has significantly weakened, with fewer companies opting to list due to stringent regulatory requirements and high costs.
2. **Corporate Transactions Decline**: Corporate activities among listed companies have also fallen, causing layoffs and a significant long-term loss of financial talent.
3. **Lagging Competitiveness**: Hong Kong is losing out to markets like the U.S., due to long vetting times, listing uncertainty, high costs and restrictive rules on delisting, mergers and acquisitions (M&A) that are not conducive to value creation for shareholders.
4. **Inadequate Support for SMEs**: Smaller companies face barriers to entry due to the inflexibility of minimum capitalization and profitability requirements, connected transaction rules, and excessive corporate governance mandates.
5. **Absence of statutory corporate rescue regime**: Unlike other developed economies, past failures to legislate make it difficult for struggling companies to recover.

Global Competition and Comparative Insights Other markets, particularly the U.S. and UK, have more competitive listing systems that allow quicker and more cost-efficient listings. The UK Financial Conduct Authority (FCA) recently shifted to a more competitive framework, which provides a useful reference for Hong Kong to reduce regulatory burdens and attract more listings.

Key to Reform The key to reform is the strengthening of statutory support for the development of Hong Kong's equity capital market.

Currently, the Securities and Futures Ordinance (SFO) does not explicitly mandate the Hong Kong Securities and Futures Commission (SFC) to focus on market development. The legislation lacks a statutory Key Performance Indicator (KPI) or objective that promotes the growth and competitiveness of Hong Kong's capital market.

Unlike other financial hubs, efforts to introduce a statutory corporate rescue regime since 1996 have repeatedly failed. Such a regime would offer distressed companies legal protection during restructuring, preventing creditor disruptions and safeguard businesses and jobs. Government legislation is essential to establish this regime, ensuring stability and value for all stakeholders.

Reasons for Reform

1. *Legislative Gap:* The SFO focuses on investor education and protection but neglects the critical role of market development. Without statutory guidance to prioritize market growth, the HKEX and SFC have been unable to sufficiently promote an innovative, competitive, and attractive listing environment, which is crucial for Hong Kong to maintain its global standing as a financial hub.
2. *Balanced Regulatory Focus:* Whilst investor protection is vital, it needs to be balanced with fostering the development of a robust market. Other leading financial centers, such as the U.S. and the UK, incorporate market development as a core regulatory objective, recognizing that a vibrant capital market benefits both issuers and investors.
3. *Aligning with Global Best Practices:* The SFC has recognized the importance of market development in its 2024-2026 Strategic Priorities, but to effect meaningful change, amending the SFO to make market development a statutory objective is necessary. This would provide the regulatory clarity and direction needed to prioritize and encourage capital market growth, and together with a statutory corporate rescue regime, Hong Kong will be on par with other global financial hubs.

Once this underlying reform is addressed, the following eight urgent policy recommendations should be implemented to operationalize this shift and restore Hong Kong's competitiveness.

Urgent Policy Recommendations

1. Shorten IPO Vetting Timelines
2. Lower Minimum Market Capitalization and Profitability Requirements

3. Reduce Sponsor Due Diligence Requirements
4. Relax M&A and Connected Transaction Rules
5. Expand HKEX's Jurisdictional Scope
6. Develop the Fixed Income Market
7. Expand RMB Trading Options
8. Support Innovation and Technology Companies, in parallel with support for the VC Market
9. Completion of the legislative process for the Companies (Corporate Rescue) Bill first introduced in 2020.

Conclusion Hong Kong's capital market faces complex challenges, but targeted reforms can restore its global competitiveness. By reducing regulatory barriers, encouraging a broader range of listings, and supporting both large and small enterprises, Hong Kong can reclaim its status as a leading global financial center.

Policy Address Recommendations

Capital Market Reforms in Hong Kong

The Role of a Thriving Capital Market

For a capital market to thrive, it requires four critical elements: products, investors, infrastructure (including a robust network of service providers), and trust. In Hong Kong, IPOs serve as a key benchmark of market vitality and the attractiveness of the HKEX as a platform for raising capital. Over the years, HKEX has positioned itself as a market for larger, more established companies, often at the expense of smaller domestic enterprises. The stringent vetting processes for smaller firms have made it increasingly difficult for them to access public capital markets. This shift in focus has resulted in a diminished pipeline of new listings, particularly among smaller, innovative enterprises that drive much of the growth in other financial centers.

