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**Comments on the Stock Exchange's Discussion  
Paper on the Growth Enterprise Market**

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**CHARLTONS**  
易周律師行  
Solicitors

**Hong Kong**

**Shanghai**

**Beijing**

**Yangon**

[www.charltonslaw.com](http://www.charltonslaw.com)

## **The Future of the Hong Kong Growth Enterprise Market**

Hong Kong Exchanges and Clearing Limited ('HKEx') published a discussion paper in January this year as to the future of its Growth Enterprise Market ("GEM"). The Discussion Paper does not contain a solution for GEM at this stage. Rather, it puts forward 3 structural options with different positioning and raises 12 key discussion questions. The consultation period for the Discussion Paper ended on 30 April, 2006. HKEx will now formulate specific proposals for GEM based on the comments received. The Discussion Paper is available on HKEx's website at [www.hkex.com.hk](http://www.hkex.com.hk)

Set out below are comments on the key discussion questions raised in Chapter 5 of the Discussion Paper.

### **Introduction**

The difficulties that Hong Kong has experienced in its attempts to establish a successful growth market are similar to those encountered in the United Kingdom. It was only after the failures of the Unlisted Securities Market and the so-called Rule 4.2 trading system, that the London Stock Exchange (the "LSE") came up with the concept of a lightly regulated, disclosure-based, caveat emptor market as the model for its Alternative Investment Market ("AIM"). As detailed in the Discussion Paper, AIM is now by most measures the leading growth enterprise market in the world. Indeed, the view has been expressed that AIM is today more likely to be the first port of call of any substantial company seeking a listing, to the exclusion of the LSE's main market<sup>1</sup>. While ostensibly a growth company market, it has attracted a number of substantial companies: the top 50 companies all have a market capitalisation of more than £100 million, while Sportingbet, the largest company, has a market capitalisation of over £1.5 billion. In addition, deterred by the increasing burden of regulation on the LSE's main market, the number of companies that have moved from the main market to AIM vastly outnumber those transferring in the opposite direction. In 2005, 40 companies transferred to AIM from the main market while only 2 transferred from AIM to the main market<sup>2</sup>. In the first three months of 2006, there were 8 transfers to AIM from the main market and none in the opposite direction<sup>3</sup>. AIM has also gained acceptance among institutional investors and is today regarded as an established market which is unlikely now to fail.

In contrast, Hong Kong's Growth Enterprise Market ("GEM"), described as "A 'Buyers Beware' Market for Informed Investors" on the Stock Exchange website, had only 10 new listings in 2005<sup>4</sup>. As outlined in the Discussion Paper, the original initiatives for GEM, namely that it should be a disclosure-based, lightly regulated market administered separately from the Main Board, have been abandoned. Indeed, the greater regulatory burdens on GEM companies (as the GEM listing rules have become more closely aligned with those of the Main Board) and the often lengthy and costly application process, have meant that AIM has become the growth market of

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1 Article "Will small caps continue to take AIM": Martin Waller in The Times, June 18, 2005

2 AIM Market Statistics at 31 December, 2005

3 AIM Market Statistics at 31 March, 2006

4 Page 23 of the Discussion Paper

choice for many Hong Kong and PRC companies. Further, with its lighter regulatory regime and simpler, faster listing application process, AIM is coming to be seen as a preferable listing venue to the Hong Kong Main Board for a number of Hong Kong and PRC companies. An AIM listing is also attractive to the increasing number of PRC companies looking to acquire assets overseas and to raise their profile in overseas markets. The LSE's stated objective for AIM (which already lists 247 international companies) in the coming decade is to establish it as the market for growing companies internationally. If Hong Kong is to retain its position as the pre-eminent home market for PRC enterprises, its growth enterprise market needs to be able to compete with AIM: it is no longer safe to assume that Hong Kong and PRC enterprises prefer to list at or near home.

**Question 1: Is there a need for a growth company market in Hong Kong?**

Hong Kong should have a comprehensive and diversified capital market and should provide facilities for both small growth companies and larger, established companies to gain access to capital. In particular, a growth enterprise market plays an important role in enabling entrepreneur or family-owned companies to seek expansion, facilitating management buy-outs and buy-ins and providing an exit route for venture capitalists and a venue for further fund raising for venture capital investments.

As a general comment, it is considered that the Stock Exchange needs a clearly articulated policy for the SME sector and that, if this is a sector which the Stock Exchange does not wish to service, the SFC should nominate a separate exchange to serve this sector. As the SME sector is likely to be the most dynamic sector of the market in the long term, failure to provide facilities for this sector would be a lost opportunity for Hong Kong.

