

**Boosting Market Liquidity and Diversity:  
Enhancing Hong Kong's  
Competitiveness as an  
International Capital Formation Centre**



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# Executive Summary

Being an international financial centre, Hong Kong is well known for its fundraising capabilities. With its vibrant financial ecosystem, companies can gain access to a deep capital pool. Hong Kong has one of the world's most active and liquid securities markets. As of July 2023, there were over 2,600 companies listed on the Hong Kong Stock Exchange (HKEX), with a total market capitalisation of approximately HK\$36 trillion.<sup>1</sup>

Nevertheless, as global financial markets continue to evolve, Hong Kong should keep pace with financial innovations and changing investor appetite. In recent years, new financing options for small cap/ mid-sized companies and pre-revenue companies have emerged, while more investors are exploring exposure to emerging investment opportunities and private market investments as a means of diversifying their portfolios and improving investment outcomes. Examples are the emergence of special purpose acquisition companies (SPACs) and virtual assets (VAs), and the notable growth of private equity (PE) investments in Asia-Pacific. At the same time, these new investment opportunities pose new risks for the investors, including liquidity risk, which are generally perceived to be higher than that of traditional asset classes.

In this context, as a leading international financial hub, Hong Kong should foster the healthy development of the financial ecosystem as a whole - the growth of non-traditional asset classes, as well as the need of closing financing gaps of small cap/ mid-sized businesses and pre-revenue companies, should be on our radars. Among others, market liquidity and diversity are key attributes of sound investor protection and sustainable market development. Having an effective market structure that facilitates the development of emerging investment products while upholding public interest can lower the risk of market manipulation as it becomes less susceptible to price distortions and other forms of fraud. This is of paramount importance to the sustainable success of all international financial centre.

To stay at the forefront of fast-evolving global financial movements, Hong Kong should continue to review the existing mechanism to ensure that its listing and regulatory regimes can address the evolving needs and appetites of different investor groups.

To this end, the Financial Services Development Council (FSDC) has formed a dedicated Working Group comprising industry experts with a view to gathering market feedback and formulating policy recommendations for the Government's and regulators' consideration.

The report recommends establishing a professional investor-only (PI-only) market in Hong Kong with a primary objective to facilitate trading activities involving emerging investment products or alternative asset classes, while having considered other short-to-medium term enhancements for the public capital market. The FSDC believes that a balanced mix of measures is essential to ensure the financial market remains dynamic and responsive to market demands. The key recommendations are summarised as follows:

## Primary recommendation:

- i. Introducing a professional investor-only market to facilitate market innovation and sustainable growth of emerging investment products and alternative asset classes;

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<sup>1</sup> HKEX (July 2023). *Hong Kong Market Highlights*. [https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Statistics/Hong-Kong-and-Mainland-Market-Highlights?sc\\_lang=en#select3=0&select2=6&select1=30](https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Statistics/Hong-Kong-and-Mainland-Market-Highlights?sc_lang=en#select3=0&select2=6&select1=30)

### **Short-to-medium term measures:**

- ii. Exploring synergies between Hong Kong's GEM and other markets;
- iii. Reviewing the stamp duty on stock transactions; and
- iv. Developing a strategic framework to promote investor education and financial literacy towards non-traditional/ emerging asset classes.

The proposed complementary approach with a series of enhancements can foster market liquidity and enhance product diversity. These will improve market efficiency in both the public and private markets, thereby cementing Hong Kong's position as a premier international capital formation hub.

# Section 1: Boosting Market Liquidity and Diversity

Market liquidity generally refers to a market's ability to facilitate a high volume of transactions effectively with limited impact on price (BIS, 2000).<sup>2</sup> As a key consideration of resource allocation and risk management within a financial market, maintaining and boosting market liquidity is critical to its continuous success. As revealed in the FSDC's paper published in August 2022,<sup>3</sup> a healthy level of market liquidity not only supports the stability of a financial market, but also promotes greater participation by reducing transaction costs for investors and by lowering capital raising costs for issuers. All other things being equal, this means less volatility in price and higher transparency in price information. An efficient and transparent market is no doubt more favourable to a broad investor base and stands a better chance of unlocking economic value.

Maintaining ample market liquidity across different asset classes is invariably beneficial to a robust financial system. Public equities are considered one of the most liquid assets, owing to the substantial number of buyers and sellers and the immediacy in trade execution. The higher level of transparency is, in part, attributable to the listing rules which regulate the disclosure obligations and other aspects of corporate governance for listed companies. This contrasts with emerging innovative assets and private market investments, access to which is traditionally more exclusive to sophisticated and institutional investors. Given the higher implied risk involved, as well as challenges in price discovery and valuation, such asset classes are usually subject to lower liquidity.

The interrelated relationship between liquidity and diversity in a capital market has been widely acknowledged (IOSCO, 2007).<sup>4</sup> A diverse representation of companies on the exchange, coupled with the availability of a wide variety of unique investment products, plays a pivotal role in increasing retail investor participation, thereby creating an impact on liquidity (Oliver Wyman & World Federation of Exchanges, 2016).<sup>5</sup>

According to a report by IOSCO, an extensive selection of product offerings caters to an array of investors, each with their own distinct trading strategies, risk appetites, and investment horizons. Of paramount importance is the notion that investors are drawn to markets that provide a comprehensive suite of products, enabling them to effectively hedge their current risk positions.<sup>6</sup> In this regard, alternative investment products, which can protect against equity volatility and provide a hedge against inflation, are particularly appealing to some investors (Mercer, 2023).<sup>7</sup> The relationship between the availability of diverse investment offerings and the appeal of such markets to investors are undeniably interconnected.

Furthermore, the availability of new and alternative asset classes in the market encourages broader participation of investors with varying preferences and strategies. The expanded participation may create potential correlations and interdependencies among the trading activities of both existing and novel investment options through cross-asset analysis. Not only can this foster a more comprehensive understanding of the overall market and enable investors to devise better-informed strategies, it can also infuse additional liquidity and stimulate

2 Bank for International Settlements (BIS) (November 2000). "BIS quarterly review". [https://www.bis.org/publ/r\\_qt0011e.pdf](https://www.bis.org/publ/r_qt0011e.pdf)

3 Financial Services Development Council (FSDC) (August 2022). *Observations on Market Liquidity Enhancement*. [https://www.fsdcc.org.hk/media/3auo4nby/up\\_market-liquidity-eng-final\\_updated.pdf](https://www.fsdcc.org.hk/media/3auo4nby/up_market-liquidity-eng-final_updated.pdf)

4 IOSCO Emerging Markets Committee (December 2007). *Factors Influencing Liquidity in Emerging Markets*. <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD258.pdf>

5 Oliver Wyman & World Federation of Exchanges (WFE) (2016). *Enhancing Liquidity in Emerging Market Exchanges*. [https://www.world-exchanges.org/storage/app/media/research/Studies\\_Reports/liquidity-in-emerging-market-exchanges-wfe-amp-ow-report.pdf](https://www.world-exchanges.org/storage/app/media/research/Studies_Reports/liquidity-in-emerging-market-exchanges-wfe-amp-ow-report.pdf)

6 IOSCO Emerging Markets Committee (December 2007). *Factors Influencing Liquidity in Emerging Markets*. <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD258.pdf>

7 Mercer (2023). *Alternative Investments through Private Markets and Hedge Funds*. <https://www.mercer.com/en-nz/solutions/investments/alternatives/#:~:text=Alternative%20investments%20provide%20an%20opportunity.of%20equities%20without%20sacrificing%20returns>

overall trading activities.<sup>8</sup> Simultaneously, a liquid market can entice more issuers, thereby enhancing the diversity of investment options. In summary, fostering liquidity and diversity in the capital market results in a more efficient market.

Over the last few years, while public market investments continue to stay active, non-traditional assets are expanding rapidly across the globe, especially with an increasing number of investors from the Asia Pacific seeking innovative and alternative products to maintain a well-diversified financial portfolio. Recognising the importance of liquidity and diversity to overall effective market functioning, Hong Kong should endeavour to maintain these two aspects across the entire financial sector. Hence, in addition to enhancement measures for the public market, this report aims to promote an efficient market that enables trading of emerging and less popularly traded investment products to be executed efficiently in a cost-effective manner, while fostering market liquidity. Such an approach can support financing for a broader range of enterprises and safeguard investors amid the evolving landscape.

## A Glance at Recent Hong Kong Public Market Development

The ongoing effort of the Government and the HKEX to keep our capital market competitive with ample liquidity has helped us weather the storm. Among others, three of the new initiatives - namely the listing reform in 2018 bringing in biotech companies who did not meet Main Board listing requirements of HKEX, new economy companies with weighted voting rights structures, and another listing route for Greater China companies to conduct secondary listing in Hong Kong - have played an important part in the resilience of the city's capital market. In particular, these measures drive global liquidity to Hong Kong by widening the investor and issuer bases through attracting high-growth and innovative companies to list in Hong Kong.

Notably, in 2022, 51 new economy companies were successfully listed and accounted for 73% of the IPO fund raised in Hong Kong.<sup>9</sup> More listings of new economy companies are expected - mainly because the Main Board Listing Rules were revised in March 2023 to facilitate fundraising activities of advanced technology enterprises that have yet to meet the profit and trading record requirements.<sup>10,11</sup> Such an arrangement would be conducive to the innovation and technology development in Hong Kong.

In recent years, the global market volatility caused by the rising interest rate environment, high inflationary pressure in developed markets, and geopolitical pressures have posed challenges to global public markets, including Hong Kong. Despite trending upward over the past decade, the average daily turnover of the HKEX stood at HK\$115.5 billion for the first six months in 2023, down 7.5% when compared to the average daily turnover recorded in 2022 (Figure 1)<sup>12,13</sup>.

8 EDHEC Business School (October 2022). *Benefits and Risks of Alternative Investment Strategies*. [https://climateimpact.edhec.edu/sites/ercii/files/full\\_text.pdf](https://climateimpact.edhec.edu/sites/ercii/files/full_text.pdf)

9 Hong Kong Stock Exchange (HKEX) (December 2022). *HKEX in 2022: Year in Review*. [https://www.hkex.com.hk/News/News-Release/2022/221220news?sc\\_lang=en](https://www.hkex.com.hk/News/News-Release/2022/221220news?sc_lang=en)

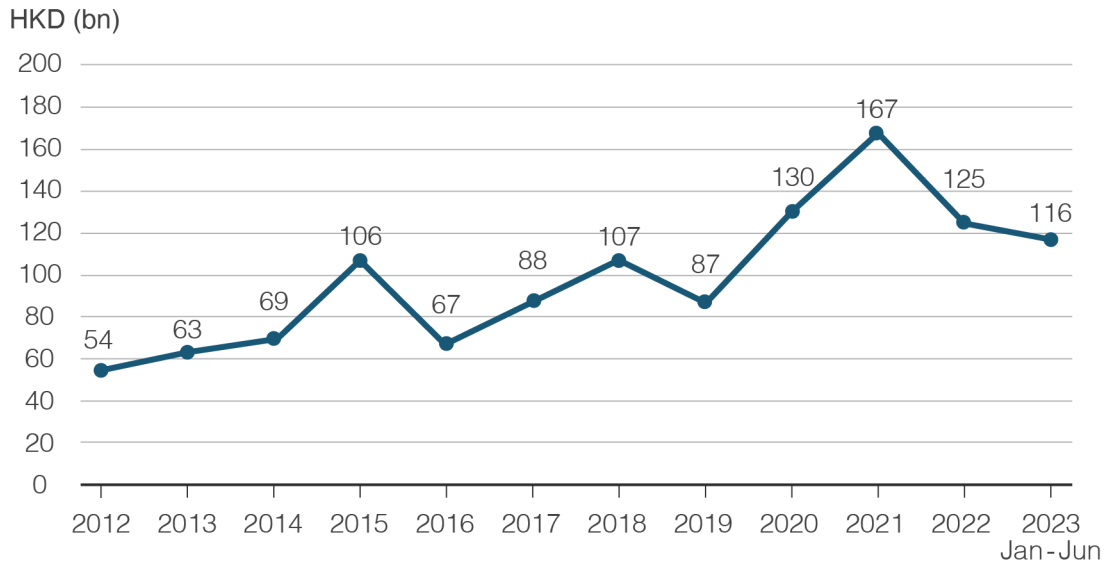
10 HKEX (March 2023). *New Specialist Technology Company Listing Rules*. [https://www.hkex.com.hk/News/Regulatory-Announcements/2023/230324news?sc\\_lang=en](https://www.hkex.com.hk/News/Regulatory-Announcements/2023/230324news?sc_lang=en)

11 To be eligible, these companies should fall within one of the five selected high-growth sectors of the specialist technology industry.

12 HKEX (June 2023). *HKEX Monthly Market Highlight*. [https://www.hkex.com.hk/Market-Data/Statistics/Consolidated-Reports/HKEX-Monthly-Market-Highlights?sc\\_lang=en&select={99B25159-DF7E-46A8-840D-](https://www.hkex.com.hk/Market-Data/Statistics/Consolidated-Reports/HKEX-Monthly-Market-Highlights?sc_lang=en&select={99B25159-DF7E-46A8-840D-)

13 HKEX (Dec 2022). *Market Statistics 2022*. [https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/Annual-Market-Statistics/e\\_2022-Market-Statistics.pdf](https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/Annual-Market-Statistics/e_2022-Market-Statistics.pdf)

Figure 1. Hong Kong securities market average daily turnover



Source: HKEX

On top of this, a market's turnover velocity, defined as the value traded relative to the overall market capitalisation, serves as an indicator of its liquidity. As revealed in the FSDC's report published in August 2022, the liquidity of Hong Kong's public market trailed behind that of other major financial markets. Its turnover velocity was 62.4% in 2022, while other major financial markets showed a turnover velocity of above 100%.<sup>14</sup> In light of this, Hong Kong should continue to review its public market in pursuit of enhancement, with a view to catering to the evolving needs of issuers and investors. In turn, this will boost trading activities and enhance market liquidity, leading to a more efficient market.

<sup>14</sup> WFE (May 2023). *Annual Statistics Guide 2022*. <https://www.world-exchanges.org/our-work/articles/annual-statistics-guide-2022> (Nasdaq at 148.2% , Shanghai Stock Exchange at 206.9%, Shenzhen Stock Exchange at 394.6%)

## Section 2: Changing Market Dynamics and Investor Demand

As an international financial centre, Hong Kong should keep pace with the rapid convergence of global financial markets. The emergence of innovative and exotic products in recent years, such as the resurgence of SPACs and the growing demand for VAs, particularly warrants attention. These developments, coupled with the volatility in public markets, have prompted investors to look more closely at alternative investments for alpha returns (see Appendix 1 for details of the trend).

Differentiating oneself from other markets hinges on the ability to offer diverse products while safeguarding public investor interest, as this attracts global investors and prompts more market activities. While Hong Kong has already introduced its own regimes on SPACs and VAs in recent years, the city should continue to broaden and diversify its market base, which can help maintain its financial stability by boosting investment activities. Among others, some trends in the private market space and the financing needs of small cap/ mid-sized companies are noteworthy.

### Private Markets

The growing importance of private market investments warrants our attention. A report by Mercer indicates that investors aim to seek higher potential return, diversify investment portfolios and enhance their protection against inflation through investing in alternative vehicles.<sup>15</sup> A report from Hamilton Lane further supports this trend, showing that most PE funds have historically outperformed corresponding public market indexes over the past two decades (Figure 2).<sup>16</sup> This evidence clarifies the rising interest in alternative investment products of private markets while investment sentiment in public markets is subdued amid uncertainties in the global environment.

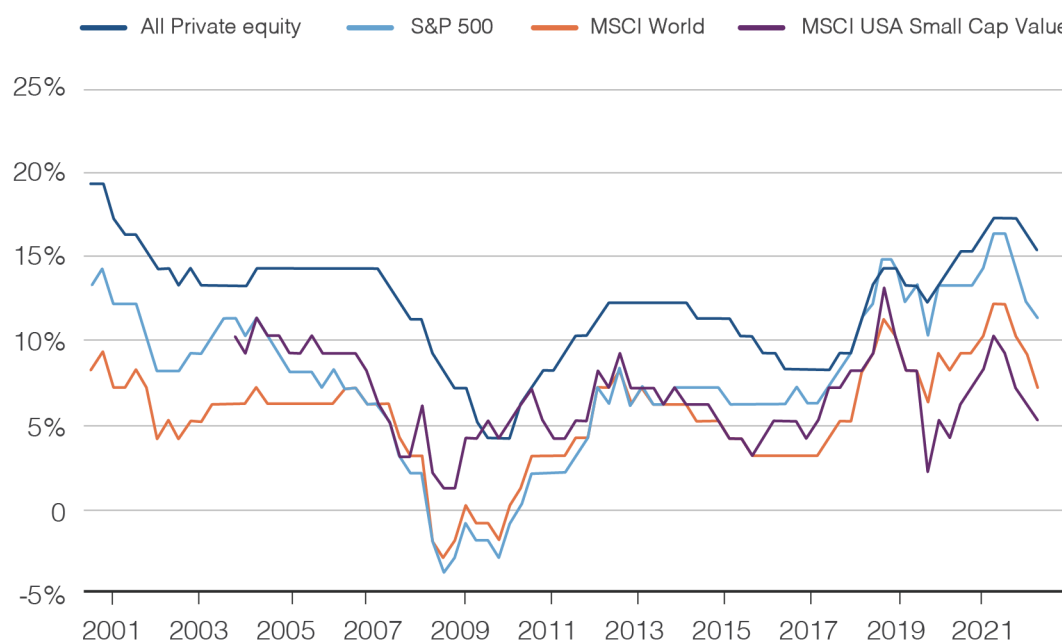
From the perspective of private companies, a private market with less friction offers access to a vast amount of capital and opportunities under a comparatively light-touch regulatory approach. It is especially favourable to start-ups and emerging companies that do not meet the revenue/ capital requirements of public listing.<sup>17</sup> The shifting paradigm in the interest and demand of investors and issuers is driving the development of global private markets.

