
CHAPTER 1

INTRODUCTION

THE PENNY STOCKS INCIDENT

1.1 Penny stocks, micro-caps¹ and delisting mechanisms have been receiving the attention of the securities industry and the media for the past two years. Suggestions for reform were formally introduced to the public on the 24 July 2002² when the Secretary for Financial Services and the Treasury (the Secretary), in the context of announcing other measures, mentioned that the Hong Kong Exchanges and Clearing Limited (HKEx) would release a consultation paper which would deal with issues to do with listing and delisting on the 25 July 2002.

1.2 At about noon on the 25 July 2002, the HKEx conducted a press briefing to introduce its “Consultation Paper on Proposed Amendments to the Listing Rules relating to Initial Listing and Continuing Listing Eligibility and Cancellation of Listing Procedures” (“the Consultation Paper”). The HKEx recommended, among other things, a revised mechanism to delist companies which fail to meet what were described as continuing listing eligibility criteria. As part of the package, the HKEx proposed that stocks with share prices quoted at HK\$0.50 or below should be consolidated, failing which, after a series of procedures and possible appeals, delisting may follow. The consultation period commenced on the 26 July, and was to end by the 31 August.

1.3 The Consultation Paper did not have any major impact on the securities market on the afternoon of the 25 July. When trading commenced at 10:00 a.m. on the 26 July (Friday), all was relatively normal until around 10:45 a.m. Thereafter, for about an hour, there was a large

¹ There is no official definition of “penny stock” and “micro-cap” in Hong Kong. Recently, the term “penny stocks” has been used to describe stocks which trade at below a certain price, say \$0.5. “Micro caps” are usually those companies with small market capitalization. There is no standard definition. The figures of HK\$100 million or US\$20 million have both been used.

² On 24 July 2002, the Financial Services and the Treasury Bureau, the Hong Kong Securities and Futures Commission and the Hong Kong Exchanges and Clearing Limited conducted a joint press briefing announcing a package of measures to improve the listing structure and procedures. This did not include proposals relating to delisting.

sell-off of stocks, leading to prices tumbling. Out of the 761 stocks³ listed on the Main Board, 577 (or 76%) recorded a loss, 151 (or 20%) had no price change and 33 (or 4%) made gains. Of the 370 penny stocks (i.e. stocks with closing prices at or below \$0.5 on 25 July), 283 (or 76%) recorded a loss, 75 (or 20%) was unchanged and 12 (or 3%) increased in price. The aggregate market capitalization for penny stocks declined by \$10.91 billion, representing about 10% of the market capitalization for that sector and 0.3% of the total market capitalization of the Main Board. Sixty-six stocks (62 of which were penny stocks) suffered a decline of 20% or more. The top loser saw a price plunge of 88%.

1.4 In view of the strong market reaction, the Secretary and, separately, the Hong Kong Securities and Futures Commission (SFC) and the HKEx stressed on the 26 July that the proposal was only part of a market consultation exercise. They stressed that it would take a few months to formulate the rules for implementation, and even if new rules were to be adopted, there would be a 12-month transitional period before they are implemented. On the 27 July, the HKEx announced its decision to extend the consultation period to the 31 October. A day later, the HKEx announced its decision to take out the whole of Part C of the Consultation Paper on continuing listing criteria as part of the current consultation. The HKEx undertook to strengthen the proposals and publish a supplementary paper by the end of October and would allow the public another three months to express its views.

1.5 Whilst stock prices stabilized after the 29 July, the incident continued to generate widespread disquiet. Against this background, the Financial Secretary appointed a panel to look into the incident and to recommend measures for improvement.

APPOINTMENT OF THE PANEL

1.6 On the 31 July 2002, the Financial Secretary announced the appointment of a panel of inquiry to look into the circumstances relating to the preparation and release of the Consultation Paper on 25 July 2002.

1.7 The terms of reference of the Panel were:-

³ This figure includes tradable stocks and excludes suspended shares.

