CHAPTER 10
WHAT HAPPENED ON THE 26 JULY 2002 AND WHY

INTRODUCTION

10.1 The following section relies substantially on a report prepared by the SFC dated the 3 September 2002. We have added our views where appropriate.

GENERAL COMMENTS

10.2 It has been widely reported that the "Penny Stocks Incident" on the 26 July was triggered by the release of the Consultation Paper by the HKEx. The information gathered by the SFC confirms that is likely to be at least partly true. However, this is not the whole picture.

10.3 There have been rumours of collusion by brokers and market participants to derail the HKEx's proposals by driving penny stocks down on the 26 July 2002. The SFC has not been able to identify sufficient evidence that supports the existence of a conspiracy to manipulate penny stocks. Nor has the SFC found evidence of a concerted sell-off by brokers or banks in response to client margin shortfalls.

10.4 On the 26 July, many investors apparently did not appreciate that the Paper was a consultation. The SFC's view is that just because the market reacted as it did, it does not mean that the HKEx somehow should have anticipated that reaction and should not therefore have released its proposals. The SFC, in common with the HKEx, thought that the public was aware of the substance of the HKEx's proposals from accurate leaks made by several reputable newspapers with large circulation from the 26 June onwards.

10.5 Much has been written recently about the lot of small retail investors, who have lost money, paper or real, in the market on the 26 July 2002. There is a very respectable body of opinion to the effect that the vast majority of retail investors understand that penny stocks are inherently more volatile than Hang Seng Index constituent stocks. Indeed volatility can be a prime attraction because these stocks may give investors a better chance of making a superior percentage profit for the small cost (relative to companies with large capitalization) involved in buying one or two board lots. Frequently, investors buy into a penny stock on incomplete information and with a limited understanding of the underlying company.

ECONOMIC OVERVIEW

10.6 Through 2002, the U.S. markets have been on a downward trend in the face of corporate scandals and poor economic conditions. In July 2002, U.S. investors pulled a record US$50 billion out of U.S. equity funds – the largest monthly net outflow in history – apparently because of a lack of confidence in the stock markets. The S&P 500 index dropped by 13.8% in the first half of 2002, compared with a decline of 7% in the Hang Seng Index. Many market analysts consider that Hong Kong's market will remain sluggish at least until the U.S.A. shows consistent signs of economic recovery. Market prices and turnover have been declining in broad terms in Hong Kong for some months. This has depressed market activity and the share performance of all but a few of Hong Kong's largest and best run listed companies. This was the economic background to the publication of the Consultation Paper on the 25 July 2002.

PRESS COVERAGE PRIOR TO THE ANNOUNCEMENT

10.7 To assess the impact of the Consultation Paper, the SFC studied the press coverage of the HKEx's proposals prior to the announcement made at noon on the 25 July 2002. We refer to a few items hereunder. A relatively complete summary is at **Annex 7.2**. On the 26 June 2002, Sing Tao ran an article suggesting that the HKEx proposed to force penny stocks to consolidate. On the 17 July 2002, South China Morning post ("SCMP") reported accurately that the HKEx planned to introduce a "compulsory consolidation rule to eliminate penny stocks". On the 18 July 2002, SCMP reported that the HKEx planned to set 50 cents "as the threshold below which companies would have to consolidate their shares or inject capital to boost their prices". Similar reports appeared in the Hong Kong Economic Times and Sing Tao on the 19 July 2002. Between the 20 July and the announcement on the 25 July 2002, more newspapers started to cover the story. In general, commentators welcomed the HKEx's proposals although some expressed reservations whether HK$0.50 was the appropriate threshold. There was no hue and cry indicating there might be a strong negative reaction to the release of the formal proposals.

THE MARKET IN THE PERIOD FROM THE 26 JUNE 2002 TO THE 25 JULY 2002

10.8 The market behaviour in the period from the 26 June to the 25 July is summarized below :-

(a) The general tone of the market was weak during the period. There were 14 days of net declines during the period, compared with seven days of net advances from the 26 June to the 25 July, 2002. As noted above, the Hong Kong market was tracking the general weakness and uncertainty in the U.S. markets over the same period.

(b) Overall, the higher priced stocks advancing or declining out-numbered the number of penny stocks going up or down in the same period[54]. There is no evidence that investors were selling their penny stocks in response to the leakage of the HKEx's proposals. If that had been the case, one would have expected the number of declining penny stocks to out-number the declining higher priced stocks.

(c) The number of penny stocks registering no price changes consistently was higher than the higher priced stocks recording no price changes[55]. This was particularly obvious for stocks that registered no daily turnover at all.