<sup>15</sup> Mercer (January 2022). *Top considerations for private markets in 2022*. <https://www.mercer.com/content/dam/mercer/attachments/global/gl-2022-mercer-private-markets.pdf>

<sup>16</sup> McKinsey & Company (March 2023). *Global Private Markets Review*. <https://www.mckinsey.com/~media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/2023/mckinsey-global-private-markets-review-2023.pdf>

<sup>17</sup> Adams Street Partners (March 2022). *Private Markets Insights: Optimism in an Age of Change*. <https://www.adamsstreetpartners.com/insights/2022-private-markets-insights/>

Figure 2. Private equity 10-year rolling time-weighted return as of September 2022



Source: Hamilton Lane Data via Cobalt, Bloomberg (January 2023)

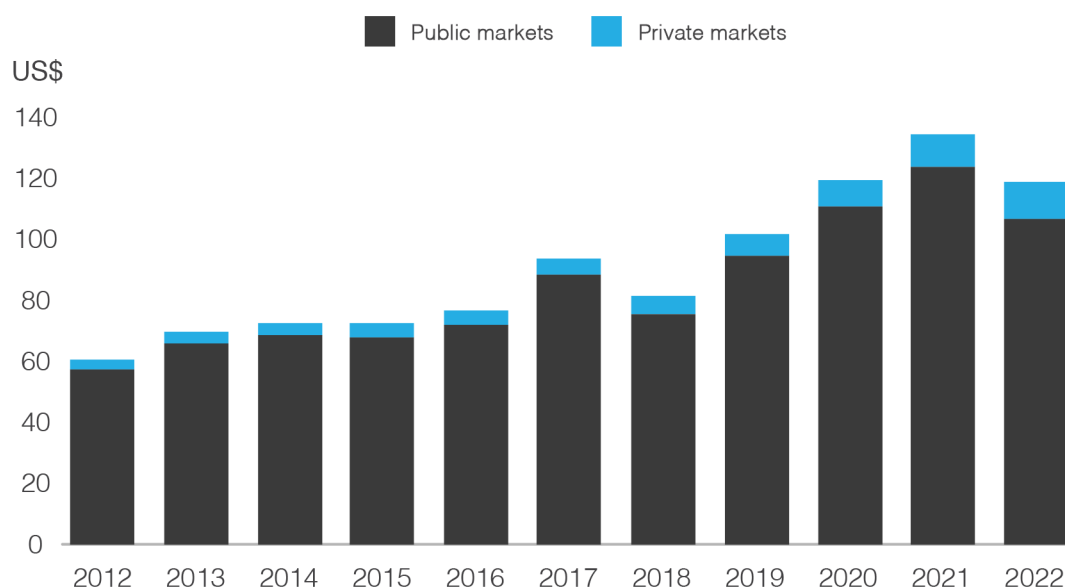
## Global private markets landscape

While the size of the private market remains incomparable to that of the public market, it has grown significantly over the last decade. The asset under management (AUM) of the global private markets expanded at a compound annual growth rate (CAGR) of 12.9% from US\$3.2 trillion in 2012 to US\$12.2 trillion in 2022,<sup>18</sup> comparatively higher than that of the market capitalisation of global public markets (CAGR: 5.5%)<sup>19</sup> during the same period (Figure 3).

<sup>18</sup> Preqin *database*. (accessed on 22 August 2023)

<sup>19</sup> SIFMA (July 2023). *Capital Markets Fact Book*. <https://www.sifma.org/wp-content/uploads/2022/07/2023-SIFMA-Capital-Markets-Factbook.pdf>

Figure 3. Global market capitalisation of public markets vs private market assets under management as of December 2022



Source: Preqin, SIFMA

In connection with such trends, Hong Kong's private market landscape has continued to evolve, with investors increasingly turning their attention to the space. As of end-2022, Hong Kong's PE capital under management amounted to US\$212 billion,<sup>20</sup> marking almost a 50% increase compared to the market size in 2017 (US\$141 billion),<sup>21</sup> and the city remained the second largest PE hub in Asia (with the first being Mainland China). Despite some volatility in recent months, Hong Kong's PE market shows much potential to grow, with references being drawn from other markets. As of December 2022, the PE market in Hong Kong was approximately 4.0% of the market capitalisation of the public equity market. This ratio was relatively higher in the Mainland market, encompassing both the Shanghai and Shenzhen Stock Exchanges, at 13.1%. Similar trends were also observed in other foreign markets, such as the UK (18.0%), US (10.6%) and Singapore (8.0%) (Figure 4).

Figure 4: Public and private market comparison (As of 2022)

	Hong Kong	Mainland China	US	UK	Singapore
<b>Public market</b>					
Market Cap <sup>22</sup>	HKEX: US\$4.6 trillion	Shanghai Stock Exchange: US\$6.7 trillion Shenzhen Stock Exchange: US\$4.7 trillion Total: US\$11.4 trillion	Nasdaq: US\$16.2 trillion NYSE: US\$22.8 trillion Total: US\$39.0 trillion	LSE: US\$3.1 trillion	SGX: US\$0.6 trillion
<b>Private market</b>					
Private Equity AUM <sup>23</sup>	US\$184.1 billion	US\$1,501.2 billion	US\$ 4,138.9 billion	US\$558.3 billion	US\$49.7 billion

Source: Preqin, WFE

20 SFC (August 2023). *Asset and Wealth Management Activities Survey 2022*. [https://www.sfc.hk/-/media/EN/files/COM/Reports-and-surveys/AWMAS-2022\\_E.pdf?rev=3b6a43ac11404a2cacf7123c2f5c949e&hash=C33D88F5AAEAC176BC072AE9326091CC](https://www.sfc.hk/-/media/EN/files/COM/Reports-and-surveys/AWMAS-2022_E.pdf?rev=3b6a43ac11404a2cacf7123c2f5c949e&hash=C33D88F5AAEAC176BC072AE9326091CC)

21 SFC (July 2018). *Asset and Wealth Management Activities Survey 2017*. [https://www.sfc.hk/-/media/EN/files/ER/PDF/2017-Asset-and-Wealth-Management-Activities-Survey\\_eng.pdf?rev=a6a391d3c1054145b1a63985c5d2878e&hash=A1727A12ABFFB88253A3F218D1121ED5](https://www.sfc.hk/-/media/EN/files/ER/PDF/2017-Asset-and-Wealth-Management-Activities-Survey_eng.pdf?rev=a6a391d3c1054145b1a63985c5d2878e&hash=A1727A12ABFFB88253A3F218D1121ED5)

22 WFE (February 2023). *Market Statistics*. <https://focus.world-exchanges.org/issue/february-2023/market-statistics>

23 Preqin *database* (accessed on 22August 2023)

At the same time, trading in the PE secondary market has scaled up rapidly, as reflected by deal activities. PE trading volume increased by more than double from US\$51 billion in 2017 to reach a peak of US\$135 billion in 2021, before retrieving to US\$106 billion in 2022. This represented a robust CAGR of 13% over the 6-year period.<sup>24,25</sup> The upward trend was largely driven by several factors, for instance, the growing popularity of PE in the primary market, a greater number of companies intending to stay private for longer, and shareholders' demand for liquidity.<sup>26</sup>

Historical data indicates that private market investments have the potential to offer favourable returns when approached with a long-term perspective in both developed and emerging markets. While these investments may show negative returns when assessed over a one-year period, data shows that global PE and venture capital (VC) investments have generated excess returns over a period of three years or longer (Figure 5).<sup>27</sup> This explains why private market investments are becoming an increasingly popular choice for investors seeking to diversify their portfolios.

Figure 5: Global ex US private equity and venture capital index returns

Index	6 Mo	1 Yr	3 Yr	5 Yr	10 Yr	15 Yr	20 Yr	25 Yr
CA Global ex US Dev Mkts PE/ VC (US\$)	-11.1	-0.1	20.4	18.6	15.3	9.6	14.8	14.5
CA Global ex US Dev Mkts PE/ VC (€)	-3.3	13.3	23.7	20.4	17.5	11.6	14.8	14.7
MSCI EAFE (US\$) mPME	-19.6	-18.1	0.6	1.9	5.9	2.2	4.4	4.0
MSCI EAFE (€) mPME	-12.5	-7.0	3.9	4.0	8.2	4.4	5.7	5.0
MSCI World/ MSCI All Country World (US\$) mPME*	-19.9	-15.4	6.6	7.5	10.0	6.0	7.6	6.8
CA Emerging Markets PE /VC (US\$)	-5.9	-7.7	12.7	11.9	11.6	10.4	11.4	10.2
MSCI EAFE (US\$) mPME	-17.5	-25.0	0.6	2.2	3.3	2.7	5.2	4.6
MSCI World/ MSCI All Country World (US\$) mPME*	-20.0	-15.3	6.8	7.6	9.2	6.9	7.6	7.0
MSCI EAFE (US\$) AACR	-19.6	-17.8	1.1	2.2	5.4	1.4	5.3	3.9
MSCI EAFE (€) AACR	-12.5	-6.7	4.0	4.0	7.5	3.2	5.0	4.2
MSCI EM (US\$) AACR**	-17.5	-25.0	0.9	2.5	3.4	2.3	8.8	5.1
MSCI World/ MSCI All Country World (US\$) AACR*	-20.0	-15.4	6.7	7.5	9.3	5.3	7.8	6.3

\* MSCI All Country World Constructed Index: Data from 1/1/1986 to 31/12/1987 represented by MSCI World Index gross total return. Data from 1/1/1988 to present represented by MSCI ACWI gross total return.

\*\* MSCI EM Constructed Index: Data from 1/1/1986 to 31/12/1987 represented by GFD Emerging Markets price return. Data from 1/1/1988 to present represented by MSCI Emerging Markets total return gross.

Source: Cambridge Associates Report, Global Financial Data, MSCI, Thomson Reuters

Another noteworthy trend is the increasing participation of individual investors in private markets, despite institutional investors being predominant for many decades. It is projected that the contribution of individual investors to the overall development of the global PE fund market will grow by 18.8% and take up 10.6% of the total market share by 2025 (Figure 6).<sup>28</sup>

24 Campbell Lutyens (March 2022). *2022 Secondary Market Overview*. <https://campbelllutyens.foleon.com/2022-secondary-market-overview/2022-secondary-market-overview/highlights/>

25 Campbell Lutyens (February 2023). *2023 Secondary Market Overview*. <http://www.campbell-lutyens.com/news-insights/publications/2023/2023-secondary-market-overview/>

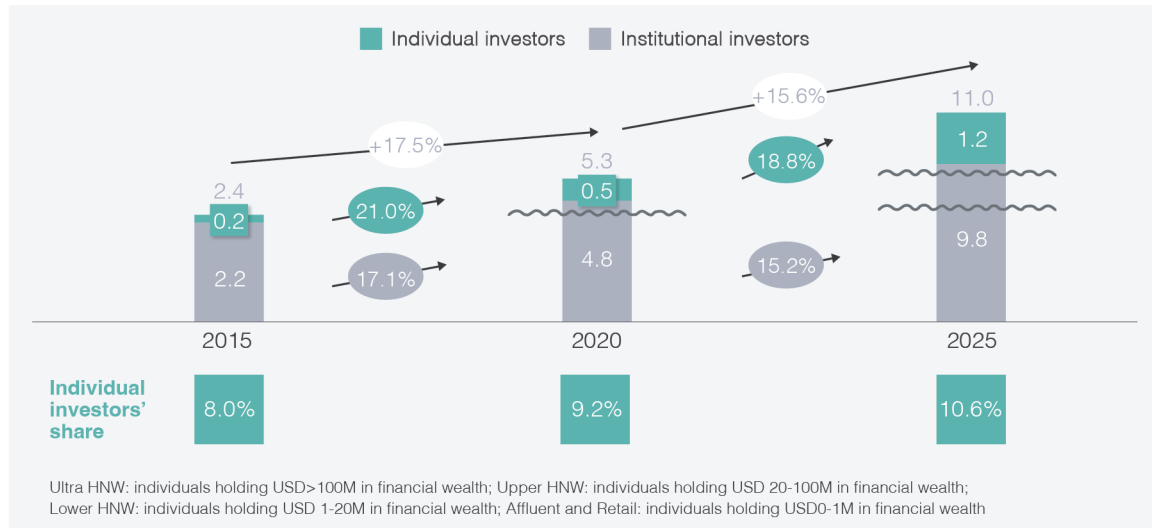
26 Forbes (June 2021). *The Key to Private Equity's Growth is the Blooming Secondary Market*. <https://www.forbes.com/sites/antoinedrean/2021/06/21/the-key-to-private-equitys-growth-is-the-booming-secondary-market/?sh=229630792c16>

27 Cambridge Associates (January 2023). *Global ex US PE/VC Benchmark Commentary: First Half 2022*. <https://www.cambridgeassociates.com/insight/global-ex-us-pe-vc-benchmark-commentary-first-half-2022/>

28 BCG (March 2022). *The Future is Private*. <https://web-assets.bcg.com/36/e6/5e6897294b22908b44c9a19d182b/bcg-icapital-the-future-is-private.pdf>

Figure 6. Global private equity funds and individual investors' share

**Total private equity fund market size split into institutional and individual investors (\$trillions)**



Source: BCG report, BCG Global Wealth Market Sizing 2021, Preqin

According to the UBS Global Family Office Report 2023, the global investment environment continues to prompt family offices to shift their asset allocations towards alternative investment products and emerging markets for potential outperformance. In general, the report highlights that majority of the survey respondents (66%) believe that illiquid assets would offer more impressive returns. While these family offices demonstrate a preference for a rise in equities investment (44%) over the next five years, their interest in PE remains robust as they seek diversification across the private market. This is evidenced by the fact that 41% of the surveyed family offices plan to shift their focus to direct investments of PE and funds/ funds of funds of PE (35%) in the next five years (Figure 7). Notably, virtual assets and blockchain-related investments have also garnered interest from family offices, with 56% of respondents engaged in related trading.<sup>29</sup>

<sup>29</sup> UBS (June 2023). *Global Family Office Report 2023*. <https://www.ubs.com/content/dam/assets/wm/static/noindex/gfo/docs/ubs-gfo-report-2023.pdf>

Figure 7. Global family offices that planned changes to asset allocation in the next five years

	Net* 2021	Net* 2022	Net* 2023	Increase	Stay the same	Decrease	Don't plan on investing in this asset class
Fixed income (Developed markets)	-18%	-4%	22%				
Fixed income (Developing markets)	3%	8%	10%				
Equities (Developed markets)	35%	29%	32%				
Equities (Developing markets)	56%	28%	18%				
Private equity (Direct investments)	42%	42%	28%				
Private equity (Funds/ funds of funds)	26%	38%	21%				
Private debt	N/A	27%	15%				
Hedge funds	16%	11%	4%				
Real estate	22%	37%	22%				
Infrastructure	23%	25%	17%				
Gold/ precious metals	10%	4%	9%				
Commodities	9%	10%	12%				
Cash (Or cash equivalent)	-18%	-15%	-13%				
Art and antiques	8%	10%	12%				

\*Net equals increase minus decreases

Source: UBS

## Challenges of investing in private markets

Despite an increasing share of investment allocations to private markets and other emerging products, investors have encountered challenges related to operations and liquidity of the market.

For instance, the launch and secondary trading of private market assets generally involves relatively higher costs, as well as more time-consuming procedures for onboarding investors and conducting KYC and AML checks. Separately, unlike public markets, private markets rely on issuers and investors' own over-the-counter (OTC) networks for trading unlisted securities, which exposes and magnifies issues related to inefficient price discovery. Trading via OTC also gives rise to another potential challenge in private markets, namely the inefficiencies in due diligence caused by the absence of a sponsor requirement.

In contrast, in the case of a public listing, HKEX mandates a sponsor due diligence exercise at the issuer's expense. This single exercise replaces the need for individual investors to conduct their own separate due diligence of the same issuer, thereby avoiding repetitive efforts and additional costs which would otherwise be incurred by the investors.

Credible information is crucial for investment risk assessments, which enables investors to make informed investment decisions. On this note, as private markets and associated projects are generally more fragmented, gathering such information usually requires extra effort and expenses. This can lead to delays in trading decisions and, relatedly, insufficient understanding, interest and

liquidity in relevant markets and products. These factors would also lead to extra uncertainty on price and return performance.

As a case in point, the secondary private market underperformed in tandem with the fluctuating public market conditions in 2022. Private market funds/ private holdings in the secondary market changed hands with a 50% discount of their previous valuation in the first six months of 2022,<sup>30</sup> compared to a -21% performance of the S&P 500 during the same period.<sup>31</sup> The absence of abundant liquidity in the secondary market has prompted industry players to turn to unconventional financing options, such as NAV loans, as alternative sources of liquidity to support their activities in the capital market.<sup>32</sup> This can, directly and indirectly, have implications and bring about risks to other sector participants.

An example is the decline in returns for VC funds caused by the fluctuating market sentiment in the global startup industry. As of 4Q2022, four consecutive negative quarterly returns were recorded, representing the worst performance in over a decade.<sup>33</sup> Additionally, the private market fundraising amount decreased by 11.4% to US\$1.2 trillion in 2022 from an all-time high of US\$1.4 trillion raised in 2021.<sup>34</sup>

Oftentimes, private markets experience a higher level of volatility at least in part as a result of the above factors. Investors should always remain mindful of the potential risks and returns associated with these investments and gain a comprehensive understanding of these factors.

## **Benchmark practices across other jurisdictions**

### ***A closer look at some private markets***

With opportunities presented in the private market, various securities exchanges have, independently or through partnerships with digital platforms, tapped into the market by strategically integrating relevant offerings into their product coverage.