A clear example of this can be seen in the temporary reforms to requirements for Specialist Technology Companies and De-SPAC transactions, announced by the HKEX and the SFC in August 2024. These reforms continue to prioritize companies with sizeable market capitalizations, leaving smaller enterprises with limited opportunities. As a stock exchange monopoly, the HKEX has a responsibility to serve companies of all sizes. This is particularly critical for smaller domestic companies, as Hong Kong lacks an established private equity ecosystem like those in the U.S. or Mainland China. The bankruptcy filings of large Chinese property developers have shown that even big market-cap companies are no guarantee of investor protection from frauds and bad corporate governance or market stability.

The reform of the Growth Enterprise Market (GEM) in early 2024 was aimed at providing a pathway for small and mid-sized enterprises (SMEs) to list. However, the reforms have failed to attract new listings, and the few companies that have listed on the GEM in 2024 were those that had submitted applications years before the reforms. This is a clear indication that the current framework is not meeting the needs of smaller companies, further weakening Hong Kong's capital markets.

Decline in Corporate Transactions and the Loss of Talent

The challenges in Hong Kong's capital market extend beyond dwindling IPO activity. Corporate transactions among listed companies have decreased dramatically, further shrinking the market.

This decline has hit the financial services sector hard, leading to significant layoffs among capital market practitioners. The layoffs have resulted in the loss of not only talent but also the accumulation of experience that is crucial for the long-term viability of Hong Kong as an international financial center.

These losses are not temporary. The people who have been laid off, many of whom are younger professionals, represent the next generation of financial talent. Their departure from the sector means that even when the market eventually rebounds, Hong Kong will be left with a significant talent gap. This is a serious problem, as the financial services industry relies heavily on the accumulation of knowledge and experience to maintain its competitive edge. The longer this downturn continues, the more difficult it will be for Hong Kong to reclaim its position as a leading global financial hub.

The situation is not just a result of cyclical market downturns but highlights significant weaknesses in the regulatory framework, operational inefficiencies, and outdated practices.

The Competitive Landscape

The competitive landscape for capital markets has evolved significantly over the past few decades. Advances in technology, the rise of cross-border trading, and the increasing ease with which information flows between markets mean that companies now have more options than ever when choosing where to list. Unfortunately, Hong Kong's capital market has not kept pace with these changes.

Hong Kong's capital market is losing out to other markets, particularly the U.S., for several reasons:

1. **Long Vetting Times**: The median time from the submission of a listing application to a decision by the Listing Committee was 146 business days, or roughly 7 months, from August 2023 to July 2024. In the U.S., the vetting process is typically completed within three months.

2. **Uncertainty Around Listing Approvals**: Even when companies meet the listing requirements, the subjective nature of the vetting process in Hong Kong can create uncertainty. Regulators often make decisions based on commercial rationale and business sustainability, even though they themselves lack substantive business experience. By

contrast, the U.S. market allows investors to make their own decisions based on the information provided.

3. **High Listing Costs**: The lengthy application process, coupled with dual filing requirements and multiple rounds of audits, significantly increases the cost of listing in Hong Kong. Due diligence requirements are also more onerous than in other markets.

4. **Inflexible Minimum Market Capitalization and Profitability Requirements**: The decline in trading multiples due to macroeconomic and geopolitical factors has made it difficult for many companies to meet the minimum market capitalization and profitability requirements for listing in Hong Kong. Other markets, including the U.S., Mainland China, and Japan, have more flexible requirements. The latest market capitalization adjustment made in August 2024 yet again is skewed in favor of large cap companies.

5. **Stringent M&A and Connected Transaction Rules**: The current rules for mergers and acquisitions (M&A) and connected transactions make it difficult for listed companies to expand through acquisitions. This has put Hong Kong-listed companies at a disadvantage compared to their peers in other markets.

6. **Excessive Corporate Governance Requirements**: While strong corporate governance is essential for market integrity, the current rules are overly prescriptive and place an undue burden on smaller companies. The ongoing consultation on corporate governance could further weaken the appeal of Hong Kong as a listing venue, especially for SMEs.

7. **Limited Opportunities for Smaller Companies**: The tightening of listing rules over the past few years has made it increasingly difficult for smaller companies to go public in Hong Kong. This contrasts with other markets, where smaller companies are encouraged to list and grow.