(d) The clear trend was that penny stocks tend to demonstrate higher volatility when compared to the behaviour of higher priced stocks.

[54] In the 22 trading days to the 26 July, 2,353 higher priced stocks recorded advances, compared with 1,592 penny stocks. 3,878 higher priced stocks recorded declines, compared with 2,514 penny stocks recording declines.

[55] During the same period, 3,325 penny stocks recorded no price change, compared with 2,776 higher priced stocks. In fact, during this period, 2,015 penny stocks recorded no turnover volume, whereas 1,344 higher priced stocks recorded no turnover volume.

THE BEHAVIOUR OF THE MARKET ON THE 25 JULY AND THE 26 JULY 2002

The 25 July 2002

10.9 Press commentaries on the market for the 25 July 2002 did not suggest anything dramatic had occurred that day.

The 26 July 2002 – Immediately after opening

10.10 Prior to the market opening at 10:00 a.m. on the 26 July 2002, no unusual movements were anticipated. Wall Street had been flat overnight (Standard & Poor 500 moved only 0.44% lower overnight) suggesting, if anything, that Hong Kong would remain largely unchanged. In headline articles, almost all local newspapers reported the release of the Consultation Paper. There was no suggestion that the proposal was a shock to the market. There was some focus whether $0.50 was an appropriate threshold, noting that over 50% of the Main Board issuers might be affected. On balance, the media seemed to support the proposals.

10.11 At 10:00 a.m., the market opened with a small downward bias. None of the brokers interviewed by the SFC subsequently foresaw any sharp movement in the market. While there were quite a number of losers in the market just after opening, nothing suggested any significant changes were about to occur given the bearish sentiment which had been overhanging the market for some time.

After 11:00 a.m. on the 26 July 2002

10.12 The situation started to deteriorate after 10:45 am as more and more stocks started to record further losses. While many stocks recorded losses (over and above those incurred over the previous few months) in relatively dismal turnover, Terabit Access (491)[56] stood out as the heaviest loser in heavy turnover. From about 11:00 a.m., according to the SFC

[56] Formerly known as Wellback Holdings Limited, Terabit Access engages in the manufacturing of consumer electronic products. In November 2001, there was a change in control in which Mr Lau Kwok Fai, currently the Vice-Chairman of the company, acquired 18.4% of the share capital of the company and became the controlling shareholder. Since the change of control, the company embarked on new acquisitions into technology companies in Taiwan and saw its share price more than triple before the sell off.

investigation, the market began to associate the market's decline with the proposals announced by the HKEx the previous day. Rumours also started to circulate that margin financiers had liquidated client securities as a result of the sharp decline in share prices of penny stocks. The selling climax for all stocks for the day came prior to the morning closing.

10.13 A noticeable recovery was seen in the market in the afternoon on an intra day basis. Out of a total of 283 penny stocks[57] that fell on the 26 July 2002, 63 of them had recovered more than 20% from their respective intra-day lows in the afternoon session. Among these 63 recovering stocks, four of them (including Terabit Access) rebounded more than 100%. Nothing comparable occurred in the higher priced stocks.

10.14 A summary of the statistics for the 26 July 2002 is as follows:-

(a) 283 penny stocks registered price declines. The total decline in market capitalization was $10.9 billion, or 10.1% compared with the previous day.

(b) In terms of market capitalization, these penny stocks accounted for 2.6% of total market capitalization of $3,664 billion on the 26 July 2002.

(c) Turnover in penny stocks amounted to $558.9 million or 7.6% of total market turnover, compared with $221.2 million or 3.3% in the previous day.

(d) Total market capitalization declined by $61 billion or 1.6% on the 26 July 2002. Overall market turnover increased by 7.9% to $7.4 billion on a decline in the Hang Seng Index of 1.1%.

[57] "Penny Stocks" refer to stocks with closing share price quoted at or below $0.5 on the 25 July 2002.

LOSS IN MARKET CAPITALIZATION ON 26 JULY 2002

10.15 One measure of loss that can be applied to stock markets is to calculate the loss of market capitalization[58]. By this measure, the drop in the value of penny stocks resulted in a decline in market capitalization for these companies of $10.9 billion in aggregate. This is approximately equivalent to 22% of the amount lost by all other companies whose share price was above $0.50 on the same day. When compared to the loss in market capitalization for the whole of the Main Board, the loss is about 0.31%, which is not hugely significant in the context of the whole market.

10.16 The market's activity on the 26 July 2002 was centered on 160 shares trading below HK$0.20 at the opening. These shares recorded the biggest jump in trading volume and turnover and the sharpest declines in share price (and hence market capitalization). Volume and turnover of penny stocks increased a respective 3.4 times and 1.5 times when compared with the previous day.