For instance, Nasdaq established the Nasdaq Private Market in 2013, a digital channel designed to cater to private companies seeking capital and secondary market trading. This initiative resulted in more than 600 liquidity programmes and a cumulative transaction value exceeding US\$43 billion in 2022.<sup>35</sup> The London Stock Exchange (LSE), on the other hand, has partnered with Floww to establish a digital infrastructure for private capital raising.<sup>36</sup> Additionally, LSE aims to launch the “Intermittent Trading Venue” by 2024, which is a platform designed to facilitate auction of shares in private companies, thereby creating liquidity for their secondary securities.<sup>37</sup> The Singapore Exchange has backed ADDX, a digital securities exchange that provides fractional access to private market products, including PE, funds, and debts.<sup>38</sup> ADDX recorded a transaction value of US\$150 million in 2021 and forged partnerships with wealth managers in Mainland China and Japan. Furthermore, Chinese regulators launched a pilot scheme in 2021 to facilitate secondary trading of PE and VC funds. Under the pilot scheme, PE firms are eligible to transfer unlisted shares of a fund investment

30 Bloomberg (June 2022). *Venture Fund Stakes Slashed by Up to 50% in Secondaries Market*.

<https://news.bloomberglaw.com/private-equity/venture-fund-stakes-slashed-by-up-to-50-in-secondaries-market>

31 S&P 500 (Accessed on June 2022). *S&P 500 Overview*. <https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview>

32 Bloomberg (November 2022). *Private Equity Funds Tap Exotic Loans for Liquidity as Deals Ebb*.

<https://www.bloomberg.com/news/articles/2022-11-15/private-equity-funds-tap-exotic-loans-for-liquidity-as-deals-ebb>

33 The Wall Street Journal (May 2023). *Venture-Fund Returns Show Worst Slump in More Than a Decade*.

<https://www.wsj.com/articles/venture-fund-returns-suffer-amid-lower-startup-values-15dc0130>

34 Mckinsey & Company (March 2023). *Global Private Markets Review 2023*.

<https://www.mckinsey.com/-/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/2023/mckinsey-global-private-markets-review-2023.pdf>

35 Nasdaq Private Market (February 2023). *State of the Private Market*. <https://www.nasdaqprivatemarket.com/state-of-private-market-thank-you/>

36 Pitchbook (March 2022). *London Stock Exchange expands beyond public markets with platform deal*.

<https://pitchbook.com/news/articles/london-stock-exchange-private-markets-Floww-vc>

37 LSEG (2023). *Connecting the private and public markets to help companies (and Britain) grow*.

<https://www.lseg.com/en/insights/private-public-markets-help-companies-britain>

38 Citywire Asia (April 2022). *Singapore's ADDX launches private market service for wealth managers*.

[https://citywireasia.com/news/singapores-addx-launches-private-market-service-for-wealth-managers/a2384716?re=96097&ea=1681969&utm\\_source=BulkEmail\\_International+Daily+Asia&utm\\_medium=BulkEmail\\_International+Daily+Asia&utm\\_campaign=BulkEmail\\_International+Daily+Asia](https://citywireasia.com/news/singapores-addx-launches-private-market-service-for-wealth-managers/a2384716?re=96097&ea=1681969&utm_source=BulkEmail_International+Daily+Asia&utm_medium=BulkEmail_International+Daily+Asia&utm_campaign=BulkEmail_International+Daily+Asia)

into other types of fund schemes, which broadens exit channels for PEVC firms and sets a beneficial trend in the long run.<sup>39</sup>

## Financing Challenges Facing Small cap/ Mid-sized Companies in Some Markets

Small cap/ mid-sized companies are widely recognised as up-and-coming firms with prodigious growth potential. Often at the vanguard of innovation, these firms excel in providing cutting-edge products and capitalising on emerging trends and opportunities in their respective fields.<sup>40</sup>

Despite their modest size at the outset, these small cap/ mid-sized ventures are often drivers of sustainable economic development, innovation and employment. Recognising the significance of this segment to the economy, international organisations such as the OECD and the World Bank, have published reports to advocate for an expanded range of financing instruments to enhance their capital structures. Among other suggestions, the potential role of capital markets in financing has been emphasised, with equity finance being deemed a crucial instrument for businesses “seeking long-term corporate investment to sustain innovation and growth” (OECD, 2015, p.8).<sup>41</sup>

Although more new and promising businesses in this category would eventually go public and raise capital for further growth and expansion, they tend to face more challenges than large firms in the earlier stages of development. For instance, the costs associated with equity financing, such as underwriting fees, legal expenses, and ongoing reporting requirements, can be prohibitively high for small cap/ mid-sized issuers. In Hong Kong, the sponsor regime for GEM listings necessitates appointing a GEM sponsor and the mandatory quarterly reporting requirements result in additional fees. This highlights the significant financial burden associated with the listing process for small cap/ mid-sized issuers that are with limited resources. For example, for all 9 recent listings on GEM in 2020 and 2021, their average estimated total listing expense amounted to HK\$37.2 million, in other words, approximately 54% of their expected gross proceeds from the offerings were absorbed by the costs.<sup>42</sup> Besides, these companies may also have difficulties complying with the stringent regulatory requirements’ threshold in relation to revenue, profitability and market capitalisation.

In absence of an effective price discovery process, these small cap/ mid-sized businesses are often subject to opaque private equity valuations. Consequently, they have little bargaining power, and the information asymmetry in private markets usually make these businesses price takers, potentially accepting terms that favour investors. This may further complicate their financial conditions and hinder their growth prospects.<sup>43</sup>

A slew of other hurdles restrain their ability to secure equity financing, ultimately hampering their potential for continued growth. Visibility poses another challenge for these small cap/ mid-sized enterprises, as they grapple with attracting investor attention and interest due to limited exposure and brand recognition. In addition, the lack of secondary market liquidity commonly associated with these companies can make exiting their positions a burning issue for investors. Furthermore, the information asymmetries prevalent in this listing segment can lead to high monitoring costs, which disproportionately burden smaller investors (OECD, 2022).<sup>44</sup> These factors collectively make investing in equities issued by small cap and mid-sized issuers a relatively risky proposition, prompting investors to turn to other investment opportunities.

39 China Securities Regulatory Commission (July 2022). 证监会启动私募股权创投基金向投资者实物分配股票试点 支持私募基金加大服务实体经济力度。  
[http://www.gov.cn/xinwen/2022-07/11/content\\_5700378.htm](http://www.gov.cn/xinwen/2022-07/11/content_5700378.htm)

40 European Investment Bank Group (November 2022). *Small and medium enterprises overview*.  
[https://www.eib.org/attachments/lucalli/smes\\_overview\\_2022\\_en.pdf](https://www.eib.org/attachments/lucalli/smes_overview_2022_en.pdf)

41 OECD (February 2015). *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*.  
<https://www.oecd.org/cfe/smes/New-Approaches-SME-full-report.pdf>

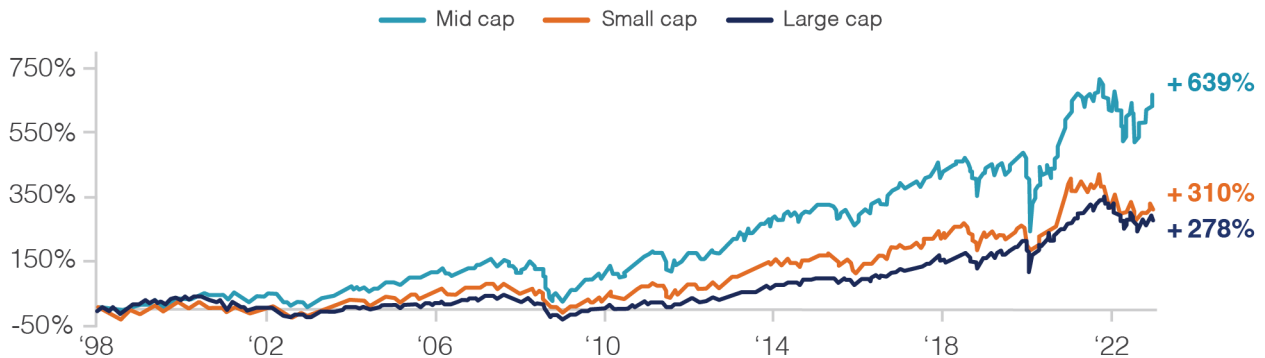
42 Calculation based on listing prospectuses and announcements published by all 9 newly GEM listed companies.

43 IFAC (September 2020). *The Challenges in Valuing Small and Medium Sized Entities*.  
<https://www.ifac.org/knowledge-gateway/preparing-future-ready-professionals/discussion/challenges-valuing-small-and-medium-sized-entities>

44 OECD (July 2022). *2022 Updated G20/ OECD High-Level Principles on SME Financing*.  
<https://www.oecd.org/cfe/smes/2022-Update-OECD-G20-HLP-on-SME-Financing.pdf>

Despite the challenges facing these firms, using US listed firms' performance as a benchmark, small/ mid-cap stocks have exhibited growth over the past 25 years, outperforming larger firms. This demonstrates the segment's agility and adaptability to the ever-changing market dynamics, as well as, perhaps, investors' interest in firms of this category. In other words, investing in the small and mid-cap segments can be an enticing option for investors pursuing portfolio diversification (Figure 8).<sup>45</sup>

Figure 8. Trailing 25-year return (%)



Note: Large cap represented by S&P500 Index., mid cap represented by S&P Midcap 400 Index, and small cap by Russell 2000 Index. Past performance is not indicative of future results. It is not possible to invest directly in an index.

Source: JPMorgan, Bloomberg Finance L.P. Data as of 2 March 2023

As for Hong Kong, our economy is home to over 360,000 small and medium sized enterprises (SMEs), which in aggregate represent over 98% of all business establishments in the city, and account for about 44% of the private sector employment.<sup>46</sup> Concurrently, as of June 2023, there were a total of 406 mid cap (198) and small cap stocks (208) listed on the Mainboard of the HKEX, boasting a market capitalisation of HK\$5.79 trillion.<sup>47</sup> However, despite being an indispensable component to the economy, small cap/ mid-sized companies have limited access to effective fundraising channels in Hong Kong's public capital market.

The GEM (formerly known as Growth Enterprise Market) was established with the objective of bridging the financing gap of SMEs. It was designed to adopt a less stringent listing requirement in comparison to the Main Board to facilitate fundraising activities. However, for various reasons, the number of new listings on GEM has been dwindling in both absolute and relative terms. As of December 2022, the total market capitalisation for GEM stood at a meagre HK\$85 billion, down 21% YoY, and represented only 0.2% of the Main Board's total market capitalisation. There were no new listings on GEM in 2022, with the last new listing taking place in 1Q2021.<sup>48</sup>

45 J.P. Morgan Wealth Management (March 2023). *Investing – Is it time to reassess your focus on large-cap stocks.*

<https://www.jpmorgan.com/wealth-management/wealth-partners/insights/is-it-time-to-reassess-your-focus-on-large-cap-stocks>

46 Hong Kong Trade and Industry Department (Accessed on 21 November 2022). *Support to Small and Medium Enterprises.*

[https://www.tid.gov.hk/english/smes\\_industry/smes/smes\\_content.html](https://www.tid.gov.hk/english/smes_industry/smes/smes_content.html)

47 Hang Seng Indexes Company (2023). *Hang Seng Composite MidCap and SmallCap Index.*

<https://www.hsi.com.hk/eng/indexes/all-indexes/sizeindexes>

48 HKEX (December 2022). *Hong Kong and Mainland Market Highlights.* [https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Statistics/Hong-Kong-and-Mainland-Market-Highlights?sc\\_lang=en#select3=1&select2=11&select1=29](https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Statistics/Hong-Kong-and-Mainland-Market-Highlights?sc_lang=en#select3=1&select2=11&select1=29)

The GEM was launched in November 1999 as an alternative capital formation platform for emerging companies. However, after the burst of the “dot-com” bubble in 2000, the number of new listings on GEM declined, and post-listing fundraising activities for GEM issuers have declined visibly compared with those listed on the Main Board. Overall, as acknowledged by the HKEX, the market was of the view that “there was a loss of confidence in the GEM market”. Consequently, with effect from 1 July 2008, GEM was re-positioned as a “steppingstone” to the Main Board, with the intention of addressing the capital raising needs of emerging growth companies.<sup>49</sup>

As a result of the limited success after nine years of operation, and market and regulatory concerns over the quality and performance of GEM listing applicants and listed issuers, GEM was re-positioned again in 2018 as a market for SMEs. The GEM Streamlined Process was subsequently removed – GEM transfers to the Main Board require the appointment of a sponsor and the issuance of a listing document.<sup>50</sup> Separately, the Main Board Listing Rules was amended with effect from April 2018 to include, among others, new chapters for the listing of biotech companies and companies with a weighted voting rights structure (Biotech and WVR Chapters). In March 2023, an additional chapter was introduced for the listing of specialist technology companies.<sup>51</sup>

Arguably, to date, the evolution of the GEM’s role, in the shape of its reforms and quick fixes, does not seem to have met the expectations of many market participants or the needs of small- and mid-sized high-growth companies (both domestic and overseas) looking to utilise Hong Kong’s world-class fundraising infrastructure (refer to Appendix 2 for details on Hong Kong’s current regulations and regulatory approach).

## **Benchmark practices across other jurisdictions**

### *A close look at small cap/mid-sized companies financing in different jurisdictions*

A multitude of regulated exchanges worldwide have been addressing the financing needs of small cap/ mid-sized issuers with corresponding efforts. In short, a number of separate markets have been set up across various financial markets to provide dedicated equity offerings to these firms under another set of less stringent listing requirements, easing the listing process for smaller businesses.<sup>52</sup>

In Mainland China, the immense potential of small/ mid-sized issuers and their strategic importance in driving nationwide market development - especially that of the innovation and technology sector - are well recognised by the Chinese government. This is, in part, reflected in the government’s efforts to address SMEs’ financing needs.

Arguably most importantly, in 2021, the reformative establishment of the Beijing Stock Exchange (BSE) signified the country’s attempt to serve the fundraising needs of innovation-oriented SMEs. It is worth noting that the trading and listing rules of the BSE are predicated upon the requirements of the National Equities Exchange and Quotation (NEEQ) board, an existing platform for smaller companies to list in Mainland China. Firms within the “select tier” of NEEQ - those being recognised as high-quality, innovative companies with consistent profitability and have listed in NEEQ for 12 consecutive months - will be integrated into the BSE. As of June 2023, there were 204 listed stocks on the BSE, with a total market capitalisation of RMB266.8 billion and a total trading volume of 28.4 billion shares for the year.<sup>53</sup>

49 HKEX (June 2017). *Consultation Paper: Review of The Growth Enterprise Market (GEM) and Changes to The GEM and Main Board Listing Rules*. <https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/Consultation-Paper-on-Review-of-the-GEM-and-Changes-to-the-GEM-and-Main-Board-Listing-Rules/cp2017062.pdf>

50 Ibid.

51 HKEX (March 2023). *New Specialist Technology Company Listing Rules*. [https://www.hkex.com.hk/News/Regulatory-Announcements/2023/230324news?sc\\_lang=en](https://www.hkex.com.hk/News/Regulatory-Announcements/2023/230324news?sc_lang=en)

52 WFE (February 2017). *SME financing and equity market*. [https://www.world-exchanges.org/storage/app/media/research/Studies\\_Reports/WFE%20Report%20on%20Equity%20Market%20Financing%20of%20SMEs.pdf#page=23&zoom=100,92,97](https://www.world-exchanges.org/storage/app/media/research/Studies_Reports/WFE%20Report%20on%20Equity%20Market%20Financing%20of%20SMEs.pdf#page=23&zoom=100,92,97)

53 Beijing Stock Exchange (June 2023). *Stock Market Statistics*. <https://www.bse.cn/static/statisticdata.html>

Other growth markets specialising in start-ups and small/ mid-sized companies include the Euronext in Europe, Alternative Investment Market (AIM) in the UK, Toronto Venture Exchange (TSX Venture) in Canada, as well as Japan's Tokyo Stock Exchange (TSE) Growth Market (formerly known as Market of High-growth and Emerging Stocks (Mothers)), and Singapore's Catalist.

While being designed to fulfil the financing needs of early-stage companies or small cap/ mid-sized companies, some are experiencing lower levels of trading volume and activity, and other issues. For instance, the AIM in the UK has faced criticism regarding its governance standards, with some investors experiencing losses of over 70% of their investment over the first two decades of its establishment.<sup>54</sup> Investor confidence, which is already more vulnerable due to the inherent characteristics of smaller cap companies as compared to large-cap companies, could have been further weakened.

Comparatively, Europe has established multilateral trading facilities with varying listing requirements to accommodate the diverse needs of start-ups and SMEs. The Euronext Growth targets high-growth SMEs, while Euronext Access and Euronext Access+ with less stringent regulations are intended to serve as entry points for start-ups and SMEs, and as a gateway to other Euronext markets, respectively. Remarkably, Euronext Growth and Access have experienced notable growth, reaching EUR7,698 million in 2022, and a CAGR of 10.8% over the past five years.<sup>55</sup>

Similarly, the TSX Venture in Canada, with its two-tier listing category, has constantly been on the radar of market participants. The exchange welcomed 161 new listings in 2022, bringing its total to 1,713 issuers. Disregarding the ticket size, listing activities on the TSX Venture closely resembled that of the Toronto Stock Exchange, which recorded 113 new listings and a total of 1,789 issuers during the same period.<sup>56</sup>

The FSDC posits that Hong Kong can draw references from the merits and drawbacks of similar listing boards in Mainland China and in other markets. By doing so, Hong Kong can make judicious adjustments to better support the financing needs of small cap and mid-sized companies, bolstering its position as an international financial centre.

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<sup>54</sup> Financial Times (September 2019). *Aim suffers fresh setback as fundraising slows to a trickle*. <https://www.ft.com/content/3eaca2bc-c8bb-11e9-a1f4-3669401ba76f>

<sup>55</sup> Euronext Live Market (March 2023). *Euronext Fact Book 2022*. <https://live.euronext.com/en/resources/statistics>

<sup>56</sup> TMX (December 2022). *the MiG Report*. <https://www.tsx.com/resource/en/2952/mi-g-report-december-2022-en.pdf>

## Section 3: Recommendations

With the above observations in mind, the key recommendation outlined in the report is to address the changing global financial market landscape and investor appetite; that is, to introduce a PI-only marketplace. While the FSDC acknowledges that this primary recommendation may only be realised if the market, or the HKEX, considers it sensible, it is worth exploring given its potential as a credible marketplace for the secondary market trading of alternative assets. The new market would provide a more solid foundation for sustainable growth and facilitate innovation over the long term. And in the case that the HKEX takes it forward, or at least gives it some serious thought, it will be attractive to investors as the HKEX is a leading reputable exchange among its peers.

