

---

## **CHAPTER 2**

# **OVERVIEW OF THE HONG KONG STOCK MARKET**

### **INTRODUCTION**

2.1 This chapter provides a brief overview of the Hong Kong stock market, summarizes the problems relating to penny stocks or micro caps, and identifies certain key stakeholders in the securities market. We believe this would be useful to the consideration and understanding of the events leading up to the preparation and release of the Consultation Paper. It would also be essential background when we come to suggest improvements for the future.

### **OVERVIEW OF THE HONG KONG MARKET**

2.2 As at the 30 July 2002, there were 934 companies<sup>4</sup> listed on the Hong Kong stock market, with an aggregate market capitalization of HK\$3,868 billion. This includes 790 companies trading on the Main Board, with market capitalization of HK\$3,802 billion (or 98% of the total), and 144 listings on the Growth Enterprise Market (GEM), with a market capitalization of HK\$66 billion (or 2% of the total). The HKEx is the only exchange company in Hong Kong.

2.3 Based on a study conducted by the SFC<sup>5</sup>, the performance and ranking of the Hong Kong market on the international scale in 2001 are as follows:-

---

<sup>4</sup> The number excludes warrants, I-shares and Nasdaq stocks but includes listed companies which were still suspended as at 30 July 2002. For companies under suspension, their market capitalization was based on closing prices prior to suspension multiplied by the units of issued share capital.

<sup>5</sup> “Quality of the Hong Kong Market – A Critical Review”, the SFC, 12 December 2001. The data show the position as at 2001.

---

<b>Performance Indicators</b>	<b>The HKEx</b>	<b>Ranking in the World</b>
Total market capitalization	\$438 billion	10 <sup>th</sup>
Total turnover for first 9 months in 2001	\$188 billion	17 <sup>th</sup>
Turnover velocity <sup>6</sup>	0.47	26 <sup>th</sup>
Funds raised	\$117 billion	7 <sup>th</sup>
Weighting in world investment portfolios <sup>7</sup>	0.7% of total	14 <sup>th</sup>

## **PENNY STOCKS OR MICRO CAPS**

2.4 Despite certain undoubted achievements of the Hong Kong market, the market and the SFC have had concerns:-

- (a) The market is heavily dependent on a few issuers. As of end May 2002, the seven largest companies accounted for 52% of our market capitalization. They also contributed 37% of the total turnover during the first five months of the year.
- (b) Turnover is low. Twenty six percent of the companies listed on the Main Board had average daily turnovers of less than \$100,000 in 2001.
- (c) There are many stocks with low trading prices, (i.e. penny stocks) and many with small capitalization (i.e. micro cap). As at the end of May 2002, about 73% of stocks in Hong Kong's Main Board traded below US\$0.2, compared to 57% in Singapore, 54% in Australia, 20% in London and Taiwan, below 1% in Tokyo and Korea, and none in New York or Mainland China. Among all the listed companies on the Main Board, 95 companies, or 12% of the total, have individual market capitalizations of less than HK\$100 million, the

---

<sup>6</sup> Turnover velocity is turnover divided by market capitalization. The figure represents the average for the nine months ended 30 September 2001.

<sup>7</sup> After the re-balancing of the Morgan Stanley Capital Investment (MSCI) World Index to account for free float.

minimum required for initial listing. Details are shown below:-

Price as at end-May 2002 (HK\$)	(1) Stocks in Hong Kong (Note 1)		(2) Aggregate Daily Turnover (Note 2) (HK\$ million)		(3) Aggregate Market Capitalization (HK\$ billion)		(4) Companies Reported a Net Loss	% (4)/(1)
		%		%		%		
Below 0.01	10	1.3%	1.8	0.0%	1.7	0.0%	10	100.0%
0.01+ to 0.1	97	12.4%	105.5	1.5%	20.1	0.5%	76	78.4%
0.1+ to 0.5	249	31.9%	391.4	5.6%	95.9	2.4%	145	58.2%
0.5+ to 1	127	16.3%	311.9	4.5%	85.3	2.1%	39	30.7%
Above 1	298	38.2%	6184.7	88.4%	3788.4	94.9%	37	12.4%
<b>Total</b>	<b>781</b>	<b>100.0%</b>	<b>6995.3</b>	<b>100.0%</b>	<b>3991.3</b>	<b>100.0%</b>	<b>307</b>	<b>39.3%</b>

**Source:** The HKEx Monthly Trading Statistics

- Notes:**
1. Excluding six companies under delisting procedures
  2. Based on turnover in January to May 2002

2.5 For the past two years, commentaries in the media and views expressed in the market combined to urge the relevant authorities to tackle the issue of penny stocks. The following are some of the concerns raised:-

- (a) Since the Automatic Order Matching and Execution System (AMS) of the HKEx cannot accommodate trading below one cent, trading of many penny stocks has to be done by brokers as odd lots manually via the Semi-automatic Matching System (SAM). This increases the possibility of mistakes in inputting trading orders and brokers have to bear the risk of loss if they are unable to rectify the errors.
- (b) Trading on the SAM is not as transparent as on the AMS. It is, therefore, undesirable for an issuer's shares to be traded on the SAM for a prolonged period.
- (c) Penny stocks are prone to market manipulation since a small amount of capital and a few trades may suffice to move the

---

price, and a small movement in share price can lead to a significant percentage change.