**Question 2: If so, should the market primarily serve local Hong Kong companies, or should it target Mainland-based companies or regional/international companies?**

It is not necessary for Hong Kong's growth market to target companies from any particular jurisdiction. It should instead be open to companies from all jurisdictions, as was originally intended for the existing GEM<sup>5</sup>. London's AIM welcomes companies from all jurisdictions and has specifically targeted companies from the growth markets of China, India and Russia. If Hong Kong is to establish itself as a truly international finance centre, it needs to make it easier for overseas companies to list in Hong Kong. Currently, for a company incorporated in a jurisdiction other than Hong Kong, the PRC, Bermuda or the Cayman Islands to list on either the GEM or the Main Board of the Hong Kong Stock Exchange, it has to satisfy the Exchange that the standards of shareholder protection in its jurisdiction of incorporation are at least equivalent to those provided in Hong Kong<sup>6</sup>. Furthermore, in order to fulfil additional qualifications for secondary listing on the Main Board, the Exchange has to be satisfied that the company's primary listing is an exchange where the standards of shareholder protection are at least equivalent to those provided in Hong Kong<sup>7</sup>. The

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<sup>5</sup> Page 5 of the Exchange's "Consultation Paper on a Proposed Second Market for Emerging Companies", May 1998.

<sup>6</sup> Rule 19.05(1)(b) of the Main Board Listing Rules and Rule 24.05(1)(b) of the GEM Listing Rules.

<sup>7</sup> Rule 19.30(b) of the Main Board Listing Rules.

prime difficulty this presents is the uncertainty it creates even for listing applicants from well-developed legal jurisdictions such as the United Kingdom and Australia. In addition, the applicant bears the burden of proof in showing that the relevant law and exchange provide the same level of shareholder protection. This can be time consuming and costly. Although, in practice, this issue can be overcome by the overseas company restructuring with a holding company in Hong Kong, Bermuda or the Cayman Islands, there will always be overseas companies who, for tax or other reasons, do not wish to be forced into restructuring in Hong Kong or a tax haven jurisdiction. In cases where the company is seeking a secondary or dual primary listing in Hong Kong a restructuring is likely to be wholly impracticable. It also seems incongruous that a company from a well established legal jurisdiction has to be told that the path to listing in Hong Kong is uncertain and the onus is on the company to demonstrate that its jurisdiction of incorporation is acceptable to the Hong Kong Stock Exchange, whereas it will be smooth, and therefore quicker and less costly, if it restructures in Hong Kong or a tax haven jurisdiction. This is an anomalous aspect of the current Listing Rules. Efforts should therefore be made to ensure that the listing process is equally streamlined for all listing applicants, whatever their jurisdiction of incorporation.

**Question 3: At what stage of development should companies be admitted to the growth market - at start-up stage, or at a more mature stage?**

This question pre-supposes that there should be a qualitative assessment of companies prior to listing. On the contrary, investors and not the Stock Exchange should assess the commercial viability and investment merits of listing applicants. It should therefore be left to the market to determine whether a particular listing applicant is successful. Any risks associated with a particular applicant should be dealt with by way of disclosure. In addition, the responsibility for ensuring that the applicant is suitable for listing could, to a certain extent, be placed with the sponsor who could fulfil a similar role to that assumed by nominated investment advisers (“nomads”) on AIM.

The Exchange should not be overly concerned about the risk of growth company failures. On any growth board, it must be expected that a certain percentage of companies will fail. The failure of individual GEM companies should not however be regarded as a failure of GEM itself, nor should they tarnish the reputation of the Hong Kong market overall. NASDAQ started with many small, often unattractive, companies: it now dominates the new issues market in the United States.

**Question 4: What should be the core investor group for the growth company market – retail, professional and/or institutional? Should the growth company market be restricted to professional and institutional investors only?**

It is not necessary to restrict investors in the growth company market to any particular group. Institutional investors will be attracted to stocks that they think will perform well. For AIM to have succeeded there must have been considerable investor appetite for smaller growing companies with potential for higher returns to off-set the greater

risk. It is however worth noting that, according to the Discussion Paper<sup>8</sup>, the return of the FTSE AIM Index was higher and its risk lower than that of the FTSE 100 for the two and a half year period from January 2003 to June 2005. As the market develops, retail investors will decide for themselves whether they wish to invest. Risks associated with particular companies should be dealt with by clear disclosure in listing documents.