During the research process, the Working Group also attended to some other important issues and believed that stakeholders in Hong Kong should collectively give priority to addressing them. To achieve the common goal of enhancing Hong Kong's competitiveness as a capital formation centre, a range of measures, spanning short-, medium- and long-term time horizons, are designed. These short-to-medium term recommendations are considered fairly actionable and can be readily accomplished with the goal to enrich product offerings within the existing market regulatory framework.

We believe these recommendations would help bolster market efficiency and liquidity across different asset classes, as well as improve diversity and transparency of Hong Kong's broader financial market. The FSDC trusts that these suggestions will, complementarily, support Hong Kong in cementing its standing as a premier capital formation hub in the global arena.

### Primary Recommendation

#### ***Recommendation 1: Introducing a professional investor-only market to facilitate market innovation and sustainable growth of emerging investment products and alternative asset classes***

Taking an initiative of starting anew is not a low hanging fruit. Nonetheless, if this is to support the development of the industry, it should at least be explored.

Currently, HKEX is offering a variety of products limited to PIs only under separate regimes, including (i) investment companies listed under Chapter 21 of the Listing Rules (offerings are restricted to PIs only); (ii) debt securities listed under Chapter 37 of the Listing Rules; and (iii) SPACs listed under Chapter 18B of the Listing Rules (until completion of a De-SPAC Transaction).

It is worth noting that companies listed under Chapter 21 of the Main Board Listing Rules (LR) are exempt from financial eligibility requirements specified under LR 8.05; this means a company seeking a listing under Chapter 21 can, technically, have no prior operations and no revenues or cash flows whatsoever. However, in order to list under Chapter 21, the listing applicant must be an investment company which does not, itself, operate any of the underlying investments and is restricted from owning or controlling 30% or more of the voting rights of any company in which it is invested. Accordingly, operating businesses that are not investment businesses would not be permitted to list under Chapter 21 and benefit from the exemption from the financial eligibility requirements.

SPAC regime has been introduced in various major financial jurisdictions to promote market innovation and emerging investment products. IPO funds raised by US-listed SPACs dramatically rose in 2020, from US\$13.6 billion in 2019 to US\$83.4 billion in 2020, and almost doubled to reach US\$162.5 billion in 2021.<sup>57</sup> In response to this market development, the HKEX introduced new rules on SPACs, which became effective in January 2022. As demonstrated, the process involving the introduction of such new rules is not short, and it becomes challenging for the city to lead market developments.

Reflecting on the situation, and having discussed the issue with different market participants and stakeholders, the FSDC recommends that, in addition to the existing Main Board and GEM, Hong Kong should consider launching a new board or an exchange that allows PIs, and only PIs, to trade among the peers. Such a platform would serve as an efficient marketplace, providing ample liquidity for trading activities involving emerging products or investments that are not publicly traded.

It is understandable to the market that access to investment products is often restricted to PIs when their associated risk level is perceived to be high. With such limitations and the absence of an established and credible trading platform recognised by local and international PIs, PIs and product originators (e.g. banks and private fund managers) often find it difficult to expect high liquidity of such products. This has caused some ripple effects; for instance, without ample liquidity of investment products and other vehicles, it would be deemed unsafe for retail investors as they can face problems in selling down their positions. A vicious circle as it sounds, non-PIs – who, oftentimes, are categorised by declaration of asset requirements – would be denied access to investments such as PE investments, which are instrumental risk diversification tools as reflected in their performance over the last few decades and would have been valuable to those investors' risk management.

Separately, PE investments were not previously classified as a permissible investment asset class of Hong Kong's former Capital Investment Entrant Scheme (CIES). This exclusion exacerbated the limited access to CIES investors, who, while not formally classified as PIs, nonetheless meet the criteria of PIs. As a result, these investors encountered limitations when seeking a diversified portfolio of investment options. As the Government unveiled plans to introduce a new form of CIES in the 2023 Budget,<sup>58</sup> it presents an opportunity to consider permitting CIES investors to allocate a portion of their investment portfolio to PE funds registered in Hong Kong under the revised scheme. This prospective change holds significant benefits. Not only can it enhance the liquidity of PE funds - a core element for a vibrant and efficient investment market, but it can also provide a significant benefit to CIES investors. By offering them access to a broader spectrum of diversified investment options, it can enhance their risk management strategies.

While the FSDC is not positing that exposure to relatively non-traditional asset classes should be encouraged or given to all types of investors, we are of the view that, ultimately, investors should be given the ability to access a broader range of investment options. At the same time, the FSDC wishes to highlight the need for such products to demonstrate their reliability through attributes such as a deep liquidity pool and high trading frequency – hence, higher efficiency and lower risk of market manipulation, among others – as an attempt to provide more assurance to the retail investor group, who is often perceived as more vulnerable. This, in our view, aligns with the investor protection approach that Hong Kong has adopted all along.

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<sup>57</sup> Statista (Accessed on May 2023). *A number of special purpose acquisition company (SPAC) IPOs in the United States from 2003 to May 2023.*  
<https://www.statista.com/statistics/1178249/spac-ipo-usa/>

<sup>58</sup> HKSAR (February 2023). *2023-2024 Budget*. p.25. [https://www.budget.gov.hk/2023/eng/pdf/e\\_budget\\_speech\\_2023-24.pdf](https://www.budget.gov.hk/2023/eng/pdf/e_budget_speech_2023-24.pdf)

Apart from the above considerations, the accelerating pace in the innovation of market development demands a flexible and nimble approach to bring new investment products to market. This is beyond what the existing listing regimes and regulatory framework can offer, as explained in Appendix 2. In this context, a new PI-only market for both primary and secondary activities can achieve a reasonable balance between investor protection, innovation and time to market. Such a framework can avoid granting retail investors undue exposure to emerging or untested products, and is particularly suitable for regulating new and complex investment products that are evolving rapidly. The experience, sophistication and risk appetite of PIs should warrant a light-touch regulatory approach, while intermediaries should be under the duty to ensure that both primary and secondary markets will be limited to PIs only.

The proposed new market can serve as a launch pad for more innovative products or markets, such as the bond and securitisation markets. While they may be less known to retail investors, they have been instrumental to and are frequently used instruments for experienced investors and businesses to diversify their portfolios and manage risks. The development and potential offerings of the bond and securitisation markets, as examples, are summarised in Appendix 3. In addition, as quite some market practitioners view product origination and innovation as equally important priorities for investors, this warrants a better understanding of various exotic asset classes and factors causing their absence or low utilisation in the market when devising the mechanism and regulatory details of the PI-only board.

## **Survey Findings – Gauging the Views of PIs on Hong Kong’s Capital Market**

To assess market interest in this potential setup, the FSDC developed a questionnaire to gauge the views of PIs on the general development of Hong Kong’s capital market and potential measures to advance market development. The survey received 63 responses from PIs within the three-week survey period.

While findings of the survey may not be conclusive about the situation of the entire industry, the FSDC believes that responses to the survey can provide some high-level insights into PIs’ perceptions of Hong Kong’s capital market.

### ***Investment behaviour and considerations of PIs***

Our city’s role as an investment gateway is manifested as respondents surveyed invest in other markets through Hong Kong.<sup>59</sup> The survey also identifies areas where the city can improve as a destination market – a lack of innovative products, a limited basket of investment products and unresponsiveness to market trends were highlighted as main reasons for investors’ hesitation.

Investors appear to have a desire to diversify their investment portfolios across a variety of asset classes, and this desire is expected to intensify over the next 12-18 months. Over half of the surveyed respondents expressed interests in almost all listed products of various risk levels. Apart from the traditional product types – such as listed traditional equities and investment funds – other newer or emerging investment vehicles – for instance, listed tech companies, ESG-related products, and cryptocurrencies-related products – are also gaining traction.

### ***Interests towards a disclosure-based PI-only market***

Considering the potential of a new market, the majority of survey respondents (71%) expressed interest in a disclosure-based PI-only market in Hong Kong. Those who were supportive believed such a market would provide them with access to a wider range of products, whereas those with hesitations shared concerns about the vulnerability of the new market and its risks. When considering a new market, the top three important attributes that constitute attractiveness are a broad set of investment options, sufficient liquidity and market depth, and reasonable trading costs (see Appendix for more details of the survey).

The FSDC is mindful that investor protection – especially the protection of retail, individual investors who constitute the majority of the market and may be less experienced in investing than PIs – is of utmost importance. It is, therefore, understandable that Hong Kong has a prudent regulatory approach in place (see Appendix 5).

That said, as supported by the FSDC’s understanding of PIs through the engagement with Working Group members, the survey and interaction with numerous trade and professional associations, PIs have displayed a strong demand for investments in new vehicles. In this context, the FSDC believes it is now an appropriate juncture to put forward a proposal on a new PI-only market.

The Government and relevant public bodies can consider conducting an implementation study to identify the detailed mechanism/ approach to implement and products to be included on the new board. We are aware that a PI-only market is not without controversy – for instance, it can be seen as overly or unnecessarily prohibitive, and retail investors-focused brokers may be excluded.

<sup>59</sup> 63% of the respondents indicated that they allocate less than 50% of their investments to the Hong Kong market.

This initiative, however, can yield the benefits of a better understanding of the market landscape and potentially expand the product diversity of Hong Kong's capital market. This will, over the medium term, benefit such stakeholder groups too.

In the case that a priority list of eligible asset class would need to be in place, the FSDC is of the view that the proposed marketplace can consider facilitating secondary market transactions for PE funds, followed by bonds and securitisation products. In short, an active market in Hong Kong will enhance its position as a global financial centre and offshore RMB hub. By using diverse, innovative products, as well as capitalising on potential partnerships with other stock exchanges, Hong Kong can provide local and international investors with new capital market opportunities beyond the equity market, which in turn will support its market development and growth across the region (please refer to Appendix 3 for opportunities brought by bonds and securitisation products). In line with the primary recommendation, it is crucial to adopt an effective Professional Investor (PI) framework, with a definition that reflects today's rapidly evolving financial sector. The FSDC welcomed the recent joint circular issued by the Hong Kong Monetary Authority (HKMA) and the SFC in July 2023. This circular introduced a new level of PI, known as Sophisticated Professional Investors (SPIs), into the PI framework and outlined procedures that intermediaries should follow to manage their suitability obligations towards these investors. This move aligns with the recommendations proposed by the FSDC in their 2022 Private Wealth Management report,<sup>60</sup> which suggested revising the net assets test for PI qualification and introducing an SPI category. This category would incorporate investor experience and sophistication into the assessment criteria.

## **Other Short-to-medium Term Measures**

As mentioned in the beginning of the recommendation section, in addition to the need of a PI-only marketplace, the Working Group also looked into other areas of high importance to the competitiveness of a capital formation centre. Some of the more pressing areas requiring prioritised attention are as follows:

### ***Recommendation 2: Exploring synergies between Hong Kong's GEM and other market***

Hong Kong has been a keen facilitator and proponent of cross-boundary investment and bilateral capital flows. Among others, through the launch and development of a series of Connect Schemes, such as the Stock Connect, the Bond Connect, the Wealth Management Connect, and the inclusion of ETFs in Stock Connect, the city has enabled international investors to participate in Mainland markets, and vice versa. The recent introduction of three major financial market integration schemes/enhancements has further deepened the connectivity between the two markets, strengthening Hong Kong's position as China's international financial centre. These key initiatives include, but are not limited to, (i) the launch of the Swap Connect in May 2023, (ii) the inclusion of additional Hong Kong-listed foreign companies in the Southbound Stock Connect programme in March 2023, and (iii) the launch of measures to support the linked development of Shenzhen and Hong Kong VC investments in Qianhai in September 2022.

It is encouraging to note that the Policy Address delivered in October 2022<sup>61</sup> highlighted the Government's exploration of options to revitalise the GEM to offer a more effective fundraising platform for small- and mid-sized issuers. Furthermore, the recent announcement in June 2023 that HKEX signed a memorandum of understanding (MOU) with the BSE to establish a long-term

<sup>60</sup> FSDC (September 2022). *Cementing Hong Kong's Role as a Premier Private Wealth Management Hub in Asia*. [https://www.fsd.org.hk/media/rvqj03sy/20220907\\_pwm-eng-final.pdf](https://www.fsd.org.hk/media/rvqj03sy/20220907_pwm-eng-final.pdf)

<sup>61</sup> HKSAR Government (October 2022). *Policy Address 2022*. <https://www.policyaddress.gov.hk/2022/en/>

cooperation aimed at supporting cross-listings is a positive development. In view of such, with reference to the FSDC Research Paper published in March 2022,<sup>62</sup> we would like to reiterate the proposal to explore potential collaboration and synergy between the BSE and GEM, specifically. This collaboration can aim to create a more accessible platform for small cap and mid-sized issuers to broaden and diversify their shareholder base.

This is likely another step further to promote attractiveness and market liquidity for prospective issuers. Facilitating mutual access between the two stock exchanges would foster market depth and breadth, thereby providing market liquidity on a two-way basis. In this context, expanding the coverage of the Stock Connect programme can expedite the process more effectively.

As proven, the Connect schemes have injected much momentum into Hong Kong's financial market. Average daily turnover of Northbound and Southbound trading of the Stock Connect scheme was RMB100.4 billion and HK\$31.7 billion in 2022, respectively; these are roughly 80.4% and 25.4% of the daily turnover of the stock market (the average daily turnover of the stock market was HK\$124.9 billion for the same period in 2022).<sup>63</sup> The schemes demonstrate the positive correlation between connectivity of exchanges and market liquidity. Consequently, the potential expansion of the Stock Connect scheme to encompass both the BSE and GEM warrants further exploration. Broadening cross-boundary investment scopes and proliferating investment products would be conducive to the vibrancy of financial markets in both Hong Kong and the Mainland, while simultaneously offering better access and greater investment diversity to investors in Hong Kong, the Mainland, and the rest of the world.

Apart from enhancing connectivity with the Mainland market, fostering connectivity with other regional capital markets is instrumental to solidifying Hong Kong's role as a pre-eminent capital formation centre. To realise this objective, public sector stakeholders, including the HKEX and relevant regulators, can explore further expanding the scope of the existing mutual market access schemes or drawing inspiration from multilateral trading facilities such as Euronext Growth/ Euronext Access/ Euronext Access+. These facilities connect European economies to global capital markets. Exploring partnerships with other regional exchanges of similar positioning as GEM can facilitate fundraising activities for small cap and mid-sized issuers, potentially expanding their reach beyond the region. These arrangements, would diversify the investor base and attract more international capital flows. The new mechanism should strive to boost liquidity, benefiting most, if not all, of the GEM listings. Moreover, such collaboration would bring more attention to Hong Kong's capital market and elevate its global standing, including GEM listings.

### ***A dedicated approach to strengthen market oversight and the efficiency of GEM***

Contemplating the variety of challenges faced by small cap/ mid-sized businesses in securing financing (as discussed in earlier sections), some industry practitioners are of the view that establishing a dedicated team and committee, specifically designed to serve companies within the GEM ecosystem can help streamline and expedite this process. These practitioners assert that, due to the distinct characteristics of GEM listing applicants, such as emerging start-ups and innovative enterprises, a specialised team with the appropriate level of expertise, resources and decision-making capabilities for vetting and approval, would be better positioned to evaluate their suitability. With the appropriate level of expertise, resources, attention, and decision-making capabilities, the dedicated team would be well-placed to act upon a deeper understanding of the obstacles facing SMEs encounter when seeking funding.

<sup>62</sup> FSDC (March 2022). *Hong Kong as an International Financial Centre – Enhancement of Hong Kong's IPO offerings*. <https://www.fsd.org.hk/media/yflh4p1h/20220303-fsdc-paper-enrichment-of-hong-kong-s-listing-offerings-en-2.pdf>

<sup>63</sup> HKEX (February 2023). *2022 Final Results. Dividend and Disclosure of Register of Members*. [https://www.hkexgroup.com/-/media/HKEX-Group-Site/ccd/Media-Centre/hkexnews/2023/230223news/230223news\\_e.pdf](https://www.hkexgroup.com/-/media/HKEX-Group-Site/ccd/Media-Centre/hkexnews/2023/230223news/230223news_e.pdf)

The FSDC recognised that a dedicated team and committee for GEM was initially in place by the HKEX at the launch of GEM in 1999. During that period, GEM had a separate Listing Committee and staffing structure from the Main Board, as it was intended to operate as a disclosure-based, light-touch market for early-stage companies. In this regard, GEM's was markedly different from the Main Board.

However, the subsequent poor performance of GEM following the end of the "dot.com" boom led to a public consultation review exercise, which resulted in the GEM being repositioned as a "steppingstone" to the Main Board, rather than a standalone market for emerging companies. Consequently, in May 2003, HKEX merged the two Listing Committees and integrated GEM's listing department into the wider listing department in January 2004. HKEX also standardised practices and interpretations as far as possible following amendments to the Listing Rules in March 2004<sup>64</sup>. GEM was then repositioned as a market for "established" small and medium-sized companies, reflecting the nature of companies seeking a listing on GEM. These companies have been in operation for an average of 15 years at the time of listing.

Notwithstanding the history illustrated above, in conjunction with the revitalisation of GEM being explored by the Government and the potential expansion of connections with other exchanges, accompanied by an increased scope of work, it is recommended that HKEX reassess the necessity of forming a standalone team and committee for the GEM ecosystem, responsible for vetting and approving GEM listings. Such a team can help address the potential need to efficiently process relevant listing applications, while strengthening market supervision and risk management through effective oversight. This proposal is testament to the industry's commitment to promoting transparency, accountability, and high standards in the listing process, ultimately, benefiting all stakeholders in the market.

### ***Recommendation 3: Reviewing the stamp duty on stock transactions***

Hong Kong's low and simple tax regime serves as a cornerstone of its success as an international financial centre. In the realm of the city's capital market, the tax regime proves particularly attractive, given the absence of withholding taxes on dividends for stocks<sup>65</sup> or interests on fixed income instruments for individual investors.<sup>66</sup> Moreover, there are no capital gains taxes on the disposal of stocks in Hong Kong for both local and foreign investors.