CHURN RATE

10.17 Churn rate is defined as the volume of market turnover of an issuer in relation to its outstanding shares in issue[59]. This indicator is useful in understanding how reliable the market price is in reflecting the collective views of investors in the share of a company. A low churn rate is normally the result of either outstanding shares being cornered or of the fact that the market has no interest in that particular issuer. An issuer with a low churn rate is also susceptible to higher volatility in its share price. The statistics also show that:-

[58] Market capitalization is the product of market price multiplied by the shares in issue of the listed company. It is also commonly referred to as the market value of a company. By definition if the share price of a company drops, there will be a loss in market capitalization.

[59] Theoretically it is better to use the free float of an issuer (i.e. after deducting the shares controlled by the controlling shareholders) instead of the shares in issue as the base. The shares controlled by the controlling shareholders are normally not used for trading purposes.

(a) Seven issuers recorded an average loss of 16.5% without any turnover[60]. In terms of loss in market capitalization, they contributed a loss of $281 million.

(b) Issuers with a low churn rate can exert a very significant leveraging impact on the loss of market capitalization. A total of 133 stocks (of which only 14 had a price above $0.50 on the 25 July 2002) with churn rates of lower than 1%, contributed an aggregate loss of market capitalization of $8.4 billion. A mere turnover of $145 million is responsible for an average price decline of 18.5%, ranging from 10.2% to 53.6%.

10.18 It is apparent that in many circumstances, significant losses were recorded on the back of a very low churn rate. The degree of significance increases the lower the share price of that stock becomes. This is consistent with the notion that lowly priced stocks tend to be monitored by fewer investors on a regular basis. They are subject to bigger price movements in the case of a sudden influx of buy or sell orders. There is a prevailing psychology amongst investors to refrain from making any investment decision (while still holding on) on investments that have already resulted in significant paper losses. Some of these penny stocks were at one time high flyers.

BEHAVIOUR OF DECLINING STOCKS PRIOR TO THE 26 JULY 2002

10.19 From the 31 December 2001, only 16 of these stocks managed to record gains for the period while 89 declined. On average, the gainers posted gains of 37% whereas the decliners registered an average loss of 34%. Included in the gainers was Terabit Access (491) which had made a gain of 198% since the beginning of the year 2000 prior to its sell off on the 26 July 2002. If Terabit Access is excluded, the average gain would be reduced to 26%. Only five stocks managed to record a loss of less than 20% from

[60] Under the AMS system, the closing price of a listed company may be adjusted even if there is no transaction done for the day. Take an example of a situation whereby someone is prepared to sell a stock and finds that no bidder is around. He can keep making successive offers at lower prices. In this instance, so long as the last offer (the lowest) is lower than the previous day's closing price, this lower offer will be considered as today's closing price. (Please note that the actual mechanism is slightly more complicated.)

their highs of the year[61]. Sixty-two stocks registered losses of more than 40% prior to the 26 July 2002. Amongst these losers, 45 of them had closing prices at or below $0.10 on the 25 July 2002.

10.20 Thus, most of the top declining stocks registered significant losses to their share price prior to the 26 July 2002. The losses in value of these stocks on the 26 July 2002 represented a fraction of the total losses incurred as a result of their earlier price declines from their previous high for 2002 or from their closing price prior to the 31 December 2001.

10.21 It can be seen that many penny stocks had been losing value for sometime. It is therefore inaccurate and wrong to suggest that investors in penny stocks lost all their money overnight. The lion's share of investor losses occurred prior to the 26 July 2002. 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 actual losses suffered in the previous six months. For example, Grand Field Group (Code: 115) that saw its share price declining from $0.087 to $0.06 (a drop of 31% and ranked 13th amongst the top losers on the 26 July 2002) was trading around $0.70 in mid-March 2002. China Star Entertainment (Code: 326) which lost $0.012 on the 26 July 2002 to reach $0.027 (a drop of 31% again and ranked 14th on the top declining list) was trading around $0.27 in early January 2002.

10.22 The SFC has also noted that prior to the 26 July 2002 a few companies published very poor results and that these may also have contributed to weakness in the market for those individual shares. On the 24 July 2002, Asia Tele-Net and Technology (Code: 679 and the 4th top loser) reported a loss of $132 million for its final results for the year ending the 31 March 2002. The loss per share was about $0.0245, roughly equivalent to 94% of its share price on the 25 July 2002. Also on the 25 July 2002, Asia Resources Transportation (Code: 899) and (the 19th top loser) reported a loss of $136 million for its final results for fiscal year 2002. The loss per share was about $0.075, about two times (in absolute terms) its share price of $0.036 on the 25 July 2002. The extremely low turnover in those shares (due to an absence of bidders) in a fast falling market is consistent with this view.