- (d) There were many instances of intentional reduction of share prices, through stock splits, rights issues and other fund raising activities carried out to the detriment of the minority interests.
- (e) Whilst a share's listed price is not necessarily an indicator of a company's quality, some companies trade at low prices because of weak fundamentals, either because they are loss-making<sup>8</sup> or because they have a small or reduced asset base. The proliferation of low-quality penny stock companies is considered by many as a blot on Hong Kong's image as a premier financial centre.
- (f) Stocks with low share prices are wrongly perceived by the less well-informed as cheap. Some small investors are also tempted to buy these stocks on a punt.
- (g) The charging structure is such that the transaction costs in percentage terms for penny stocks are higher than those for higher priced stocks. The burden on investors is therefore disproportionately larger.

2.6 Having regard to what other leading markets do to maintain quality, there was a widely felt need to improve the quality of the Hong Kong market by:-

- (a) actively identifying quality candidates for listing from other jurisdictions and devoting efforts to attract them to the Hong Kong market;

---

<sup>8</sup> According to the SFC's Paper "Quality of Market and the Case for More Effective Delisting mechanism" (July 2002), market cap and stock price are negatively correlated with financial performance of the listed companies. 72 out of the 95 companies with market cap below HK\$100 million were loss-makers, whereas only 2 out of the 71 companies with market cap larger than HK\$5 billion reported losses. Among the 107 companies with prices below HK\$0.1, 86 or 80% were reporting losses, compared to 12% for companies traded above HK\$1.

- 
- (b) ensuring proper “gate-keeping” through more stringent initial listing requirements as well as strict enforcement of disclosure, corporate governance and other regulatory rules; and
  - (c) amending existing delisting rules and introducing meaningful continuing listing requirements to weed out poor-quality companies and to signal that questionable businesses are not welcome.

## **KEY STAKEHOLDERS IN THE SECURITIES INDUSTRY**

### **Interested Parties**

2.7 Apart from the Government, the SFC, the HKEx and the issuers, there are three main interested parties in the securities market namely, investors, securities intermediaries and credit providers.

### **Investors**

2.8 According to a recent survey conducted by the HKEx<sup>9</sup>, 93% of the trading on the Hong Kong cash market<sup>10</sup> is on shares. In terms of trading value, overseas institutional investors and local retail investors are the two major contributors, accounting for 38% and 36% respectively. Local retail trading has always had a large share, though the ratio has fluctuated over the past decade from about one-third to over 50%, depending on market sentiment. Local institutional investors account for 19%<sup>11</sup>. Local retail investors make up the largest numbers of customers. It is thought that there were over one million retail investors in the Hong Kong stock and derivatives markets in 2001. Or, to give it more perspective, one out of five adults in Hong Kong invested in stocks or derivatives. This figure is more than twice the ratio of 9% in 1992.

---

<sup>9</sup> The five surveys conducted by the HKEx are (a) Cash Market Transaction Survey; (b) Derivatives Market Transaction Survey; (c) Retail Investor Survey; (d) Derivatives Retail Investor Survey; and (e) Primary Market Survey. Latest reports on all of the above surveys are available on HKEx’s website (<http://www.hkex.comhk/research/research.htm>).

<sup>10</sup> Cash market includes shares, warrants, debt instruments, unit trusts and Exchange Traded Funds.

<sup>11</sup> The data are extracted from an article in the SFC Quarterly Bulletin Summer 2002 “Increasing Investor Participation: Insights from the HKEx Surveys”. Principal trading and overseas retail investors accounted for 4% and 3% respectively. The Bulletin is available on the SFC’s website ([http://www.hksfc.org.hk/eng/press\\_releases/html/index.html](http://www.hksfc.org.hk/eng/press_releases/html/index.html)).

---

## **Securities Intermediaries**

2.9 As at 30 June 2002, there were 715 securities intermediaries including 707 securities dealers and eight margin financiers. Based on the SFC's latest survey<sup>12</sup>, securities intermediaries employed about 17,000 people in 2001. 41% of these employees worked in firms with fewer than 50 staff, 27% in medium sized firms of 51 to 200 people and the remaining 32% in firms with over 200 staff. In 2001, the total value of transactions in securities amounted to \$7,248.8 billion<sup>13</sup>, representing an annual increase of 41% over 2000. However, from responses collated by the SFC, net profits of securities intermediaries had dropped substantially (by 90% from \$4,290 million in 2000 to \$429 million in 2001). Brokers complain of declining turnover and increasing competition from banks. Small-and-medium-sized firms were hit the hardest.

2.10 Similar to other mature markets, margin trading is now active in Hong Kong. In June 2002, there were 571,534 active cash clients and 57,358 active margin clients. Margin financiers, most of whom are also securities dealers, are bound by the Financial Resources Rules approved and administered by the SFC to ensure adherence to prudent capital adequacy ratios.

## **Credit Providers**

2.11 Credit providers, mostly financial institutions, also play an important role. They are the ultimate source of finance. Investors, securities dealers and margin financiers often use shares as collateral for bank loans. Fluctuations in share prices have implications on the value of collateral and the statutory ratios of financial institutions. Banks are also increasingly competing for securities business.

## **OBSERVATION**

2.12 The authorities and the various stakeholders acknowledge the need to improve the quality of the Hong Kong securities market. The crux is how best to achieve this. The success of any major proposals hinges on

---

<sup>12</sup> Business Activities Surveys on Securities/Futures Intermediaries and Exempt Persons conducted by the SFC for October 2001. The response rate was 88%.

<sup>13</sup> The value of transactions includes trading equities and bonds both in Hong Kong and overseas.

---

the concerted efforts of many stakeholders whose size, nature of business and interests may be very different. Furthermore, as the securities and banking sectors are both involved, regulators have to be mindful of the possible knock-on effects on other sectors of the economy.