Stamp duty, a major form of tax in Hong Kong, is levied on instruments concerning financial transactions involving the transfer of Hong Kong stocks. It falls under the four heads of charge under the first schedule of the Stamp Duty Ordinance (SDO) in Hong Kong:<sup>67</sup>

- Immovable property situated in Hong Kong;
- Hong Kong stock;
- Hong Kong bearer instruments; and
- Duplicates and counterparts of instruments chargeable for the above three heads of charge.

While it is well understood that stamp duty is one of the few forms of taxation on financial instrument transactions, numerous industry practitioners have questioned whether it should be further reviewed. They are of the view that such a review is of primary importance to enhance the competitiveness of Hong Kong's capital markets and ensure alignment with international norms.

<sup>64</sup> HKEX (July 2007), *Consultation Paper on the Growth Enterprise Market*. <https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2006-to-2010/July-2007-Consultation-Paper/Consultation-paper/cp200707e.pdf>

<sup>65</sup> Chinese withholding taxes are nevertheless imposed on certain H stocks and Red Chip stocks traded at the HKEx.

<sup>66</sup> HKSAR (July 2023). *Hong Kong e-Legislation. Cap. 112 Inland Revenue Ordinance (Article 26)*. <https://www.elegislation.gov.hk/hk/cap112>

<sup>67</sup> HKSAR (February 2023). *Hong Kong Stamp Duty Ordinance*. <https://www.elegislation.gov.hk/hk/cap117>

Currently, since August 2021, the stamp duty charge for the sale and purchase of Hong Kong stocks is 0.13% payable each by the buyer and the seller (i.e. 0.26% in total). It is estimated that no more than 30 economies in the world impose stamp duty on stock trading.<sup>68</sup> In fact, major leading international financial centres, except for Hong Kong and the UK, have not been imposing stamp duty on stock transactions. Recently, China's Ministry of Finance announced a reduction in stamp duty on stock transactions from 0.1% to 0.05% starting from 28 August 2023, a move aimed to stimulate the capital market and bolster investor confidence (Figure 9).<sup>69</sup>

Figure 9: Market capitalisation by the world's top exchange (as of June 2023)<sup>70</sup>

Name of Stock Exchanges	World Ranking	Asia Ranking	Market Capitalisation US\$ (in trillions)	Stamp Duty Rates
US (NYSE)	1		24.8	Nil
US (Nasdaq)	2		21.3	Nil
China (Shanghai)	3	1	6.8	Effective on 28 Aug 2023, the rate is reduced to 0.05% (seller only) <i>The previous rate was 0.1%</i> <sup>71</sup>
Europe (Euronext)	4		6.7	Nil
Japan (Japan Exchange Group)	5	2	5.8	Nil
China (Shenzhen)	6	3	4.7	Effective on 28 Aug 2023, the rate is reduced to 0.05% (seller only) <i>The previous rate was 0.1%</i> <sup>72</sup>
Hong Kong	7	4	4.3	0.26% <sup>73</sup> (0.13 % Buyer) (0.13% Seller)
India	8	5	3.3	0.00001% - 0.015% <sup>74</sup>
UK (London Stock Exchange Group)	9		3.2	0.5% (buyer only) <sup>75</sup>
Canada (Toronto)	10		3.0	Nil
Saudi Arabia (Tadawul)	11		2.9	Nil
Germany (Deutsche Börse)	12		2.2	Nil
Northern Europe (NASDAQ Nordic Exchange)	13		2.0	Nil
Switzerland	14		1.9	0.15% for Swiss securities, or 0.3% for foreign securities (with involvement of a Swiss Securities Dealer) <sup>76</sup>
Korea	15	6	1.9	Nil (but there is securities transaction tax, 0.15%, payable by the seller on KRX, and 0.3% on KONEX) <sup>77</sup>

68 Hong Kong LegCo Research Office (August 2022). *Securities transaction taxes and fees in selected places*. <https://www.legco.gov.hk/research-publications/english/2022rt07-securities-transaction-taxes-and-fees-in-selected-places-20220810-e.pdf>

69 Ministry of Finance of the People's Republic of China (27 August 2023). Announcement on stamp duty on stock transactions. [http://szs.mof.gov.cn/zhengcefabu/202308/t20230827\\_3904226.htm](http://szs.mof.gov.cn/zhengcefabu/202308/t20230827_3904226.htm)

70 SFC (June 2023). *Market Capitalisation of the World's Top Stock Exchanges*. <https://www.sfc.hk/-/media/EN/files/SOM/MarketStatistics/a01.pdf>

71 Shanghai Stock Exchange (2019). *Trading, Clearing & Settlement*. <http://english.sse.com.cn/access/stockconnect/settlement/>

72 Shenzhen Stock Exchange (2023). *Trading Fees*. <http://www.szse.cn/English/services/trading/tradingFees/index.html>

73 HKEX (2023). *Transactions*. [https://www.hkex.com.hk/Services/Rules-and-Forms-and-Fees/Fees/Securities-\(Hong-Kong\)/Trading/Transaction?sc\\_lang=en#:~:text=Stamp%20Duty%20on%20Stock%20Transaction,the%20buyer%20and%20the%20seller.](https://www.hkex.com.hk/Services/Rules-and-Forms-and-Fees/Fees/Securities-(Hong-Kong)/Trading/Transaction?sc_lang=en#:~:text=Stamp%20Duty%20on%20Stock%20Transaction,the%20buyer%20and%20the%20seller.)

74 National Stock Exchange of India (2023). *Other levies and taxes*. [https://www1.nseindia.com/int\\_invest/content/tax\\_other\\_taxes.htm](https://www1.nseindia.com/int_invest/content/tax_other_taxes.htm)

75 London Stock Exchange (2023). *Stamp Duty Exemptions*. <https://www.londonstockexchange.com/securities-trading/stamp-duty-exemption>

76 BNY Mellon (2018). *A Global View of Financial Transaction Taxes*. <https://www.bnymellon.com/content/dam/bnymellon/documents/pdf/emea/global-view-of-financial-transaction-taxes.pdf.coredownload.pdf>

77 RBC Investor Services (January 2023). *South Korea Market Profiles*.

<https://www.rbcits.com/fr/gmi/global-custody/market-profiles/market.page?dcr=templatedata/globalcustody/marketprofiles/data/south-korea>

The FSDC recognises that stamp duties collected from the Hong Kong stock transactions constitute a significant revenue source for the city. Truth be told, stamp duty revenue amounted to HK\$99.7 billion for the fiscal year of 2021/2022, accounting for approximately 14.4% of Hong Kong's total Government revenue.<sup>78,79</sup>

This is compared with other explicit costs, such as HKEX trading levies and SFC transaction levies which are currently imposed at rates of 0.00565% and 0.0027% on exchange traded stock transactions, respectively.<sup>80</sup> Hong Kong's stamp duty, by comparison, constitutes a substantial part of the cost of trading listed stocks. In today's predominantly electronic and globally connected markets, market participants and investors can readily opt to trade other international stocks or products as proxies in other financial markets that do not impose stamp duties, with a view to achieving lower transactional costs with similar returns.

Moreover, the imposition of a stamp duty can potentially deter high-frequency trading activities. The nature of high-frequency trades is characterised by high turnover rates and high order-to-trade ratios.<sup>81</sup> As of 2020, high-frequency trades constituted approximately half of the trading volume in the US equity markets and ranged between 24%-43% of the trading volume in European equity markets.<sup>82</sup> Given these considerations, the imposition of a stamp duty can influence trading behaviours and market dynamics. The potential shift towards trading in markets without stamp duties can lead to reduced liquidity and overall trading volume in markets where such duties are imposed.

It is encouraging to see that over the past few years, with an aim to nurture product innovation and promote product diversification in local securities markets, more products listed on HKEX, including exchange-traded funds (ETFs), debt securities, derivative warrants and callable bull/bear contracts, are exempted from stamp duty. Furthermore, the stamp duty exemption for transactions relating to dual-counter stocks made by dual-counter market makers, which came into operation in January 2023,<sup>83</sup> can also be viewed as a market development measure.

Lowering trading friction can indeed enhance market liquidity and provide a strong foundation for future improvements or innovations, potentially attracting more private and public funds. Therefore, instead of imposing stamp duty on stock trading, the Government may wish to align itself with international practices. To this end, the FSDC considers it the right time to review the current stamp duty rate in light of the ever-changing financial markets and global best practices. Such a review can help determine Hong Kong's competitiveness as a capital formation centre, with the understanding that any enhancement in trading activities will be perceived as a steadfast commitment by issuers and global investors.

#### ***Recommendation 4: Developing a strategic framework to promote investor education and financial literacy towards non-traditional/emerging asset classes***

The rapid advancement of digital technology, burgeoning market connectivity, and the rise of innovative investment products across the globe have transformed financial markets in many ways.<sup>84</sup>

78 Inland Revenue Department (August 2022). *IRD Collections*.

<https://www.legco.gov.hk/research-publications/english/2022rt07-securities-transaction-taxes-and-fees-in-selected-places-20220810-e.pdf>

79 Hong Kong Legco Research Office (November 2022). *Major sources of government revenue*.

<https://www.legco.gov.hk/research-publications/english/2022issf03-major-sources-of-government-revenue-20221110-e.pdf>

80 HKEX (2023). *Transactions*. [https://www.hkex.com.hk/Services/Rules-and-Forms-and-Fees/Fees/Securities-\(Hong-Kong\)/Trading/Transaction?sc\\_lang=en#:~:text=Stamp%20Duty%20on%20Stock%20Transaction,the%20buyer%20and%20the%20seller](https://www.hkex.com.hk/Services/Rules-and-Forms-and-Fees/Fees/Securities-(Hong-Kong)/Trading/Transaction?sc_lang=en#:~:text=Stamp%20Duty%20on%20Stock%20Transaction,the%20buyer%20and%20the%20seller).

81 CFA Institute (2023). *High Frequency Trading*.

<https://www.cfainstitute.org/en/advocacy/issues/high-frequency-trading#sort=%40pubbrowsedate%20descending>

82 European Central Bank (December 2020). *Research Bulletin No. 78: How does competition among high-frequency traders affect market liquidity by Johannes Breckenfelder*. <https://www.ecb.europa.eu/pub/economic-research/resbull/2020/html/ecb.rb201215~210477c6b0.en.html>

83 Inland Revenue Department (May 2023). *STAMP OFFICE Stamping Circular No. 02/2023*.

[https://www.ird.gov.hk/eng/pdf/sdo/ext\\_cir/so\\_ext\\_cir\\_02\\_2023.pdf](https://www.ird.gov.hk/eng/pdf/sdo/ext_cir/so_ext_cir_02_2023.pdf)

84 OECD (June 2019). *Regulatory effectiveness in the era of digitalisation*.

<https://www.oecd.org/gov/regulatory-policy/Regulatory-effectiveness-in-the-era-of-digitalisation.pdf>

In recent years, global financial markets have witnessed a rise in new types of emerging investment opportunities, such as SPACs and VAs. However, their fast-evolving nature and the universal accessibility of offshore investment platforms to the public have revealed regulatory arbitrage. To say the least, existing regulatory frameworks remain fragmented across global markets.<sup>85</sup> In particular, the increasing connectivity among global financial markets enables retail investors to engage offshore trading platforms effortlessly, thereby accessing a diverse array of products, including emerging or private market opportunities that are yet to be regulated in Hong Kong.

Considering these developments, limiting access to certain investment vehicles to PIs only should be merely the initial step in Hong Kong's market development. The introduction of new and innovative investment products ultimately requires prompt responses. Access to these PI-only products can be expanded to the retail market when their traits and features become more familiar to the public as their track records continue to grow.

To this end, the ultimate goal is to raise the market's awareness and knowledge of innovative products and fostering a comprehensive ecosystem for them is imperative. By doing so, both exposure and liquidity can be achieved. The following should be included as part of Hong Kong's regulatory response to market innovation:

**Comprehensive capacity building:** New investment products may include features which are complex and abstract not only to investors but also to intermediaries and professional practitioners. As such, extensive training, upskilling, and reskilling efforts are greatly needed. For example, there is already a demand for experts in scientific data to verify sustainability claims related to sustainable finance products. Building a sustainable ecosystem will stem from education at universities to continued training for intermediaries and professional practitioners. As an international capital formation centre, it is crucial to attract foreign experts as well as cultivate local talent to develop expertise in these new fields. It is encouraging to note that the Government and regulators have been working collaboratively to support talent development within the financial sector. An example of this is the Green and Sustainable Finance Cross-Agency Steering Group, which comprises various regulators and government departments. They launched the Pilot Green and Sustainable Finance Capacity Building Support Scheme<sup>86</sup>, providing subsidies to local practitioners for training in green and sustainable finance. In the context of innovative products and a PI-only board, similar efforts should be pursued to ensure continued growth and expertise in these areas.

**Investor education and financial literacy:** Promoting investor education and financial literacy is of paramount importance to maintaining economic stability, as they improve investment behaviour and build investors' confidence in the financial market.<sup>87</sup> Investors' awareness and knowledge of new investment products and embedded risks should be raised even when new products are initially limited to PIs only. Given the novelty of new investment products and their evolution, this will be a joint continuous effort by regulators and market participants. The transition from offering to PIs only to being accessible to all investors will require orchestrated efforts in promoting investor education and financial literacy. For instance, the Investor and Financial Education Council (IFEC) and Hong Kong Securities and Investment Institute (HKSI) are channels that we can leverage for such purposes. Additional resources may be considered for relevant parties with the aim of enhancing the public's knowledge of emerging products and trends.

85 KPMG (2021). *Ten Key Regulatory Challenges of 2022*.  
<https://advisory.kpmg.us/articles/2022/ten-key-regulatory-challenges-2022-crypto-digital-assets.html>

86 FSTB (December 2022). *Pilot Green and Sustainable Finance Capacity Building Support Scheme*. [https://www.fstb.gov.hk/fstb/en/business/funding\\_schemes/pilot-green-and-sustainable-finance-capacity-building-support-scheme.html#:~:text=The%20Government%20launched%20the%20Pilot,trend%20of%20developing%20low%20carbon](https://www.fstb.gov.hk/fstb/en/business/funding_schemes/pilot-green-and-sustainable-finance-capacity-building-support-scheme.html#:~:text=The%20Government%20launched%20the%20Pilot,trend%20of%20developing%20low%20carbon)

87 EFAMA (July 2014). *EGAMA Response to IOSCO Consultation paper on Strategic Framework for Investor Education*.  
<https://www.iosco.org/library/pubdocs/462/pdf/EFAMA.pdf>

# Conclusion

In the grand scheme of things, as the world economy and investment appetite continue to evolve, it is inevitable for Hong Kong to service an expanding global customer base by augmenting its suite of products, and maintaining ample liquidity across the entire spectrum of asset classes of the financial market. In recent years, we have seen the emergence of alternative financing options for small cap/ mid-sized companies, pre-revenue companies and private market investments. Hong Kong, as a premier international financial centre, is well positioned to foster financial innovation whilst safeguarding investors' interests.

To accomplish this, Hong Kong should maintain a resilient and efficacious financial ecosystem. By diversifying its product offerings through enhanced access to emerging investment opportunities and private market investments, and maintaining a robust yet adaptable regulatory framework, Hong Kong can cater to the demands of investors across the globe.

It is believed that the recommendations set forth in this paper can help promote liquidity and boost the range of offerings through infusing innovation into Hong Kong's capital market. Such endeavours will facilitate the city's transition to a more vibrant marketplace for both public and private investments. By strengthening the breadth and depth of the city's fundraising platform, Hong Kong can cement its pre-eminent role as a conduit for global capital flows between the East and West.

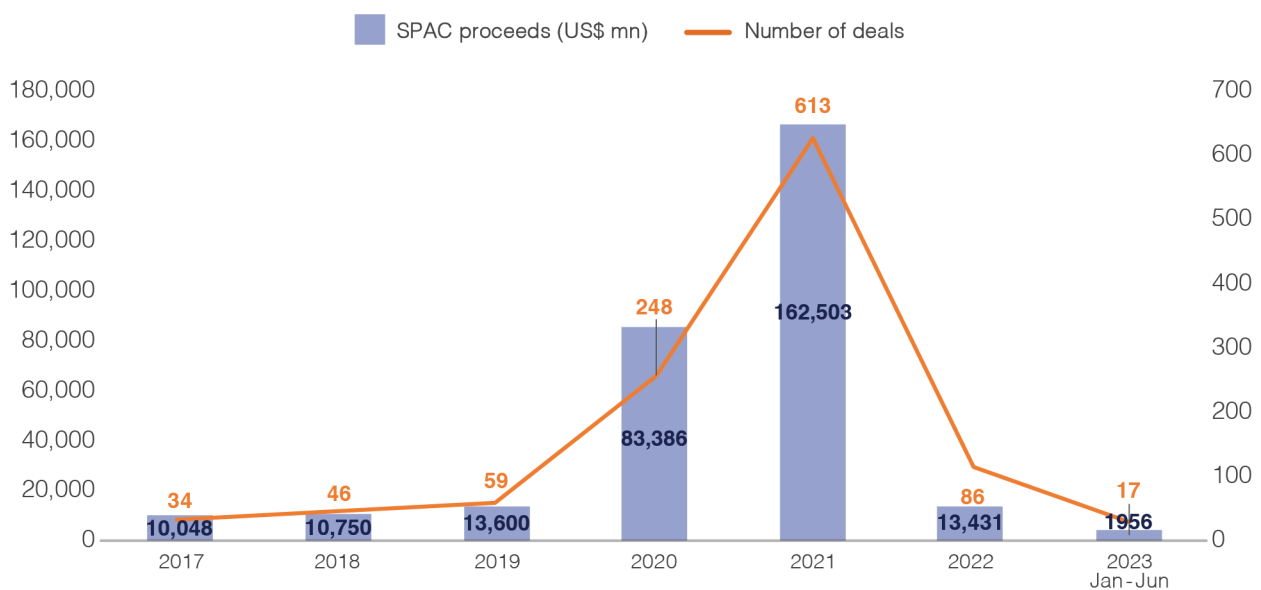
# Appendix 1: SPACs and Virtual Assets

## Special Purpose Acquisition Companies (SPACs)

SPACs, sometimes referred to as blank check companies, have been in existence since the 1990s. However, it was not until 2019 that there was a resurgence of interest in the US market. Despite disruptions to public markets amidst the pandemic, SPACs experienced a surge in demand starting 2020, with the number of deals peaking in 2021. The surge can be largely attributed to the expedited listing process offered by SPACs in comparison to traditional IPOs. That stated, as markets became more volatile due to geopolitical uncertainties, rising interest rates and a high inflationary environment, global SPAC activities were subdued in 2022 (Figure 10).<sup>88</sup>

Despite the shrinkage of SPAC IPO proceeds, the amount recorded in the US was at US\$13 billion, accounting for over 59% of the nation's total IPO proceeds, surpassing the 49% recorded in 2021.<sup>89</sup>

Figure 10. US SPAC activities since 2017



Source: SPAC Analytics Database

Following the popularity of SPAC listings in the US market, other major financial centres also established new listing regimes for SPACs. For instance, the UK and various Asian markets, such as Singapore, Korea and Malaysia, made similar legislative arrangements to facilitate SPACs listing structures in 2021.