61 By definition, this ratio must be negative.

THE MARKET SINCE THE 26 JULY 2002

10.23 On the back of the withdrawal of Part C of the Paper on the 28 July 2002, a number of the penny stocks rebounded on the 29 July 2002. However, in light of the prevailing weak economic environment and the uncertainties of the overseas market, the rebound was very selective. While it is widely believed the announcement of the Consultation Paper triggered the sell-off, there were rumours that a group of brokers had met on the evening of the 25 July and conspired to derail these proposals by deliberately driving penny stocks down the next day. In turn, this is alleged to have caused the margin squeeze already mentioned.

PRELIMINARY FINDINGS

10.24 The SFC's preliminary findings are as follows:-

(a) It has information that the announcement of the Consultation Paper and the general weakness of penny stocks in the weeks prior to the 26 July 2002 were the principal reasons for some sellers wanting to sell.

(b) However, the lack of liquidity in many penny stocks (in the form of a lack of demand) exacerbated the situation.

(c) None of the brokers with whom the SFC had been in contact foresaw the magnitude of the decline that subsequently occurred.

(d) None of those brokers said they had been squeezed by margin calls from their banks. They said it was their client's decision to sell that day, not theirs.

(e) Some of the brokers interviewed by the SFC pointed to the sharp fall of Terabit Access as having a significant psychological impact on market behaviour on the 26 July 2002, but this was not a unanimous view.

(f) Terabit's fall was fuelled by forced sales by brokers as a result of margin calls. To date, the SFC has no evidence that these were not genuine calls.

(g) There is no evidence of widespread forced sales by brokers of client shares pledged for margin, nor were brokers forced to seek further credit from their banks to cover clients' unsettled trades from the 25 July 2002.

(h) No systematic overnight short selling has been identified.

THE SFC'S CONCLUSIONS

10.25 Based on the above findings, it is the SFC's view that the sell-off of penny stocks on the 26 July 2002 was primarily an over-reaction by investors to a set of proposals for market consultation that were unfortunately misunderstood by some as policy changes.

10.26 Market sentiment was already weak because of world and local economic conditions. These same factors and the fact that a number of penny stocks continued to have losses contributed to the majority of the top declining stocks suffering significant erosion of their share price long before the 26 July 2002. In fact, the losses incurred on the 26 July represented a small fraction of the losses incurred by penny stocks due to earlier price declines from either their closing prices at the 31 December 2001 or from their previous high in 2002. Investors in these stocks did not lose all their money overnight.

10.27 The true scale and market impact of the decline on the 26 July 2002 should be evaluated against the market as a whole. A large percentage drop in the value of stocks does not necessarily equate to a similarly dramatic drop in absolute value. For example, Dah Hwa International lost 54% of its value on the 26 July 2002 but this represented a drop from $0.11 to $0.051 on turnover of a mere HK$50,000. In many ways, the trading in Dah Hwa is a paradigm of the problems that penny stocks pose for the fair and transparent operation of the market.

10.28 Furthermore, the illiquidity of penny stocks contributed to their volatility. 133 stocks (of which only 14 had a price above HK$0.50 on the

25 July 2002) with churn rates of lower than 1%, contributed an aggregate market loss of $8.35 billion. A turnover of only HK$145 million or 0.2% of total turnover on the 26 July 2002 was responsible for this decline in market capitalization. Compared to the overall losses suffered by the whole of the Main Board on that day, the loss of capitalization in penny stocks accounted for 0.31% of overall capitalization.

10.29 Unfounded rumours were another ingredient in the brew: rumours that a concerted credit squeeze by banks and brokers forced the market down have not been substantiated. Nor is there evidence of a conspiracy amongst a group or groups of investors and/or brokers to manipulate the penny stock sector as a whole.

THE PANEL'S VIEWS

10.30 The Penny Stocks Incident seemed to have been the outcome of a combination of factors which fed on and magnified each other. There was the prevailing unfavourable market sentiment, the generally weak investor confidence, and the inherent volatility of these stocks. We have noted criticisms of the contents of and the arrangements surrounding the release of the Consultation Paper. Clearly its release triggered the reaction on the 26 July, but it would be simplistic and inaccurate to identify the consultation Paper as the single cause of what happened. Unfounded rumours about margin calls, panic reaction to the dumping, an element of when fortune smiles, take advantage as well as unreflecting herd instincts also played a part.