

## TOPIC 2 - OVERVIEW

<b>1. PRIMARY MARKET</b>	2.2
1.1 What is the Primary Market?	2.2
1.2 Why Do Companies Go Public (listed)?	2.2
1.3 Advantages and Disadvantages of Listing	2.2
1.4 Types of Equity Markets in Hong Kong	2.2
1.5 Initial Public Offering	2.3
1.6 Listing Rules	2.3
1.7 Types of Listing Methods	2.3
1.8 Role of Advisers and Professionals	2.5
1.9 HKEx Hearing	2.7
1.10 Road Show	2.7
1.11 Prospectus Conventions	2.7
1.12 Prospectus Preparation	2.9
1.13 eIPO	2.9
<b>2. SECONDARY MARKET</b>	2.10
2.1 What is the Secondary Market?	2.10
2.2 Trading System	2.10
2.3 Corporate Actions and Raising Additional Funds	2.11
2.4 Clearing and Settlement System	2.12
<b>3. MARKET SURVEILLANCE AND ITS EFFECT ON PARTICIPANT BEHAVIOUR</b>	2.13
<b>4. REPORTING TO INVESTORS AND THE MARKET – KEEPING THE MARKET INFORMED</b>	2.13
<b>5. EXCHANGE PARTICIPANTS</b>	2.14

## 1. PRIMARY MARKET

### 1.1 What is the Primary Market?

- Where new capital is raised and securities are issued for the first time
- Operates between companies/government and investors

### 1.2 Why Do Companies Go Public (listed)?

- To gain **initial and ongoing access to capital**
- To go back to the market for future funds allowing capital to be raised for expansion
- Raises **company profile** and spreads risk across many owners

### 1.3 Advantages and Disadvantages of Listing

#### Advantages

- Access to capital market for **future expansion**
- Provides sharing of risks
- Allows owners/entrepreneurs to liquidate their interests
- **Promotes name of company** and its products
- Provides an **objective market valuation**

#### Disadvantages

- **Loss of control** by original owners/entrepreneur
- Subjected to **public scrutiny**
- Administrative **costs**, including ongoing regulatory compliance costs and regular market communications
- **Greater scrutiny** of company dealings and performance by regulatory authorities, shareholders, analysts, the media etc
- External factors/market forces influence **company value**

### 1.4 Types of Equity Markets in Hong Kong

- There are two equity markets in Hong Kong: the Main Board and the Growth Enterprise Market (GEM)

#### Main Board

- Lists established companies meeting prescribed profit requirements and/or financial standards
- Listing requirements include: operating history and management, minimum market capitalization, accounting standards, public float and spread of shareholders
- Since 30 April 2018, biotech companies at the pre-profit/pre-revenue stage are permitted to list on the Main Board

**GEM**

- Offers small and mid-sized companies with growth aspirations a means of raising capital
- The main financial requirement is HKD30 million positive cash flow from the two preceding financial years
- Scope of listing requirements is largely in line with that of the Main Board, but less stringent
- Given the higher risk (buyer beware) of GEM, it caters primarily for professional and sophisticated investors

**1.5 Initial Public Offering**

- The listing of debt or equity on a stock exchange for the first time
- In 1993, Tsingtao Breweries was the first of several **H-share IPOs** involving companies incorporated in the PRC and approved by the China Securities Regulatory Commission (CSRC) being listed in Hong Kong. Shares are traded in HKD, although from June 2011, issuance and trading in Rmb is also available
- The book-building approach to IPOs was introduced in 1993

**1.6 Listing Rules**

- The SEHK administers listing matters as part of its responsibility to perform its function of providing a fair, orderly and efficient market for the trading of securities.
- The Listing Rules prescribe requirements for the listing of securities and are intended to ensure:
  - the suitability of applicants for listing;
  - the fair and orderly issue and marketing of securities;
  - the provision of sufficient, material and timely information which might concern the investors and the public and affect the prices of listed securities by issuers;
  - the fair and equal treatment of shareholders;
  - that the directors act in the interests of the shareholders as a whole, particularly where the public shareholders are a minority; and
  - that all new issues are first issued to existing equity shareholders as rights issues unless they agree otherwise