<sup>88</sup> S&P Global Market Intelligence (November 2022). *SPAC offerings. deals fall to pre-surge levels.* <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/spac-offerings-deals-fall-to-pre-surge-levels-72960244>  
<sup>89</sup> SPAC Analytics (Accessed on 6 January 2023). *SPAC Analytics Database.* <https://www.spacanalytics.com/>

As for Hong Kong, the HKEX launched a SPAC listing regime in January 2022, offering IPO applicants a “dual-track” listing option in addition to the traditional IPO route. Given SPAC is a relatively new investment vehicle for general investors in Hong Kong, and considering the inherent risks involved, the city’s SPAC regime limits the subscription and trading of SPAC securities to PIs until the SPAC completes its acquisition of a “De-SPAC Target”.<sup>90</sup> In principle, taking into account local market conditions, the HKEX’s SPAC listing regime seeks to strike a balance between investor protection and innovation. The consistent efforts to provide sufficient protection to retail investors are manifestly evident in this regime.

## Virtual Assets (VAs)

In recent years, advancements in digital technology have made VAs widely accessible, garnering much attention from global investors.

The trading of VAs witnessed substantial growth, as demonstrated by the significant surge in the market capitalisation of the global cryptocurrency market. In November 2021, the market reached a peak of US\$2,888 billion, representing some 140 times increase since 2017. Despite market turbulence in the following years, the cryptocurrency market remained robust, standing at US\$1,137 billion as of May 2023 (Figure 11).<sup>91</sup> It is expected that the number of cryptocurrency owners will surpass 410 million by 2023, equivalent to 4.2% of the world’s population.<sup>92</sup>

Figure 11. Total cryptocurrency market capitalisation



The above graph shows the total market cap of all **cryptoassets**, including **stablecoins** and **tokens**

Source: Coinmarketcap

<sup>90</sup> In this paper, an individual professional investor means a non-institutional professional investor and includes any individual and corporate entity falling under the Securities and Futures (Professional Investor) Rules (Cap. 571D). Accordingly, it includes: (i) an individual having a portfolio of not less than HK\$8 million, (ii) a trust corporation with total assets of not less than HK\$40 million, and (iii) corporation or partnership which have a portfolio of not less than HK\$8 million or total assets of not less than HK\$40 million.

<sup>91</sup> Coinmarketcap (Accessed on 3 November 2022). *Global Cryptocurrency Charts*. <https://coinmarketcap.com/charts/>

<sup>92</sup> Triple-A (Accessed on 6 January 2023). *Cryptocurrency Ownership Data*. <https://triple-a.io/crypto-ownership-data/#:~:text=Global%20crypto%20adoption&text=As%20of%202023%2C%20we%20estimated,420%20million%20crypto%20users%20worldwide>

## VA landscape and the regulatory regime in Hong Kong

In light of the potential risks associated with VAs, an increasing number of jurisdictions, including the UK, US and others, are prioritising the development of comprehensive regulatory frameworks for this emerging asset class. These regulatory frameworks, in general, share the objective of safeguarding investors' interests and fostering the sustainable development of the industry.

As for Hong Kong, VAs first appeared in the SFC's regulatory purview in 2017 when initial coin offerings became prevalent.<sup>93</sup> In 2018, the SFC introduced a regulatory framework for VA trading

platform operators, portfolio managers and fund distributors. Funds investing more than 10% of their portfolio in VAs are obligated to meet additional requirements, such as restricting participation to PIs exclusively.

Hong Kong's regulatory framework for VAs is evolving in response to the rapid development of the VA industry. In 2021, the Financial Services and the Treasury Bureau (FSTB) proposed amendments to the Anti-Money Laundering Ordinance with the intention of introducing a licensing regime for virtual asset service providers (VASPs).<sup>94</sup> The proposal aimed to regulate VA activities and require any person engaging in the activity to obtain a VASP licence from the SFC. Upon the passage of the amendment bill in December 2022, and the subsequent consultation on the proposed regulatory requirements, it came into effect in June 2023. It is worth noting that, in contrast to the initial proposal, there is a shift in position in which licensed exchanges are now permitted to extend services to retail clients, subject to specific constraints. For instance, only large-cap VAs included in at least two acceptable indices are made available to them, and additional disclosure obligations, among other requirements, are imposed.<sup>95,96</sup> The change in direction has been well received by practitioners of both the Web3 ecosystem as well as those of the traditional finance. A multitude of firms have been attracted to the city since the Government dedicated efforts towards the industry. Between November 2022 and mid-May 2023, over 90 VA-related companies from Mainland China and overseas expressed interest in establishing business in Hong Kong.<sup>97</sup> As of August 2023, Cyberport, managed by a wholly owned subsidiary of the Government, has gathered more than 180 firms that specialise in Web3 technology.<sup>98</sup>

93 SFC (November 2021). *Keynote address by Ms. Julia Leung, Deputy Chief Executive Officer and Executive Director, Intermediaries, the SFC at Hong Kong FinTech Week 2021*. <https://www.sfc.hk/-/media/EN/files/COM/Speech/DCEO-at-HK-FinTech-Week-2021.pdf>

94 FSTB (May 2021). *Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong*. [https://www.fstb.gov.hk/fsb/en/publication/consult/doc/consult\\_conclu\\_amlo\\_e.pdf](https://www.fstb.gov.hk/fsb/en/publication/consult/doc/consult_conclu_amlo_e.pdf)

95 FSTB (October 2022). *Policy Statement on Development of Virtual Assets in Hong Kong*. [https://gia.info.gov.hk/general/202210/31/P2022103000454\\_404805\\_1\\_1667173469522.pdf](https://gia.info.gov.hk/general/202210/31/P2022103000454_404805_1_1667173469522.pdf)

96 King & Wood Mallesons (April 2023). *Hong Kong's New Virtual Asset Regime*. <https://www.kwm.com/global/en/insights/latest-thinking/hong-kongs-new-virtual-asset-regime-what-you-need-to-know.html#:~:text=What%20is%20the%20Hong%20Kong,a%20licence%20is%20an%20offence>.

97 LegCo Panel on Financial Affairs (June 2023). *Development of Financial Technologies and Other Innovations for Financial Services in Hong Kong*. <https://www.legco.gov.hk/yr2023/english/panels/fa/papers/fa20230605cb1-569-3-e.pdf>

98 Blog of the Financial Secretary (27 August 2023). *Boundless Entertainment: A New Vision with Web3 (娛樂無邊界 Web3新視界)*. <https://www.fso.gov.hk/eng/blog/blog20230827.htm>

# Appendix 2: Hong Kong's Current Financial Regulations and Regulatory Approach

## Eligibility and Suitability for Listing

Hong Kong is one of the world's premier listing centres of choice. While upholding a high standard of eligibility and suitability to uphold market integrity and public investor confidence, the HKEX has devoted much effort to addressing investor demand and bringing in a broader range of investment options. There is, however, a general consensus among market participants that further enhancement is beneficial. For instance, some of the listing requirements can be revisited to better accommodate the financing needs of potential issuers in an emerging industry.

In particular, according to existing rules, an applicant for a new listing on the Main Board of the HKEX must, in general, satisfy the profit test in LR 8.05(1), the market capitalisation/ revenue/ cash flow test in LR 8.05(2) or the market capitalisation/revenue test in LR 8.05(3). For a listing on the GEM, an applicant must fulfil minimum positive cash flows. Besides financial performance thresholds, listings on both the Main Board and the GEM require trading records to demonstrate the continuity of ownership and management.

The eligibility requirements for new listings on the Main Board and the GEM of the HKEX are summarised as follows:

	Main Board			GEM
	Profit test	Market capitalisation/ revenue/ cash flow test	Market capitalisation/ revenue test	
<b>Trading record</b>	Three financial years			Two financial years
<b>Profit</b>	At least HK\$35 million for latest year; HK\$45 million in aggregate for two preceding years	N/A		N/A
<b>Revenues</b>	N/A	At least HK\$500 million for most recent audited FY		
<b>Operating cash flow</b>	N/A	Positive operating cash flow of at least HK\$100 million in aggregate for three preceding financial years	N/A	Positive operating cash flow of at least HK\$30 million in aggregate for two preceding financial years
<b>Market cap</b>	HK\$500 million at the time of listing	HK\$2 billion at the time of listing	HK\$4 billion at the time of listing	HK\$150 million at the time of listing
<b>Ownership continuity</b>	For at least the most recent audited financial year			For at least the most recent audited financial year
<b>Management continuity</b>	Three financial years			Two financial years

In addition to meeting eligibility requirements, a business must be deemed suitable for listing on the Main Board and the GEM. The HKEX considers various factors when determining a listing applicant's suitability, including but not limited to the use of proceeds, future objectives and strategies, profit and revenue growth, cost of listing, and whether the applicant is in a potential sunset industry.

As they stand, the current listing eligibility and suitability requirements, generally favour established businesses that are already profit-making or revenue-generating, with a significant expected market capitalisation at the time of listing. These requirements may, as a result, skew the profile of companies eligible and suitable for listing towards traditional industries and/or companies that have been operating for some time. Start-ups, small cap and mid-sized companies may potentially be excluded from accessing fundraising support.

In recent years, efforts have been made to provide greater flexibility to the eligibility and suitability requirements for companies in specific industries, such as biotech, mining and specialist technology. Nonetheless, such flexibility remains confined to certain types of businesses and comes with its own set of criteria.

The key listing requirements for companies in biotech, mining, specialist technology industries and companies with WVRs are summarised as follows:

	Biotech Companies	Mining Companies	WVR Companies	Specialist Technology Companies
<b>Able to list without meeting financial eligibility requirements under LR 8.05?</b>	Yes, subject to compliance with suitability, eligibility and other requirements and modified financial eligibility requirements of: (1) A market capitalisation of at least HK\$1.5 billion at the time of listing; and (2) Management continuity for two financial years	Yes, subject to compliance with other requirements	Modified financial eligibility requirements:  (1) A market capitalisation of at least HK\$40 billion at the time of listing; or  (2) A market capitalisation of at least HK\$10 billion at the time of listing and revenue of at least HK\$1 billion for the most recent financial year	Modified financial eligibility requirements:  (1) A market capitalisation of at least HK\$6 billion at the time of listing for commercial companies; or a market capitalisation of at least HK\$10 billion at the time of listing for pre-commercial companies, and  (2) Substantially the same management continuity for at least three financial years
<b>Suitability and eligibility</b>	Must have developed at least one core product beyond the concept stage  Primarily involved in R&D for the development of core product for at least 12 months prior to listing  The primary reason for listing is to commercialise core product  Pipeline of potential products if R&D has been of pharmaceutical (small molecule) products or biologic products  Meaningful third-party investment from sophisticated investor <sup>99</sup> at least 6 months prior to listing	At least one mining asset in development / exploration stage only  Must establish that directors and senior managers, taken together, have sufficient relevant experience, and each individual has at least five years' relevant industry experience  Must demonstrate a clear path to commercial production and a plan for achieving profitable commercial production	Must be an "innovative company" <sup>100</sup>  Must demonstrate a track record of high business growth that is expected to continue  WVR holders must be individuals who have been materially responsible for growth; must have had active executive roles within the business, with material contributions to the ongoing growth of business; and must be directors of the listing applicant at the time of listing  Meaningful third-party investment from at least one sophisticated investor <sup>101</sup>	Must be a "specialist technology company" <sup>102</sup>  Must engaged in R&D of its specialist technology products for at least three financial years and have incurred R&D expenditure amounted to:  (i) At least 15% of its total operating expenditure for commercial companies; or  (ii) At least 30% of its total operating expenditure for pre-commercial companies with revenue from HK\$150–HK\$250 million/At least 50% of its total operating expenditure for pre-commercial companies with revenue less than HK\$150 million for its most recent audited financial years.  Meaningful investment from two to five sophisticated independent investors <sup>103</sup> who have invested at least 12 months before the date of application <sup>104</sup>
<b>Other requirements</b>	Operating current line of business for at least two financial years  Sufficient working capital to cover 125% of group's costs for at least 12 months from the date of publication of the listing document	Detailed disclosures in compliance with specific disclosure requirements <sup>105</sup>  Sufficient working capital to cover 125% of group's costs for at least 12 months from the date of publication of the listing document	The beneficiaries of WVRs must collectively own at least 10% of the underlying economic interest in the applicant's total issued share capital at the time of initial listing	Operating current line of business for at least three financial years  Sufficient working capital to cover 125% of group's costs for pre-commercial companies for at least 12 months from the date of publication of the listing document

99 HKEX (2023). *Rulebook – Rules and Guidance*. <https://en-rules.hkex.com.hk/>. The HKEX will assess whether an investor is a "sophisticated investor" for the purpose of applications for listing under Chapter 18A on a case-by-case basis by reference to factors such as net assets or assets under management, relevant investment experience, and the investor's knowledge and expertise in the relevant field (paragraph 3.2(g)(i), GL92-18)

100 HKEX (2023). *Rulebook – Rules and Guidance*. <https://en-rules.hkex.com.hk/>. An innovative company would normally be expected to possess more than one of the following characteristics: (a) its success is demonstrated to be attributable to the application, to the company's core business, of (1) new technologies; (2) innovations; and/or (3) a new business model, which also serves to differentiate the company from existing players; (b) research and development is a significant contributor of its expected value and constitutes a major activity and expense; (c) its success is demonstrated to be attributable to its unique features or intellectual property; and/or (d) it has an outsized market capitalisation / intangible asset value relative to its tangible asset value (paragraph 4.2, GL93-18)

101 HKEX (2023). *Rulebook – Rules and Guidance*. <https://en-rules.hkex.com.hk/>. An investor that the HKEX considers to be sophisticated by reference to factors such as net assets or assets under management, relevant investment experience, and the investor's knowledge and expertise in the relevant field. (Paragraph 4.6, GL93-18)

102 HKEX (2023). *Rulebook – Rules and Guidance*. <https://en-rules.hkex.com.hk/>. A company primarily engaged (whether directly or through its subsidiaries) in the research and development of, and the commercialisation and/or sales of, Specialist Technology Product(s) within an acceptable sector of a Specialist Technology Industry (paragraph 7, GL 115-23)

103 HKEX (2023). *Rulebook – Rules and Guidance*. <https://en-rules.hkex.com.hk/>. The HKEX Exchange will publish guidance on the Exchange's website, amended from time to time, on the definition of sophisticated independent investors, and the nature and extent of investment that would meet this rule (Paragraph 31, GL 115-23)

104 HKEX (2023). *Rulebook – Rules and Guidance*. <https://en-rules.hkex.com.hk/>. At least two to five sophisticated independent investors (Pathfinder SIs) that in aggregate  $\geq 10\%$  of an applicant's issued share capital or otherwise have invested an aggregate sum of  $\geq$  HK\$1.5 billion in the applicant, given that, at least two Pathfinder SIs each hold  $\geq 3\%$  of an applicant's issued share capital or otherwise each have invested  $\geq$  HK\$450 million in the applicant (Paragraph 37 (a), GL 115-23)

105 HKEX (2023). *Rulebook – Rules and Guidance*. <https://en-rules.hkex.com.hk/>. Under Chapter 18 of the Listing Rules and the HKEX's guidance letter GL52-13

## **Implementing new rules/ consultation process**

The listing regimes for biotech companies, mining companies and companies with WVR structures, SPACs, and most recently, specialist technology companies, have distinct eligibility requirements tailored for specific types of company or business, which are established through a public consultation process. A listing applicant must fall within an identified industry or type of company for which bespoke rules are crafted.

The first step in this process requires the HKEX to determine whether the new industry, type of company, or market development would qualify for listing under the existing Listing Rules and whether any exemptions should be granted. Following such a review, the HKEX publishes a consultation paper outlining the proposed new rules, which is then followed by a consultation period. The HKEX subsequently collates and contemplates the responses to the consultation, with the conclusions being published prior to the implementation of the new rules.

While the flexibility of such a regime contributes to the promotion of innovation within the capital market. However, the protracted procedures associated with establishing such a regime present certain limitations in terms of promptly and adaptively responding to the dynamic and emerging trends in the global investment market. Therefore, it is essential to strike a balance between maintaining stability and fostering innovation in the market.

# Appendix 3: Potential New Product Developments in the Newly Proposed PI-only Market

Enhancing market liquidity and diversity is critical to strengthening Hong Kong's position as a leading capital formation hub. The city should capitalise on emerging trends to expand its product offerings, thereby fostering a more dynamic and vibrant marketplace.

In Hong Kong, bank lending, coupled with bond and equity issuances, are the primary sources of government and corporate financing.<sup>106</sup> While a number of Asian markets, including Mainland China, Japan and Singapore, have made varying efforts to diversify their financing channels over the years, such as establishing guiding bond and securitisation frameworks, Hong Kong has yet to achieve a commensurate level of progress. Despite representing 9.1% of global equity issuance in 2021, Hong Kong contributed to 0.4% of global bond issuance only.<sup>107</sup> Comparatively, Mainland China (16.4% and 20.3%), the US (35.8% and 33.9%), Japan (3.5% and 13.7%) and Singapore (0.4% and 0.2%) exhibited more balanced dynamics in this regard.<sup>108</sup>

Enhancing Hong Kong's bond issuance and securitisation capabilities would not only provide asset and business owners with supplementary capital raising options, but also expand the range of investment offerings. PIs seeking attractive, diverse investment opportunities beyond equity investments would particularly benefit from this.