The Need for Capital Market Reforms

Hong Kong's capital market is not only facing challenges in attracting new IPOs but also in supporting the growth and development of its existing 2,600 listed companies. Many of these companies are struggling to compete in an increasingly globalized and competitive market. Encouraging M&A activity among listed companies is as important as reviving the IPO market. However, the current regulatory environment makes it difficult for Hong Kong-listed companies to pursue acquisitions, particularly when it comes to connected transactions and continuing obligations.

Smaller companies are particularly disadvantaged by the current rules, as they face higher risks of delisting if their businesses are deemed insufficient. Unlike other markets, Hong Kong does not have an over the counter (OTC) market for shares of delisted companies, which increases the risk for investors and makes it harder for companies to recover from difficult periods.

An important feature of a successful capital market is a statutory corporate rescue regime. However, despite being a global financial hub, the Hong Kong capital market lacks corporate rescue legislation, unlike the U.S. (Chapter 11 legislation), Singapore, Korea, Malaysia, India, and China.

Corporate rescue reforms in Hong Kong have had a capricious history. Discussions around a statutory corporate rescue regime began in 1996 with the Law Reform Commission's recommendations. Attempts to legislate in 2000 and 2001 failed, with unresolved issues. Following the 2008 financial crisis, renewed efforts in 2010 and 2014 included public consultations and detailed proposals. In 2020, the government introduced the Companies (Corporate Rescue) Bill, which aimed to establish a statutory moratorium during the restructuring and supervision of distressed companies. This failed to proceed through the legislative process. Currently, company restructuring in Hong Kong lacks statutory support, allowing creditors to initiate legal actions, exert disproportionate leverage, thereby introducing uncertainties and disruption to restructuring efforts. A statutory corporate rescue procedure ("CRP") would provide companies with breathing space during restructuring, preventing rogue creditors from initiating unilateral actions. This would help preserve business operations, protect jobs, and enhance value for shareholders and creditors.

Shell Companies, Delisting and RTO Rules

Shell company activities, while often viewed negatively, are common in many international markets. In fact, some of the largest companies listed on HKEX today were created through the acquisition of shell companies. The delisting regime as applied to these companies further the destruction of shareholders' value. While it may be desirable to regulate the excesses of reverse takeovers (RTOs), the current principle-based tests are too subjective. A return to a clear, bright-line test would provide more certainty for companies and investors alike.

The current 36-month disposal restriction for shell companies should also be reviewed. This rule creates unnecessary hurdles for companies that want to restructure and grow through acquisitions and letting go of under-performing existing businesses.

At a time when global competition for capital is intensifying, Hong Kong cannot afford to maintain regulatory barriers that discourage change, growth and innovation.

A Lesson from the UK

The UK has faced similar challenges in recent years, with declining listings and an increasing number of delistings from the London Stock Exchange. Recognizing the need for change, the UK Financial Conduct Authority (FCA) has implemented a major overhaul of its listing rules, moving towards a disclosure-based approach. These reforms reduce regulatory burdens, increase flexibility, and create a more competitive environment for companies looking to list.

Extract from the Foreword of the UK Listing Rules Review: Feedback

"The UK's capital markets are the engine room of our economy. They allow companies to raise capital, expand and innovate to grow. They provide investors, including pension funds, with investment opportunities that can benefit from that growth. The UK's capital markets need to operate efficiently and competitively to thrive on the global stage and contribute to the growth of the country.

[………]

Our aim is to encourage a wider range of companies to choose to list, raise capital, and grow in the UK, while maintaining high standards of market integrity and consumer protection.

[………]

Our final rules for the new listing regime confirm a shift to a more disclosure-based approach, putting information in the hands of investors so they can make informed decisions. They remove barriers for listed companies by no longer imposing shareholder votes on significant and related party transactions, provide more flexibility on enhanced voting structures, and create a single, simpler equity listing category for commercial companies. At the same time, important protections have been retained, for example shareholder votes for reverse takeovers and cancellations of listings.

We have kept in mind that investors have already chosen to put their money in companies listed outside the UK, where the costly obligations we are removing do not exist. We believe institutional investors have the ability and heft to steer the companies they co-own. What's more, evidence does

not suggest that UK-listed companies are valued more highly by investors because of the current regime.

Our reforms emphasize the choices available to investors and companies, rather than the regulator making prescriptive, one-size-fits-all decisions. These reforms may mean investors change how they engage with companies, making more use of shareholder rights at law and other mechanisms to scrutinize boards and business strategies."