If the intention is to make the growth market effectively a market for institutional investors only, this could be achieved by requiring listings to be achieved by way of placings, thus forcing investors to go through their brokers.

**Question 5: Depending on your answers to the foregoing questions, what kind of regulatory regime would be appropriate for the growth company market? In particular, should growth companies have low-cost access to public capital, or should they, because of their higher risk, be required to comply with procedures that dictate relatively higher costs than those for Main Board companies?**

GEM should follow AIM in adopting a light, disclosure-based regulatory regime with emphasis on the responsibilities of sponsors. It should be a true alternative market which would compete against the Main Board in the same way as NASDAQ competes against the New York Stock Exchange. It would need to be administered entirely separately from the Main Board and would require its own staff and rules.

On the issue of costs, the current approval process for listing GEM applicants already imposes significant costs on applicants relative to the size of their business operations and the amounts they raise and delays applicants' access to the market. A simpler, more streamlined listing application process should be adopted to provide small growth companies with faster, low cost access to public capital.

**Question 6: Bearing in mind your responses to questions 1 to 5 above, please comment on the suitability of the following possible structural options for a growth company market in Hong Kong:**

**(a) GEM as a second board**

**(b) GEM and the Main Board to merge into a single board:**

**(i) Universal single board – GEM and the Main Board to merge into a single board, with no distinction between them;**

**(ii) Tiered single board – GEM and the Main Board to merge into a single board with the growth market forming the lower tier and the existing Main Board the upper tier. Further tiers might be introduced as well.**

**(c) New alternative market – GEM to merge into the Main Board, and a new market with an enhanced regulatory regime to be launched for growth**

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<sup>8</sup> Page 42 of the Discussion Paper

**companies.**

**(d) Others – do you have any other suggested structural options for GEM?**

The preferred option is option (c), namely the establishment of a new alternative growth company market. As outlined in the response to Question 5 above, this should be an AIM-style alternative market which would be entirely separate from the Main Board and would compete against it. It should be a lightly regulated, caveat emptor, disclosure-based market.

**Question 7: Based on your preferred structural option for GEM, do you have any specific views or recommendations concerning the following?**

**(a) The targeted issuers (eg type of business, stage of development) and investors (eg retail, professional, institutional)**

As outlined above in the responses to Questions 2, 3 and 4, it is not necessary to target any particular type of issuers or investors: this should be left to the market to determine. The new alternative market should be equally accessible to companies from all jurisdictions and business sectors. Care should be taken in particular to ensure that the new market does not become overly dependent on any one business sector.

Any risks in investing should be dealt with by clear disclosure in the listing documents. It is also suggested that there should be a regulatory requirement for listing applicants to commission a long-form report (ie. a detailed due diligence report). While long form reports are typically requested by AIM nomads, there is no regulatory requirement for an AIM listing applicant to commission such a report.

**(b) the regulatory approach**

The on-going obligations of companies listed on the new market should be considerably less onerous than those of the current GEM Listing Rules. They should be modeled on the current AIM Rules and should be disclosure-based.

**(c) the initial listing requirements and the listing process**

The new market should be open to all companies, whatever their stage of development, including start-ups. Like London's AIM, there should be no suitability requirements in terms of market capitalisation, trading history or number of shares publicly held. To prevent the listing of mere shells, the market could, like AIM, impose a minimum limit on the amount of funds to be raised. As highlighted above, the listing process should be straightforward and quick to allow growth companies low cost access to the markets.

**(d) the process of ongoing regulatory supervision**

Please see the response to (b) above. In addition, documents should be post-  
vetted by the Exchange and a certain degree of responsibility could be placed  
with sponsors who could perform a role similar to that assumed by AIM's  
nomads.

**(e) the disclosure and corporate governance requirements**

There should be obligations to disclose price sensitive information, deals by  
directors, changes to significant shareholders and substantial and related party  
transactions. Financial results should be required to be published half-yearly  
rather than quarterly. This should not adversely affect investors' interests if  
issuers are obliged to disclose price sensitive information about changes in  
financial condition, sphere of activity, business performance or expectation of  
business performance.

As regards corporate governance, companies should be required to use their  
best efforts to comply with the provisions of the Code on Corporate  
Governance Practices.