**1.7 Types of Listing Methods**

- No matter the method of listing, a listing document is usually required and can take the form of a prospectus, a circular or any equivalent document
- Details of different methods of listing follow

**Offer for Subscription**

- An offer of new securities to the public by or on behalf of an issuer
- The listing document must assure both investors and the issuer that the listing will raise the full amount of funds
- Subscription must be fully underwritten

**Offer for Sale**

- An offer of securities to the public by or on behalf of holders of securities already in issue
- As with offer for subscription, the stock exchange must be satisfied of the fairness of a tender process and a listing document must be prepared

**Placing**

- A sale of securities to a selected group of persons rather than to the general public
- An intermediary (investment bank) identifies investors and arranges for the placing of securities
- The stock exchange may not allow this method of listing if there is likely to be a significant public demand for the securities

**Introduction**

- The listing of securities already in issue where no marketing activities are required as the amount and dispersion of the securities underpin their marketability
- Introductions are appropriate where:
  - Securities are already listed on another exchange
  - Securities are distributed by a listed issuer to its shareholders or the shareholders of another listed issuer
  - A holding company is formed and its shares are exchanged for those of one or more listed issuers
- Only permitted in exceptional circumstances. A listing document is still required

**Rights Issue**

- The offer of a right to existing shareholders allowing them to subscribe for additional securities in proportion to their existing holdings, usually at a discount to the market price
- Normally, a rights issue must be fully underwritten
- A listing document is required

**Open Offer**

- An offer to existing securities holders for additional securities, irrespective of their existing holdings
- Not renounceable – the rights cannot be sold
- May be combined with a placing
- A listing document is required
- If not fully underwritten, this fact must be disclosed in the listing document

**Capitalisation Issue**

- An issue of securities to existing shareholders in proportion to their existing holdings and fully funded out of the issuers' reserves or profits, avoiding any need for monetary payment
- Must be supported by a listing document in the form of a circular to shareholders

**Consideration Issue**

- Securities are issued as consideration in a transaction or in connection with a takeover or merger
- Must be announced through a press notice

**Exchange or Substitution**

- The exchanging, substituting or converting existing listed securities into other classes of securities
- Must be supported by a listing document in the form of a circular to shareholders

**Hong Kong Depositary Receipt (HDR)**

- In July 2008, the SEHK introduced a framework for the listing of HDRs
- Purpose is to attract equities currently listed in overseas markets to be listed and traded in Hong Kong
- Applies to Main Board only
- The depositary receipt is issued by a depositary representing the underlying shares of the issuer, which have been lodged with the depositary or its nominated custodian
- The depositary receipt transfers all the rights of the underlying shareholders, including dividends and all cash flow (converted into the local currency)
- A depositary receipt represents a fixed number of shares, according to a certain ratio

**Other Methods**

- Exercise of options or warrants
- Issue of securities on exercise of options or warrants granted to executives/employees
- Other methods approved by SEHK, from time to time

## 1.8 Role of Advisers and Professionals

**Sponsor**

- Can be a corporation or an AFI licensed or registered under the SFO for Type 6 regulated activity
- Responsible for preparing the new applicant for listing, lodging the formal application and preparing all supporting documentation for the SEHK
- Ensures that the issuer satisfies the listing requirements and that the directors understand their responsibilities and honour their obligations under the Listing Rules
- On listing, the issuer must appoint a compliance adviser, who can be the sponsor, to serve for at least a year following the listing

**Underwriter**

- An intermediary between the issuer and the investing public – usually an investment bank or brokerage house
- Primary responsibility is to organise the issue of securities
- Will often organise a syndicate to help with sale, promotion and distribution of securities
- Can also share the risk by agreeing to buy all unsold securities or buy all securities and then resell them

**Accountant**

- The firm of accountants engaged by the issuer must be qualified under the Professional Accountants Ordinance and be independent of the issuer
- The chosen firm must prepare the required accounting reports, including profit and loss accounts and statements of assets and liabilities

**Legal Advisers**

- Responsible for reviewing the legal structure of the listing company and verifying that all documents to be submitted comply with relevant laws
- Play a particularly important role when companies have to restructure to comply with Hong Kong's laws

**Valuers**

- Significant assets (eg land and buildings) are required to have their values assessed by qualified independent valuers
- Valuation reports are required for substantial transactions (acquisitions or disposals) and in connected transactions