The FCA's approach provides a relevant and strong reference for Hong Kong. The UK reforms are designed to give investors more information and more choices, while reducing the regulatory burdens on companies. This is exactly the kind of change Hong Kong needs to remain competitive in a rapidly evolving global market.

Policy Recommendations

To revitalize Hong Kong's capital market and ensure its long-term sustainability, several key reforms are urgently needed. These recommendations are designed to increase the efficiency and competitiveness of the market, while maintaining important safeguards for investors.

Statutory support for the development of HK's equity capital market must be strengthened.

There is a lack of emphasis in the SFO on market development. The root of the problem is the legislation – there is no statutory KPI to encourage market development.

Development of the HK market is *not* part of the regulatory objectives *(SFO Part 2 (4))*. Whilst education and protection of investors *is* a regulatory objective, *nothing* is said about issuers, nor the corporates.

The SFC has already recognized its role in steering market development in its "SFC's Strategic Priorities for 2024-2026" published in January 2024.

The current focus on investor protection is essential but must be balanced with the need for market development. To achieve this, we recommend amending the Securities and Futures Ordinance (SFO) to include market development as a statutory objective. This would align Hong Kong's regulatory framework with those in other leading financial centers, where the development of a vibrant capital market is seen as equally important as investor protection.

With the overriding objective of encouraging market development, we also recommend the following actions be implemented as soon as possible.

1. **Shorten IPO Vetting Timelines**: The time taken to process IPO applications should be significantly reduced. The subjective merit-based approach currently in place should be replaced with a disclosure-based system, like those in the U.S. and the UK. This would allow companies to list more quickly and at a lower cost while giving investors the information they need to make informed decisions.

2. **Lower Minimum Market Capitalization and Profitability Requirements**: Considering the current market environment, the minimum market capitalization and profitability requirement for listing should be relaxed.. This would encourage more companies to list in Hong Kong and increase the diversity of the market.

3. **Reduce Sponsor Due Diligence Requirements**: The current due diligence requirements for IPO sponsors are excessive and add to the cost and complexity of listing. These requirements should be streamlined, with greater reliance placed on the disclosures made by companies. Sponsors should play a supportive role, but the primary responsibility for due diligence should rest with the companies themselves.

4. **Relax M&A and Connected Transaction Rules**: The current rules governing mergers and acquisitions, and connected transactions should be relaxed to allow listed companies more flexibility to grow through acquisitions. This is particularly important for smaller companies, which often rely on M&A activity to expand their businesses. The rules should also be clarified to remove unnecessary uncertainty.

5. **Expand HKEX's Jurisdictional Scope**: The HKEX should broaden the scope of eligible jurisdictions from which companies can readily list, making it easier for companies from around the world to choose Hong Kong as their preferred listing destination. This would enhance Hong Kong's appeal as a global financial center and increase the diversity of companies listed on the exchange.

6. **Develop the Fixed Income Market**: The fixed income market in Hong Kong remains underdeveloped, particularly in terms of corporate bond listings. More needs to be done to encourage companies to issue bonds and to make bonds available to retail investors. Developing this market would provide companies with more options for raising capital and give investors more choices for diversifying their portfolios.

7. **Expand RMB Trading Options**: All companies listed on the HKEX should be allowed to trade in both Hong Kong dollars (HKD) and Renminbi (RMB). This would not only increase liquidity in the market but also support the internationalization of the RMB, a key objective for both Hong Kong and Mainland China.

8. **Support for Innovation and Technology Companies**: Hong Kong needs to take bold steps to attract innovation and technology companies. The venture capital ("VC") market is a key provide of equity and funding to such companies, and as such, the development of the VC market needs to be focused on. By further reducing listing barriers and offering more flexible market conditions, the HKEX could become a hub for cutting-edge sectors, enhancing its global competitiveness.

Conclusion

The challenges facing Hong Kong's capital market are complex and multi-faceted. However, they are not insurmountable. With the right reforms, Hong Kong can regain its position as a leading global financial center. The recommendations outlined here provide a comprehensive roadmap for revitalizing the market, ensuring its long-term sustainability, and maintaining its global competitiveness. By making these changes, Hong Kong can continue to attract top-tier companies, investors and professionals from around the world, securing its future as a thriving international financial hub.