## Hong Kong's Bond Market

Hong Kong's bond market is not as heavily utilised as its equity market, as reflected in the market size. In 2022, while the capitalisation of the city's stock market reached 1,265% of its GDP, the outstanding debt securities constituted only 159% of the GDP.<sup>109,110,111</sup>

Government bonds are generally regarded as the cornerstone of fixed-income markets globally. They provide a benchmark for the market, bolster liquidity, and stimulate the participation of the private sector in the bond market (The World Bank, 2016).<sup>112</sup> In Hong Kong, government-issued outstanding debt securities represented 54% of the GDP in 2022.

Contrasting these numbers to those of other markets, while noting that Hong Kong's debt may not be fully domestic-focused, further usage of our debt facilities and ecosystem can be encouraged (Figure 12). Moreover, the scope for issuances by the Government and relevant agencies presents a compelling opportunity. By exploring further in this direction, Hong Kong can cultivate a more robust and diverse bond market.

<sup>106</sup> BIS (4Q 2022). *Summary of debt securities outstanding*. <https://stats.bis.org/statx/srs/table/c1>

<sup>107</sup> i.e. fixed income securities with maturity of 13 months or longer.

<sup>108</sup> SIFMA Research (July 2021). *2021 Capital Markets Fact Book*. <https://www.sifma.org/wp-content/uploads/2021/07/CM-Fact-Book-2021-SIFMA.pdf>

<sup>109</sup> BIS (4Q 2022) (Accessed on August 2023). *Summary of debt securities outstanding*. <https://stats.bis.org/statx/srs/table/c1?p=20224&c=>

<sup>110</sup> WFE (2023). *Statistics Portal*. <https://www.world-exchanges.org/our-work/statistics>.

<sup>111</sup> IMF (2023). *IMF Data*, <https://www.imf.org/en/Data>

<sup>112</sup> The World Bank (December 2015). *Government Bond Market Development*.

<https://www.worldbank.org/en/topic/financialsector/brief/government-bond-markets>

Figure 12: Outstanding value of the debt securities market as a percentage of GDP (2022)

2022 (US\$, bn / % of GDP)	Hong Kong	Mainland China	UK	US
Equity market capitalisation	4,567 (1,265%)	11,425 (63%)	3,096 (101%)	39,004 (153%)
Total outstanding debt securities	573 (159%)	21,660 (120%)	4,793 (156%)	51,937 (204%)
Government-issued outstanding debt securities	194 (54%)	9,147 (51%)	3,071 (79%)	25,464 (106%)

Source: BIS, IMF, WFE

Furthermore, the robust demand for capital for infrastructure projects in Asia, alongside the increasing popularity of green and sustainable finance,<sup>113</sup> presents Hong Kong with significant opportunities to expand its bond market offerings. The city can capitalise on this trend to explore novel and further issuance of infrastructure bonds, green bonds, social bonds and sustainability-linked bonds.

On this front, FSDC is pleased to acknowledge the establishment of the Steering Committee on Bond Market Development in 2021. In the following year, the Committee formulated pertinent recommendations under three strategic directions aimed at advancing Hong Kong's bond market. Among these, the proposal to promote the development of an electronic bond trading platform to facilitate secondary trading and broaden the investor base, shares some parallels with the concept of a PI-only market, as suggested in this report's recommendation.<sup>114</sup>

## Secondary bond market development

The development of the secondary bond market and introduction of repurchase (repo) trading for public and corporate on-exchange bonds hold equal significance to the enhancement of the primary bond market. These aspects contribute to the strengthening and deepening of the overall bond market.

A liquid and efficient secondary bond market provides investors with a platform to trade their holdings, which in turn, can help bolster market participation and entice new investors.<sup>115</sup>

Separately, the secondary bond market and bond repo trading are inextricably linked. Bond repo trading is a form of short-term borrowing wherein a dealer sells bonds to an investor, with a commitment to repurchase them at a specific date and price. Despite its importance, bond repo trading is currently not available on the HKEX.<sup>116</sup> This trading mechanism is pivotal in determining the liquidity of the bond market, creating opportunities for arbitrage within swap markets. Arguably, more importantly, it supports the liquidity of bonds need as collateral in bond repo transactions.

Therefore, the development of the secondary bond market and bond repo trading should be explored further to endow investors with additional avenues for managing their portfolios effectively.

<sup>113</sup> PwC (2022). *Bridging the trillion-dollar infrastructure gap in Asia Pacific*.

<https://www.pwc.com/id/en/pwc-presence-at-the-b20-forum/bridging-the-trillion-dollar-infrastructure-gap-in-asia-pacific.html>

<sup>114</sup> HKSAR Government (August 2022). *Report of the Steering Committee on Bond Market Development in Hong Kong*. [https://www.fstb.gov.hk/fsb/en/publication/report/docs/Report%20of%20the%20Steering%20Committee%20on%20Bond%20Market%20Development%20in%20Hong%20Kong\\_EN\\_2022\\_08.pdf](https://www.fstb.gov.hk/fsb/en/publication/report/docs/Report%20of%20the%20Steering%20Committee%20on%20Bond%20Market%20Development%20in%20Hong%20Kong_EN_2022_08.pdf)

<sup>115</sup> BIS (2022). *Bond markets in emerging economies: an overview of policy issues*. <https://www.bis.org/publ/bppdf/bispap11b.pdf>

<sup>116</sup> HKEX (September 2020). *The Rising on-exchange bond market in Mainland China and Hong Kong - HKEX*.

[https://www.hkex.com.hk/-/media/HKEX-Market/News/Research-Reports/HKEx-Research-Papers/2020/CCEO\\_ExBond\\_202009\\_e.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/News/Research-Reports/HKEx-Research-Papers/2020/CCEO_ExBond_202009_e.pdf?la=en)

## Hong Kong's Securitisation Market

Asset securitisation is well recognised as a financing alternative that plays a role in risk diversification, especially in times of economic uncertainty. According to the Association for Financial Markets in Europe and the European Central Bank, securitisation transforms illiquid assets into tradable securities with varying risk profiles. Engaging investors in capital markets can mitigate credit risk by shifting loans off the balance sheet.<sup>117,118</sup>

In 2022, China's securitisation market accounted for approximately 27% of the worldwide share in terms of new issue volumes of structured finance, marking it as the second-largest, following the US (~54%). Furthermore, China is expected to continue to spearhead the APAC region in 2023 (Figure 13).<sup>119</sup>

Figure 13: Global structured new issue volumes

Approximate Global Structured Finance New Issue Volumes							
(Bil. \$ unless otherwise noted)	2017	2018	2019	2020	2021	2022	2023f
U.S.	510	540	582	452	783	595	507
Canada (C\$)	20	25	19	11	14	17	21
Europe (€)	82	107	102	69	114	81	80
China	220	292	334	432	485	299	310
Japan	48	56	61	60	61	45	45
Australia	36	23	31	22	38	32	31
Latin America	17	9	13	13	24	22	25
<b>Approximate global new issue total</b>	<b>930</b>	<b>1,050</b>	<b>1,150</b>	<b>1,070</b>	<b>1,530</b>	<b>1,092</b>	<b>1,019</b>

Source: S&P Global Ratings, Association for Financial Markets in Europe and European Central Bank

Hong Kong's securitisation market is predominantly driven by private assets, with institutional investors, such as financial institutions, insurance companies and private funds, being the principal part-takers.<sup>120</sup> While the private sector plays an integral role in the securitisation market, involvement from the public sector remains limited in Hong Kong. The Hong Kong Monetary Authority maintains a minimal presence in the local securitisation market, except for some legacy residential mortgage-backed securitisations issued by the Hong Kong Mortgage Corporation Limited. Consequently, investors in Hong Kong are less accustomed to asset securitisation plans, given that the government has not issued any for public assets or infrastructure projects for more than a decade.<sup>121</sup>

In this context, asset-backed securities (ABS) and synthetic securitisation warrant exploration as potential offerings for the development of the securitisation market. ABS, a popular structured securities product in global financial markets including the US and Mainland China, can provide a significant boost.<sup>122</sup> While the HKEX has established listing rules for ABS issuance to PIs, active issuance of ABS has been absent.<sup>123</sup>

117 Association for Financial Markets in Europe (September 2021). *Securitisation as a key pillar of the UK Future Regulatory Framework (p.9 – the unique value of securitisation)*. <https://www.dlapiperintelligence.com/export/sites/intelligence/investmentrules/securitisation/commentary/Securitisation-as-a-key-pillar-of-the-UK-Future-Regulatory-Framework-September-2021.pdf>

118 European Central Bank (December 2007). *Working Paper Series No. 838 P.25*. <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp838.pdf>

119 S&P Global Ratings (January 2023). *Global Structured Finance 2023 Outlook*. [https://www.spglobal.com/\\_assets/documents/ratings/research/101571302.pdf](https://www.spglobal.com/_assets/documents/ratings/research/101571302.pdf)

120 The Legal 500 (January 2022). *The Legal 500 Country Comparative Guides*. <https://www.legal500.com/guides/chapter/hong-kong-securitisation/?export-pdf>

121 Asian Academy of International Law (January 2020). *A Securitisation Financing Hub for Infrastructure and Small and Medium Enterprises*. [https://www.hkib.org/pdf/1596682794\\_HK-A%20Securitisation%20Financing%20Hub%20for%20Infrastructure%20and%20Small%20and%20Medium%20Enterprises-final.pdf](https://www.hkib.org/pdf/1596682794_HK-A%20Securitisation%20Financing%20Hub%20for%20Infrastructure%20and%20Small%20and%20Medium%20Enterprises-final.pdf)

122 Regulation Asia (November 2021). *China ABS Market: A Magnet for Global Investors*. <https://www.regulationasia.com/china-abs-market-a-magnet-for-global-investors/>

123 HKEX (2023). *Asset-backed Securities Rules and Guidance*. <https://en-rules.hkex.com.hk/rulebook/asset-backed-securities-0>

Synthetic securitisation, another form of transaction that enables financial institutions to transfer credit risk and lessen their regulatory capital requirements, also holds potential. A synthetic securitisation is typically a transaction where a bank with a portfolio of loans (or other financial assets) buys credit protection against one or more tranches of risk in that portfolio while retaining legal ownership.<sup>124</sup> Following the introduction of new capital rules in June 2021, the full spectrum of synthetic securitisation structures can now be used in Hong Kong, with Special Purpose Vehicles (SPVs) serving as providers of guarantees or credit default swaps - a common structure for synthetic securitisation products. These changes have paved the way for the growth of Hong Kong's synthetic securitisation market.

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<sup>124</sup> Simmons & Simmons LLP (August 2020). Synthetic securitisation: opening the Basel toolbox in Asia-Pacific. <https://www.simmons-simmons.com/en/publications/ckdsmlx0c0i9t09790z1qey1a/synthetic-securitisation-opening-the-basel-toolbox-in-asia-pacific>

# Appendix 4: Survey Findings

## Background

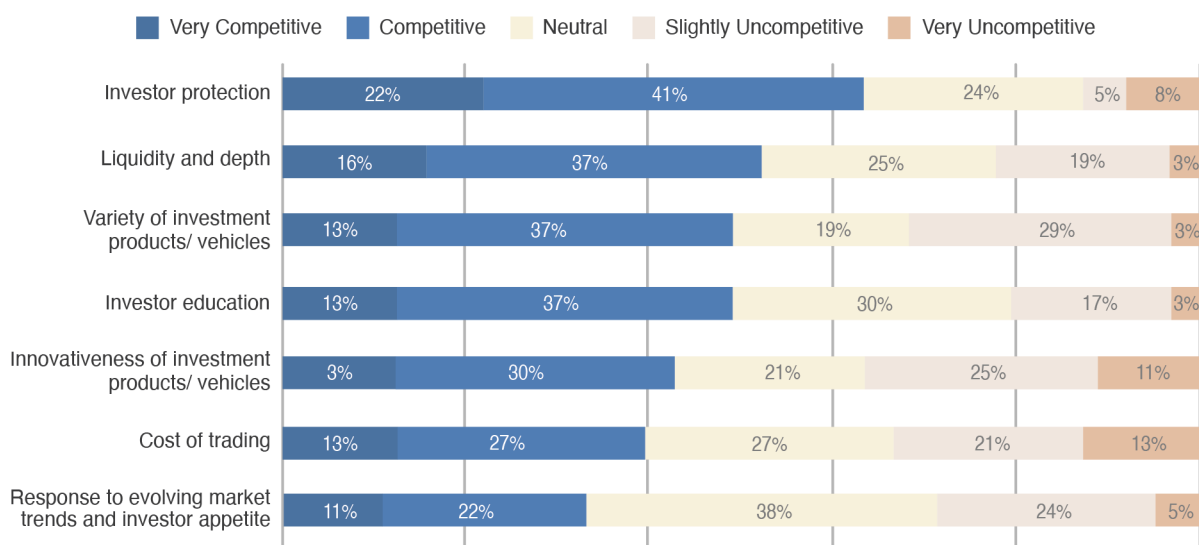
As discussed in the previous sections, building on Hong Kong’s success as a leading capital formation hub, a progressive stance toward promoting an efficient market that fosters liquidity for emerging and popularly traded investment products will ensure that Hong Kong retains and enhances its competitiveness going forward. Among others, a disclosure-based PI-only market can be explored to complement the existing listing regime. To gauge market interest in this potential setup, the FSDC developed a questionnaire to gauge the views of PIs on the general development of Hong Kong’s capital market and potential measures to advance market development. 63 responses from PIs were received in the three-week survey period.

While the findings of the survey may not be conclusive regarding the situation of the industry as a whole, the FSDC believes responses to the survey can provide meaningful insights into PIs’ perceptions of Hong Kong’s capital market. This view is also confirmed by our discussion with relevant trade and professional associations.

## Competitiveness of Hong Kong’s Capital Market

Comparing to other leading international financial markets, Hong Kong is seen by the clear majority of respondents to be competitive in investor protection (63%), followed by liquidity and depth (52%). However, divergence in views on the city’s competitiveness in the variety of investment products/ vehicles (50%), innovativeness (43%), and cost of trading emerged (40%). Although over 40% of the respondents considered Hong Kong to be competitive in each of these aspects, about a third of the respondents expressed opposing views.

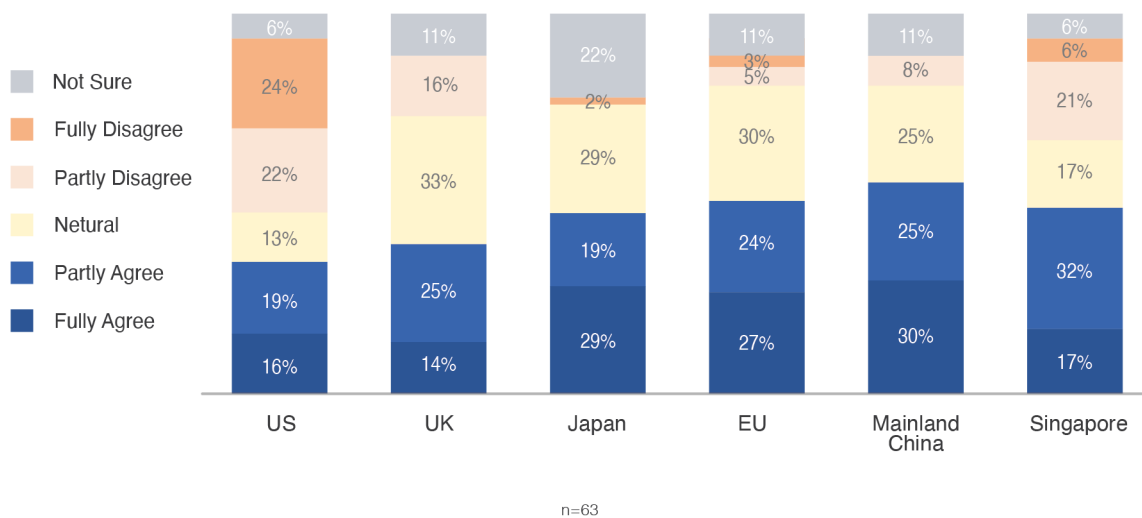
Figure 14. Hong Kong’s capital market comparing to other leading international financial markets



n=63

There is no outright conclusion on the relative competitiveness of Hong Kong comparing to other markets. In respect of Hong Kong’s responsiveness to new investment trends and products, a significant proportion of the respondents agreed that the city is comparable to Mainland China, the EU, Singapore, Japan and the UK, with over 40% of the respondents agreeing to the statement. Asked how our market is compared to that of the US, a clear majority of the respondents considered the latter as more responsive and advanced in market innovation and in addressing evolving market demands.