**Depository (for HDR)**

- Issues depository receipts as an agent of the issuer
- Holds the issuer's underlying shares

**Share Registrar**

- Shares issued by Hong Kong listed companies must be registered via approved share registrars
- An approved share registrar must be a member of the Federation of Share Registrars
- All share registrars must comply with the Code of Conduct for Share Registrars (published by SFC)

## 1.9 HKEx Hearing

- The Listing Committee of the SEHK will hear the listing case and question the applicant to establish whether the company is suitable for going public
- When the Committee is satisfied, the company can start its advertising and marketing campaign to attract investors

## 1.10 Road Show

- Promotion of the company's listing to prospective investors
- The company and its advisers have a number of meetings and presentations with potential investors, brokers, analysts and fund managers to persuade them to invest in the company's shares
- Also allows the company and its advisers to assess the likely demand from investors for the shares

## 1.11 Prospectus Conventions

### Equity Securities

- **Contents:** sufficient information covering the industry, business overview and risk factors should be provided to allow investors to make an informed investment decision. Information should also cover the company's past results, the timetable of the offering and the rights of the securities being offered
- **Responsibility:** a statement of the directors' commitment to the prospectus must appear in the prospectus. All directors are held responsible for the information presented
- **Subsequent events:** a supplementary listing document must be issued if the following events occur after the prospectus is issued:
  - A significant **change** affecting any matter covered in the prospectus
  - A significant **new** matter which would have required inclusion in the first place
- **Language:** must be published in both English and Chinese
- **Illustrations:** the prospectus may contain illustrations and/or graphs, as long as they are not misleading
- **Profit forecasts:** if future profits and dividends are referred to, they must be supported by a formal profit forecast. Any forecast must be supported by underlying assumptions and the reporting accountants and the financial advisers must state that they are satisfied that the profit forecast has been made after due and careful enquiry. All assumptions made should be specific, not general, and should help investors form a view on the reliability of the forecast
- **Disclaimer:** the following should appear in every prospectus:

*Hong Kong Exchanges and Clearing Limited and The Stock Exchange of Hong Kong Limited take no responsibility for the contents of this document, make no representation as to its accuracy or completeness and expressly disclaim any liability whatsoever arising from or in reliance upon the whole or any part of the contents of this document*

**Debt Securities**

- The conventions for content, responsibility, subsequent events, language, illustrations and disclaimers are the same as those above
- A listing document is required for all kinds of offer to Hong Kong retail investors, including:
  - offers for subscription
  - offers for sale
  - placement
  - exchanges or substitution of securities



## 1.12 Prospectus Preparation

- All prospectuses must be in printed form and a formal notice must be published in newspapers on the date of issue of the listing document
- In the case of **equity securities**, the notice must contain the following:
  - Name and country of incorporation of the issuer
  - Amount and title of the securities being issued
  - The address at which copies of the listing document are available to the public
  - Date of notice publication
  - Names of lead broker and distributors
  - A statement that an application for listing has been made to SEHK
  - A statement that the notice is for information purposes only and does not constitute an invitation or offer of securities
  - Date on which dealings are expected to commence
  - In the cases of offers for sale or subscription, a statement that applications will only be considered on the basis of the prospectus
  - Name and address of the sponsor
- In the case of **debt securities**, the notice must contain the following:
  - Name and country of incorporation of the issuer
  - Name and country of incorporation of the guarantor
  - Amount and title of the debt securities being issued
  - The address at which copies of the listing document are available to the public
  - Date of notice publication
  - For a tap issue<sup>1</sup>, total amount of debt securities which would be issued under the arrangement
  - Names of issuing houses, where applicable
  - A statement that an application for listing has been made to SEHK
  - A statement that the notice is for information purposes only and does not constitute an invitation or offer of securities
  - Date on which dealings are expected to commence
  - In the cases of offers for sale or subscription, a statement that applications will only be considered on the basis of the listing document
- Although a prospectus must be in printed form, it can also be made available in electronic form. Any electronic prospectus must contain confirmation that it is identical to the printed form

## 1.13 eIPO

- Under the Electronic Initial Public Offering (eIPO) services provided by the SEHK, Hong Kong investors can apply for shares electronically. Some share registrars also provide eIPO services for public subscription