As a general comment, if the Exchange is keen to see more PRC companies  
(or indeed companies from other growth markets such as India) listing in  
Hong Kong, whether on a new growth company market or on the existing  
Main Board, it needs to acknowledge the gap in corporate governance  
standards between companies from developing countries and those from  
developed jurisdictions and the risks associated with the former. In particular,  
difficulties remain with enforcement actions in relation to PRC-based  
companies and this is unlikely to change in the short term. These risks should  
be dealt with by disclosure and the adoption of a "let the buyer beware"  
philosophy.

**(f) the roles of sponsors and other professionals**

The Discussion Paper attributes a degree of AIM's success to its nomads  
whose performance is in turn explained by the LSE's supervision and the  
importance of reputation<sup>9</sup>. Hong Kong is however also served by a unique  
community of finance professionals, sponsors, accountants and legal advisers.  
The obligations on sponsors under the Listing Rules are already extremely  
stringent, particularly since the introduction of the new Practice Note on Due  
Diligence and related listing rules. Any remaining reservations regarding the  
competency of individual sponsors should be allayed on the introduction of  
stringent new eligibility criteria and on-going obligations for sponsors and  
compliance advisers with effect from January 1, 2007. Quite apart from the  
regulatory requirements for sponsors, it should also be noted that in a market

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<sup>9</sup> Page 44 of the Discussion Paper.

as small as Hong Kong's, the issue of reputation is just as important for the vast majority of sponsors as it is for London's nomads.

Sponsors/compliance advisers to companies listed on the new market should perform a similar role to AIM's nomads. In particular, listed issuers should have a nomad equivalent at all times. That said, however, the Exchange needs to recognise that sponsors cannot assume the responsibilities of issuers' directors or those of other professionals or experts. No due diligence can be fool proof, however assiduous, and company failures will occur irrespective of the extent of due diligence performed. A number of sponsors consider that the current regulation of sponsors is unfair and, in practice, is unlikely to work when tested. Sponsors are required to take responsibility for parts of the prospectus which should be that of the issuers' directors or of other experts. Sponsors also consider the sanctions imposed on sponsors to be unfair: sponsors are regulated by an outside agency (the Exchange) whereas other experts are either self-regulated (eg. accountants and legal advisers) or are not regulated at all (eg. professional valuers). The Stock Exchange has confined its disciplinary proceedings to directors and sponsors, notwithstanding that the principal cause of a listing's early failure is rarely the description of the business in the prospectus and is usually a misstatement of the company's historic financial performance. Whatever the Stock Exchange would like, this has to be the responsibility of an auditor. As a practical matter, this cannot be properly delegated to the sponsor or anyone else. Only an auditor is competent to audit financial statements and to examine financial reporting systems.

If the retention of a nomad-type adviser is to be a prerequisite of continued listing on the new market, the adviser's obligations should be framed along the lines of existing GEM Listing Rules 6A.23 and 6A.24. That is to say that the circumstances in which an issuer must consult its adviser should be specified and the adviser's own obligations should therefore be conditional upon having been consulted by the issuer.

**Question 8: If you consider that there is no need for a growth company board in Hong Kong, what should be done with GEM and its existing issuers?**

There is undoubtedly a need for a growth enterprise market in Hong Kong.

**Question 9: What, if anything, should be done with delisted companies? Should there be a separate market for trading these companies?**

There should be a trading facility to enable trade in these stocks.

**Question 10: Do you have any suggestions to raise the profile of companies listed on the growth company board?**

There seems to be a view that greater regulation of Hong Kong's markets will attract more investors. However, increasing investments in unregulated products such as



hedge funds and lightly regulated markets such as AIM suggest that this is not necessarily so. From London's experience, the key to raising the profile of companies listed on the growth company board would appear to be the establishment of a lightly regulated, non-bureaucratic board to which both companies and investors will be attracted. Provided the regulatory approach to growth companies can be improved as described above, the GEM board can be successful in the long run. The Stock Exchange should take a longer view as it takes time for a growth market to mature.

**Question 11: Should more information be provided on growth companies? If so, what information, and who should provide it?**

Prospectuses should contain only information that is relevant to investors. As regards on-going disclosure obligations, half-yearly (instead of quarterly) reporting should be required.

**Question 12: Should market making be permitted on the growth company board? If so, what should be the obligations of and incentives provided to market makers?**

Market making should be allowed in the same way as it is allowed on AIM. It should be noted that the International Committee on Listing of New Enterprises appointed by the SFC in 2000 recommended the introduction of market making.

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*This note is provided for information purposes only and does not constitute legal advice. Specific advice should be sought in relation to any particular situation. This note has been prepared based on the laws and regulations in force at the date of this note which may be subsequently amended, modified, re-enacted, restated or replaced.*