Figure 15. Hong Kong is at least as responsive as the following markets in launching new investment products/ vehicles

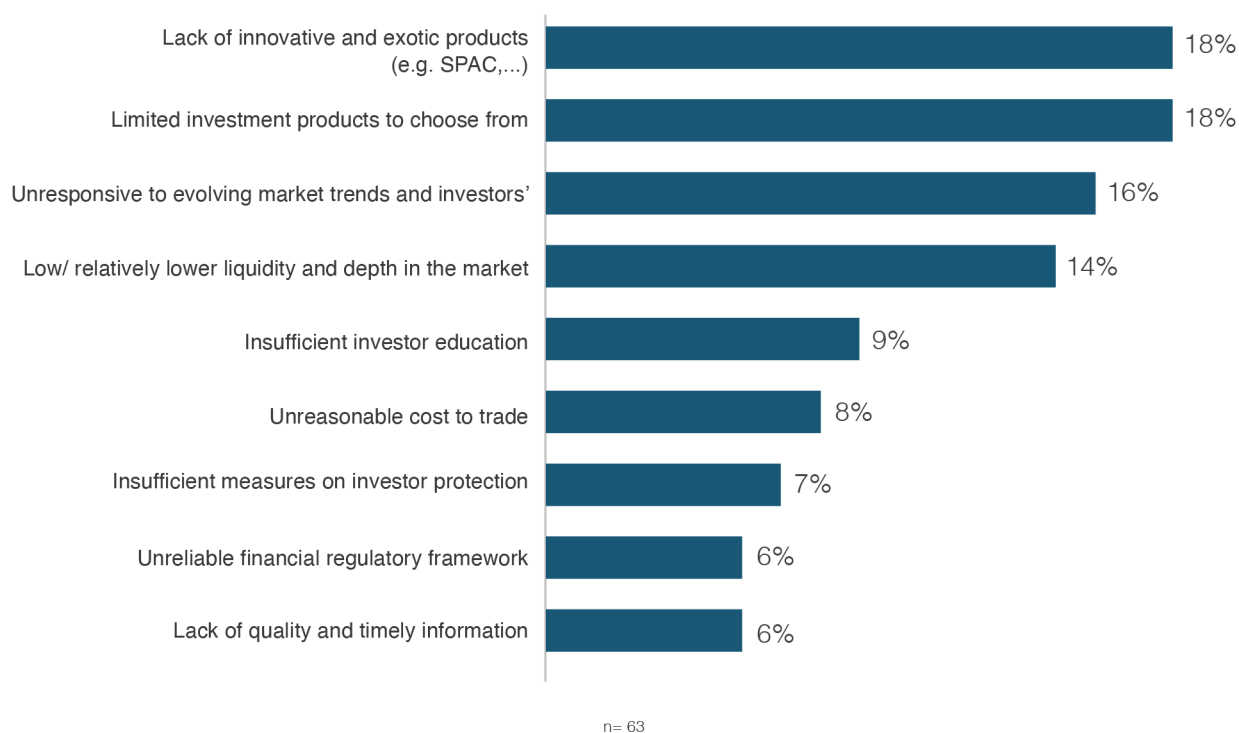


Hong Kong and the US are the two most popular markets for trading a broad range of investment products among the respondents. Among others, the US market is more preferred for trading in newer types of investment products, such as SPACs (33%), cryptocurrency-related products (27%) and tokenised assets (23%). Despite this, 35% of the respondents were uncertain as to their go-to-market for investing in these products. Notably, Hong Kong was ranked as a major market for listed tech companies (35%), other equities (29%) and derivatives products (26%).

### Investment Behaviour and Considerations of PIs

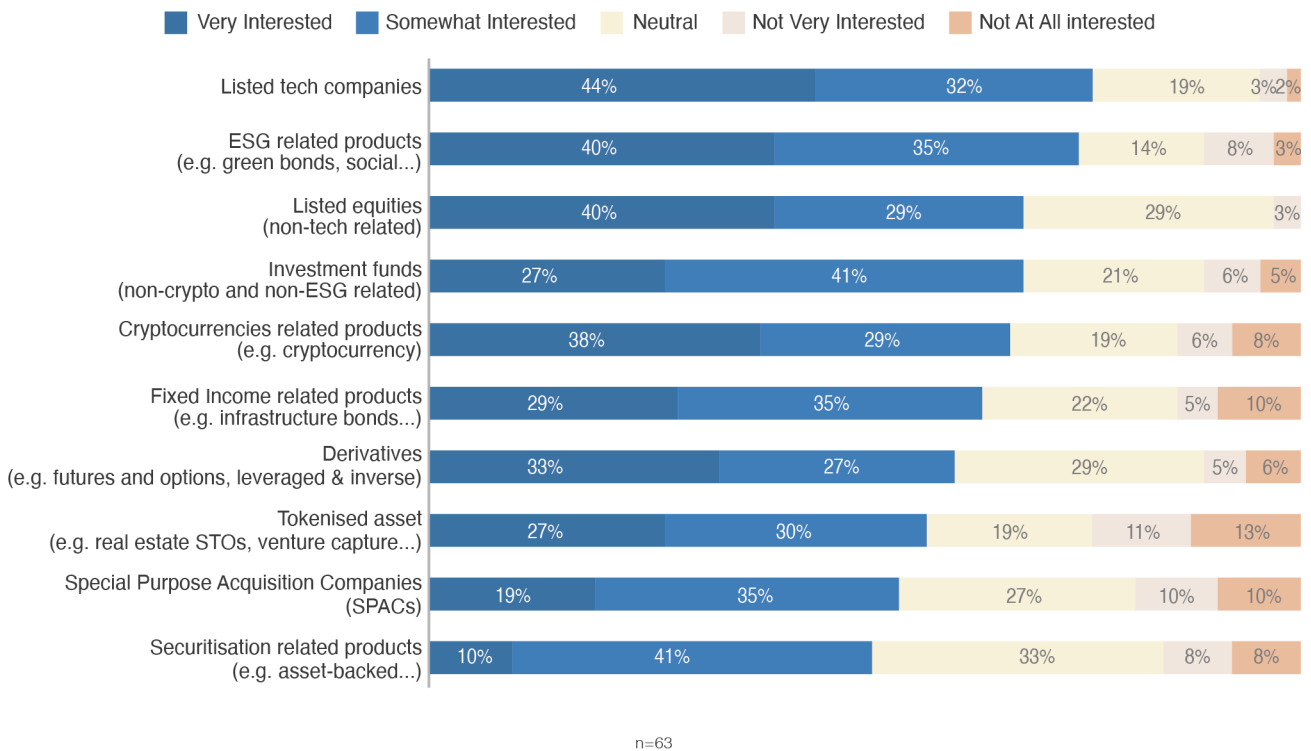
Investors invest through Hong Kong in other markets. Our city’s role as an investment gateway is manifested by the fact that 63% of the respondents indicated that they allocate less than 50% of their investments with exposure related to the Hong Kong market. This figure, on the other hand, reveals the areas where Hong Kong can do better as a destination market – a lack of innovative products (18%), a limited selection of investment products (18%) and unresponsiveness to market trends (16%) were highlighted as key reasons for investors choosing other markets as investment destinations. Among the 37% of respondents who had the majority of their investment with exposure related to the Hong Kong market, the decision to pursue such an investment strategy had been made based on home-base preference (20%), trust in the city’s reliable financial regulatory framework/ ecosystem (14%) and proximity to investment opportunities (12%).

Figure 16. Reasons to NOT invest in or NOT allocate a major proportion of your investment to the Hong Kong market



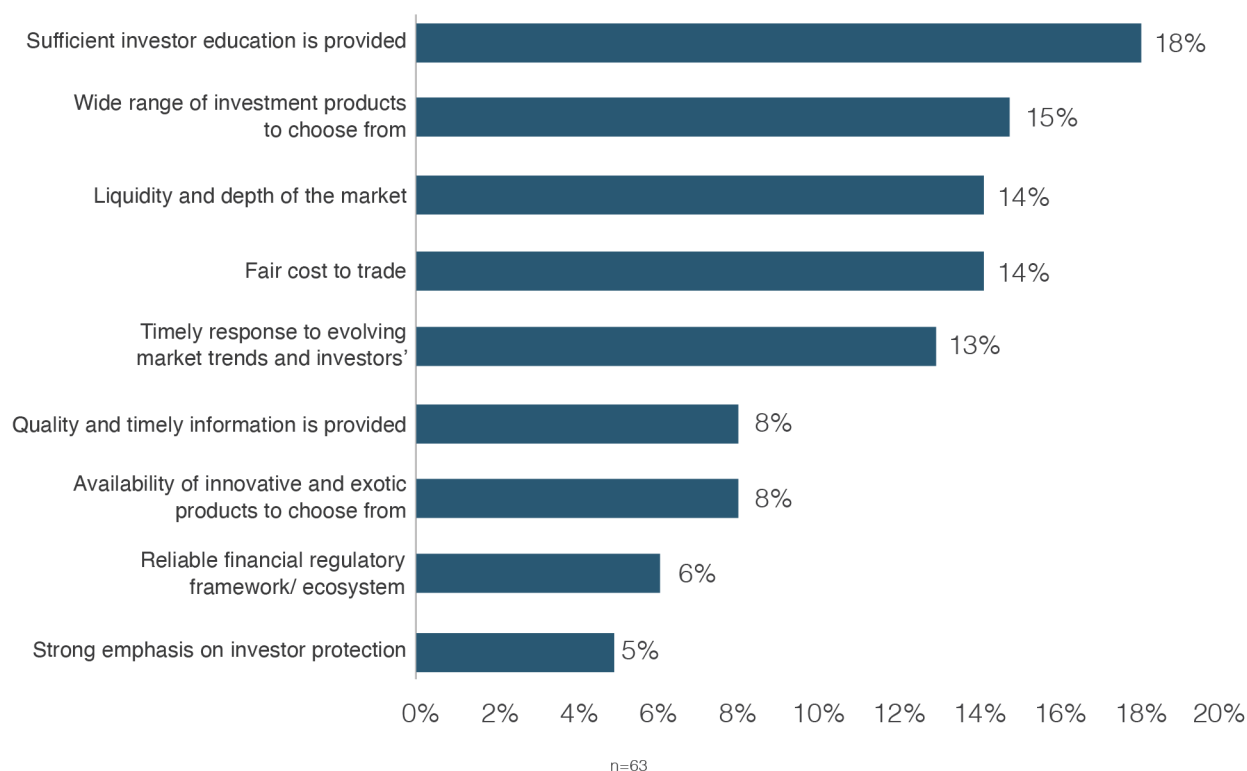
Investors are keen to diversify their investment portfolios across a range of asset classes, and their intention to diversify is expected to increase in the coming 12-18 months. Over half of the surveyed respondents indicated interest in almost all of the listed products of various risk levels. Apart from traditional product types such as listed traditional equities and investment funds, other newer or emerging investment vehicles, such as listed tech companies, ESG-related products, and cryptocurrency-related products, are also gaining traction.

Figure 17. Interest in investing in each of the following products in coming 12-18 months



To boost Hong Kong's attractiveness as a leading capital market, respondents saw the need for Hong Kong to be more proactive in driving product innovation, offering a broader spectrum of investment products and enhancing market liquidity and depth.

Figure 18. Top three areas that Hong Kong's capital market needs to improve to boost its attractiveness to you as an investor



## Interests towards a Disclosure-based PI only Market

Most survey respondents (71%) expressed interest in a disclosure-based PI-only market in Hong Kong. Supporters of this complementary market believed that it would allow them to gain exposure to a wider range of products, while those with reservations expressed concerns over the vulnerability of the new market and associated risks. The top three essential attributes the new market should possess when starting up in Hong Kong are a broader set of investment options/ variety (81%), sufficient liquidity and market depth (79%), and reasonable trading costs (49%), respectively.

Figure 19. Interest in a disclosure-based market with limited access to PI in Hong Kong

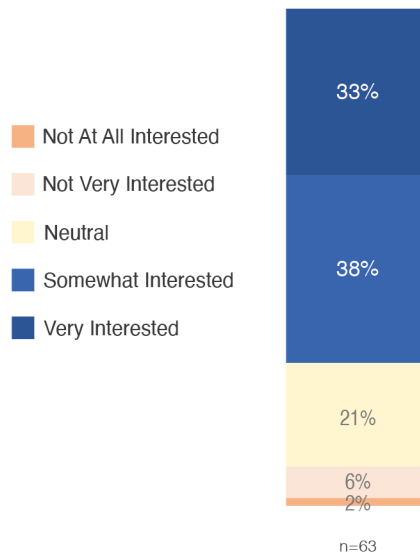
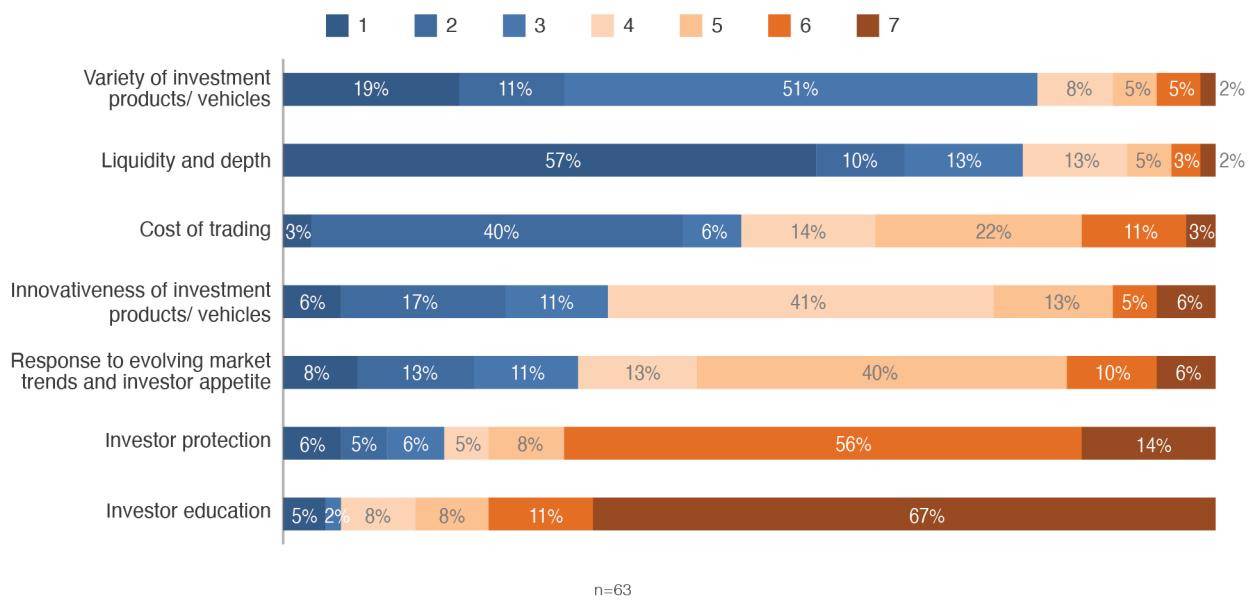


Figure 20. Importance of aspects if a disclosure based market with limited access to Professional Investors is set up in Hong Kong (1 is the most important and 7 is the least important)



More than half of the respondents further elaborated on key strengths and weaknesses of Hong Kong's capital market, as well as potential measures to foster market development while upholding market quality and investor protection.

A considerable number of respondents highlighted that the bedrock of Hong Kong's status as a leading capital formation hub stems, in part, from its proximity to Mainland China, its sufficient market liquidity and its sound financial regulatory framework.

In terms of weaknesses, the most critical factor, as revealed by the respondents, is the comparatively more stringent regulatory framework which, to a certain extent, limits flexibility in product and market innovation, making it difficult for Hong Kong as a market to keep pace with rapidly evolving global trends.

According to the respondents, these weaknesses can be addressed by (i) streamlining the regulatory regime for the capital market, (ii) benchmarking other jurisdictions in response to evolving market trends, and (iii) providing strong policy support from the government to retain and attract quality corporations and investors.

# Appendix 5: Examples of Hong Kong Regulations on Professional Investors

The following are examples of the different ways in which PI are treated under the existing Hong Kong regulatory framework (non-exhaustive).

Source	Description	Exemption or restriction?
<b>Securities and Futures Ordinance</b>	Securities marketing restriction-  Any document which contains an invitation to the public to acquire, dispose of, subscribe for or underwrite securities must be authorized by the SFC. However, there are exceptions, including where the document is intended for PI only.	Exemption
<b>Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (CWUMPO)</b>	Prospectus requirements-  Any document that offers shares or debentures of a company to the public must satisfy certain prospectus requirements under the CWUMPO. However, there are exceptions relating to specific types of offers, including where the offer is made to PI.	Exemption
<b>Securities and Futures (Contract Notes, Statements of Account and Receipt) Rules (Cap. 571Q) (Contract Note Rules)</b>	Provision of contract notes, statements of accounts and receipts-  Intermediaries that are licensed or registered with the SFC must provide clients with contract notes, statements of accounts and receipts, in accordance with the Contract Note Rules. However, this can be waived for PI.	Exemption
<b>SFC licensing / registration conditions</b>	Condition to deal with PI only-  The SFC may impose a licensing / registration condition specifying that an intermediary can only deal with PI.	Restriction
<b>The SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct)</b>	Conduct requirements for intermediaries licensed or registered with the SFC-  Intermediaries are subject to conduct requirements set out in the Code of Conduct. Certain requirements can be waived when dealing with PI (e.g. the need to enter into a client agreement, or the need to ensure suitability of a product). However, note that the Code of Conduct distinguishes between "institutional" PI, high net-worth corporate PI (that satisfy certain requirements), high net-worth corporate PI (that do not satisfy the requirements) and high net-worth individual PI. Not all of the requirements can be waived for high net-worth corporate PI (that do not satisfy the requirements) and high net-worth individual PI.	Exemption
<b>The SFC's Guidelines for Virtual Asset Trading Platform Operators (VATP)</b>	Trading of virtual assets-  An operator holding a VATP license is permitted to facilitate trading in virtual assets for PIs (as stipulated in the Securities and Futures Ordinance). Additionally, such a licensed operator can also extend trading services in specific virtual assets to retail investors.	Restriction
<b>The HKEX's Rules and Regulations of the Exchange and the Options Trading Rules</b>	Sale of Chapter 37 bonds-  Only PI are allowed to purchase debt securities listed on the Exchange under Chapter 37 of the Main Board Listing Rules.	Restriction
	Chapter 21 investment companies-  Only PIs are allowed to purchase funds listed on the Exchange under Chapter 21 of the Main Board Listing Rules.	Restriction
	Chapter 18B special purpose acquisition companies (SPACs)-  SPACs will only be marketed to, traded by and freely transferrable between PIs only.	Restriction
<b>The Hong Kong Monetary Authority's (HKMA) circular entitled "Selling of Investment Products to Private Banking Customer" on 12 June 2012</b>	Investor protection measures-  In 2012, the HKMA introduced the concept of "private banking customer". With respect to such customers, banks are permitted to apply certain relaxations to the investor protection measures which arise during the sale of investment products. "Private banking customer" has been mentioned in subsequent HKMA circulars on investor protection measures.	Exemption

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Financial Services Development Council

### **About the FSDC**

The FSDC was established in 2013 by the Hong Kong Special Administrative Region Government as a high-level, cross-sectoral advisory body to engage the industry in formulating proposals to promote the further development of the financial services industry of Hong Kong and to map out the strategic direction for the development.

The FSDC has been incorporated as a company limited by guarantee with effect from September 2018 to allow it to better discharge its functions through research, market promotion and human capital development with more flexibility.

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