---

<sup>1</sup> Debt securities where subscription may continue, or further tranches thereof, after the initial listing

## 2. SECONDARY MARKET

### 2.1 What is the Secondary Market

- Listed securities are traded among investors, where market liquidity is an important factor
- A successful primary market relies upon a liquid secondary market

### 2.2 Trading System

- The SEHK operates Monday to Friday, excluding public holidays

#### Trading Platform for the Securities Market

- The SEHK's trading system moved to the Orion Trading Platform – Securities Market (OTP-C) from AMS/3 in February 2018, and is only accessible to Exchange Participants (EPs)

#### Liquidity

- Liquidity is the ability of investors to buy or sell securities easily in the market
- If a security can only be bought (or sold) at prices much higher (or lower) than the current price, the market is not considered liquid

#### Bid/Offer Prices

- The **bid price** is the highest price that a buyer is willing to pay for a security at a particular time
- The **offer (or ask) price** is the lowest price at which a seller is willing to sell a security at a particular time
- The **spread** is the difference between the current bid price and the current offer price of a given security. The **incremental spread** is the marginal/additional spread between the prices and depends upon the price of that security

#### Common Types of Orders

- When trading, an investor should provide the EP with clear instructions covering account number or name, securities code or name, **order type**, price and quantity
- The most **common order types** include:
  - *Market order*: also referred to as “unrestricted order”, it instructs the EP to execute the order at the best available price
  - *Limit order*: the instruction specifies the highest or lowest price acceptable for a transaction as well as the size, expiry time and date
  - *Stop-loss order*: used to limit an investor's loss. When the market price hits or goes beyond the stop price, a market order will be triggered to limit the investor's loss
  - *Stop-gain order*: opposite of a stop-loss order to enable a gain to be realised. Used for hedging or risk-management purposes
  - *Discretionary order (careful discretion)*: investors rely upon the dealer or broker's professional judgment for entering into a particular transaction

## 2.3 Corporate Actions and Raising Additional Funds

- A listed company may initiate transactions involving its shares which can affect shareholder positions
- Accurate and sufficient information about corporate actions should be disclosed in a timely manner, especially in the case of a book closure arrangement
- The company's share registrar will not handle any share transfer requests during the book closure period
- The **ex-date** is the date on or after which the shares will be traded without specific entitlement of the corporate action (eg **ex-div**, **ex-rights**)
- Examples of corporate actions affecting shareholder positions are: a **bonus issue**; a **rights issue**; a **placing**; and an **equity warrant**

### Bonus Issue

- An issue of new shares to existing shareholders at no cost, usually in proportion to a shareholder's existing holding. That is, the shares are issued "for free". Illustrated by the following example:

#### **Example – theoretical price per share after bonus issue**

Charlie holds 200 shares worth HKD2.00 each immediately before a 1 for 4 bonus issue. The price per share immediately after the bonus issue is shown below.

Number of shares before issue		200
Value of shares before issue	200 shares x HKD2	HKD400
Bonus issue entitlement	200 shares/4	50 shares
Number of shares post issue	200 + 50	250 shares
<b>Price per share post issue</b>	HKD400/250	<b>HKD1.60</b>

Net effect is an increase in number of shares held and a proportionate decrease in share price, effectively diluting the share price or share value

### Rights Issue

- A new share issue that is offered to existing shareholders
- **Renounceable rights issues** allow shareholders to sell their entitlement to subscribe to the new issue
- **Non-renounceable rights issues** can be exercised or they will lapse if not taken up. There is no right to sell the entitlement
- The number of rights is pro-rated on the existing number of shares held – e.g. a 1 for 3 rights issue will provide one new share for every three shares currently held
- A rights issue subscription price will always be set **below the current market price**, providing existing shareholders with an incentive to subscribe

- The theoretical price that rights can be sold for is a function of entitlement and subscription and is illustrated by the following example:

**Example – theoretical price of rights to a share issue**

Charlie holds 200 shares worth HKD2.00 each before a 1 for 4 rights issue is announced, with a subscription price of HKD1.00 per share. That is, for every four shares held by Charlie, he is entitled to subscribe for one additional share at a price of HKD1.00 per share