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- (a) To examine the existing procedures for the preparation and making of new or amended Hong Kong Exchanges and Clearing Limited (HKEx) rules and regulations, including the process of consultation with the trade and the public;
 - (b) Having regard to the findings in (a), to review the arrangements for the preparation and release of the Consultation Paper;
 - (c) To make recommendations as to the measures to be adopted to improve where necessary the co-ordination in and procedures for the preparation and making of similar rules and regulations in the future, including the process of consultation with the trade and the public; and
 - (d) To submit a report with conclusions and recommendations to the Financial Secretary by 10 September 2002.

SCOPE OF THE INQUIRY

1.8 It became apparent to us from the very beginning that the issues of concerns surrounding the penny stocks incident were many and varied. We were on a very tight schedule and even if the terms of reference had permitted, we would not have been able to cover more than we have. Clearly we would not have been able to consider all the rules of the HKEx or issues of compensation. At the same time, encouraged as we were by the public utterances of the Financial Secretary and the Chief Executive of the HKSAR after our appointment, we felt able to consider various matters of public interest and concern which may not, on a very strict reading, be within the scope of the words employed in the Terms of Reference. We felt that it was important and necessary to supply the necessary background and context without which our report would have been less meaningful. While we obviously could not venture beyond our mandate, we felt able to construe our remit fairly generously where necessary. We anticipate that there may still be those who would say that our focus has nonetheless been too narrow and some who would say we have cast our net too widely.

1.9 Within the time and with the resources available to us, and given that we have been appointed to look into fairly specific areas, we felt that while we could take a broad view in a number of instances, we nevertheless had to adopt a balanced approach and be guided by the

framework of the Terms of Reference. In the end, within that framework, we decided that we would:-

- (a) cover the Listing Rules of the HKEx; and
- (b) focus this inquiry on the background and arrangements for the preparation and release of the Consultation Paper. The substantive issues or the merits of the proposals would, in any event, be outside the Terms of Reference, however broadly construed.

1.10 Besides, there are the consultation exercises being conducted and to be conducted by the HKEx, between now and the end of October and beyond. Any extensive consultation, which we believe would be desirable and necessary, would be beyond our remit and resources and not something we could have accommodated within the time designated. All we would say, at this stage, is that the proposals deserve full and open discussion and debate.

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1.11 To discharge our task, we:-

- (a) collected all available public documents and media reports on the Penny Stock Incident, some of which going back to the beginning of 2001;
- (b) invited all parties directly or indirectly involved in the incident to provide detailed chronologies, written statements, copies of relevant documents and suggestions for improvement;
- (c) invited interested parties to provide written submissions; and
- (d) conducted meetings with those who had some involvement or participation in the events.

1.12 During the inquiry, the Panel received 71 written submissions from 20 organizations and eight individuals. Included among the respondents were all those individuals and bodies who made representations

to the LegCo Panel on Financial Affairs on the 31 July 2002, major organizations associated with the financial services industry in Hong Kong, members of the Legislative Council and many individuals who were prepared to share their views with us. The Panel interviewed 11 individuals.

1.13 Where appropriate, the Panel provided undertakings to respondents who requested that submissions from them would be used only for the purpose of the inquiry and would be treated in the strictest confidence. The Panel further undertook, in some instances, at the request of certain respondents, to refrain from quoting from their submissions without their written permission. For these reasons, we have not appended any of the submissions to this report. None of the protagonists, save for the HKEx, requested similar undertakings. And the HKEx only requested undertakings in respect of sensitive information which we thought reasonable in the circumstances.

1.14 All the submissions were carefully reviewed and, in many instances, additional information and clarification were requested from the respondents. The facts presented and views expressed in the submissions and in meetings with us and the voluminous documentation supplied to us formed the basis of our consideration of the issues involved. We express our gratitude to all those who have participated in the inquiry, supplied information or offered views and advice to us. Their names are set out at **Annex 1.1**.

STRUCTURE OF THE REPORT

1.15 This report is divided into three parts. The first part sets out the background of the regulatory framework of the securities industry. This became necessary when, in the course of our inquiry, we detected much misunderstanding and some misguided commentary and criticism. We feel that fairly full background information is desirable to facilitate a detailed analysis and understanding of the Penny Stocks Incident and related issues. The second part describes the preparation and release of the Consultation Paper up to the appointment of this Panel. It highlights the interaction amongst the various parties and the circumstances surrounding the whole event. The third part summarizes key findings and recommendations of the Panel.