Value of shares before issue	200 x HKD2.00	HKD400
Rights issue entitlement	200 shares/4	50 shares
Cost of rights issue	50 shares x HKD1.00	HKD50
Value of total shares post issue	HKD400 + HKD50	HKD450
Theoretical value of shares post issue (ex-rights price)	HKD450/250	HKD1.80
<b>Theoretical value of rights</b>	Ex-rights price – subscription price	HKD1.80 – HKD1.00 = <b>HKD0.80</b>

**Placing**

- Involves shares being issued to a specified class of shareholders or selected investors
- A placing of new shares that raises new capital will have a dilution effect on existing shareholders
- A placing can be made with existing shares which will not raise new capital and, therefore, will have no dilution effect

**Equity Warrant**

- An equity or company warrant is issued by the company issuing the underlying security
- Warrant holders have the right to subscribe for the underlying security at a predetermined price at some time in the future
- When the warrant is exercised, new shares are issued
- Discussed further in Topic 4

## 2.4 Clearing and Settlement System (CCASS)

- Except for stock option transactions, which are settled through DCASS, all SEHK EPs settle all transactions through CCASS
- Settlement occurs on the second business day after the transaction date (T+2)
- EPs receive Provisional Clearing Statements showing their trading-day transactions and money positions for reconciliation
- All transactions are settled under Continuous Net Settlement (CNS) on a netting basis
- Discussed further under Topic 5

### 3. MARKET SURVEILLANCE AND ITS EFFECT ON PARTICIPANT BEHAVIOUR

- The SFC is responsible for raising market standards through effective surveillance and prompt investigation of misconduct and crime in the securities market
- The Enforcement Division of the SFC is responsible for:
  - Enforcing the SFO
  - Monitoring stock and derivative markets trading while enquiring into any irregularities
  - Disciplining dishonest regulated intermediaries who are in breach of rules
  - Reporting suspected market misconduct to the Financial Secretary
  - Inspecting the books and records of listed companies if impropriety is suspected
  - Cooperating with domestic and overseas regulators in local and overseas investigations
- The SFC and SEHK have the power to investigate any unusual price movements of listed securities
- The SEHK can suspend or delist a company for a number of reasons, including:
  - Issuer fails in a material manner to comply with the Listing Rules or its Listing Agreement
  - Insufficient securities in the hands of the public
  - Issuer does not have a sufficient level of operations or assets to warrant the continued listing of its securities
  - Issuer or its business is no longer suitable for listing
  - Suspension for a prolonged period of time without issuer taking adequate action to restore listing

### 4. REPORTING TO INVESTORS AND THE MARKET – KEEPING THE MARKET INFORMED

- Under the Listing Rules, a listed issuer is required to provide the following reports to the SEHK and its shareholders:
  - A Directors' Report
  - Annual accounts plus a copy of the auditors' report
  - An interim report
  - A notice of meeting
  - A listing document and/or a circular
  - A copy of any other announcement required to be submitted to the newspapers
- The above must be submitted to the SEHK electronically so that they can be published on the SEHK's website

## 5. EXCHANGE PARTICIPANTS (EPs)

- Only EPs can access the SEHK trading system
- An EP must be a corporation and must hold at least one Stock Exchange Trading Right (SETR), which can be purchased from HKEx for HK\$500,000 and is non-transferable
- EPs must pay the following charges to the SEHK and to Hong Kong Securities Clearing Company Limited (HKSCC):
  - HK\$50,000 to the SEHK Compensation Fund for each SETR held
  - HK\$50,000 Fidelity Fund deposit for each SETR held
  - HK\$5,000 stamp duty deposit for each SETR held
  - A monthly subscription for each SETR held (HK\$2,900 in December 2018)
  - HK\$50,000 admission fee to HKSCC for each SETR held
  - HK\$50,000 deposit to the Hong Kong Clearing Guarantee Fund for each SETR held
  - System related costs and installation charges
  - Monthly/annual fees and charges for the various systems
- An EP satisfying relevant eligibility requirements can apply to the HKEx to be a **Securities Market Maker (SMM)**. SMMs provide market liquidity, especially for exchange-traded funds (ETFs) and Leverage and Inverse Products (L&I Products)