Charltons - Hong Kong Law Newsletter - 06 August 2007

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# HKEx Proposes A Second Board Model For GEM: Invites Responses On Consultation Paper By 31 October 2007

## Introduction

Hong Kong Exchanges and Clearing Limited (**HKEx**) released a [Consultation Paper](http://www.hkex.com.hk/eng/newsconsul/mktconsul/documents/cp200707e.pdf) (the **Consultation Paper**) ([see archive](cp200707e.pdf)) on the Growth Enterprise Market (**GEM**) on 27 July 2007. The paper sets out HKEx's proposals for further developing GEM as a second board and invites comments on 8 key consultation questions put forward in Chapter 5 of the Consultation Paper by 31 October 2007. The key consultation questions are reproduced at Annex A to this note.

The purpose of the note is to summarise the new proposals.

## I. Background

Following the lacklustre performance of GEM in recent years, HKEx commenced a review of GEM in mid-2005. It then published a Discussion Paper in January 2006 inviting the market to comment on three possible structural options for GEM: (a) GEM as a second board; (b) GEM and the Main Board to merge as a single board; and (c) a new alternative market along the lines of London's Alternative Investment Market (**AIM**).

While option (c), the establishment of a new AIM-style market, was favoured by the vast majority of respondents to the Discussion Paper, HKEx in consultation with the SFC, concluded that the Hong Kong market is not yet ready for the AIM model. The reasons for this are discussed in detail in Chapter 2 of the Consultation Paper and can be summarised as follows:

### 1. Different Investor Base

The Consultation Paper points to the predominance of institutional investors on AIM - citing a survey that found that 56.7% of AIM shares were controlled by institutions as of 23 August 2007. In contrast, it claims that GEM shares are normally subscribed and traded to a greater extent by retail investors and that this requires market regulators to play a more active role.

### 2. Sponsors

The role of the sponsor or "nomad" is also seen as critical to AIM's success. AIM is a buyer-beware market on which the approval of admissions is in effect delegated to issuers' nomads. After listing, nomads advise issuers on on-going compliance enabling the market to be operated with a light regulatory touch. In Hong Kong, the revised regulatory regime for sponsors only came into effect in January 2007 and it is considered that more time is needed to see whether it will have the desired effect of raising standards among Hong Kong sponsors.

### 3. Transitional Phase For The Statutory Regime In Hong Kong

It is also considered that the statutory regulation of Hong Kong issuers is less stringent than in other overseas markets. A statutory backing initiative is in progress which will embody the more important provisions of the Listing Rules into statute, breaches of which will be enforceable by the SFC. Until this statutory framework is in place, HKEx considers it unwise for regulators to give up their screening powers through the initial listing approval and transaction vetting process.

### 4. Tax Incentives

The Consultation Paper attributes a degree of AIM's investor following to the wide base of UK tax concessions aimed at fostering the UK small and medium enterprise sector. It is considered highly unlikely that the Hong Kong Government would offer similar tax concessions for investment in GEM companies.

Option (b), a single merged board, did not receive much support due to concerns about the dilution of Main Board listed company quality. Accordingly, HKEx considers that repositioning GEM as a second board, option (a), is the most feasible option.

## II. The Main Proposals

The new proposals are aimed at raising the quality of companies listing on GEM in order to strengthen market confidence and reducing the cost and duration of the listing process. They will also facilitate the process of transfer of GEM companies to the Main Board. The principal proposals are as follows:

### 1. Enhanced Admission Requirements

#### A. Cash Flow Requirement

The only new quantitative requirement will be for GEM applicants to have an adjusted cash flow from operating profits before changes in working capital and taxes paid of HK$20 million in aggregate for the preceding two financial years. Cash flow is considered to be a better indicator of business viability than profit since profit can be affected by significant valuation measurement adjustments and increased by one-off items, whereas operating activities that are generating a reasonable level of cash flow are more likely to be sustainable.

#### B. Market Capitalisation Requirement

The minimum market capitalisation requirement would also be raised from an effective HK$46 million to HK$100 million.

#### C. Minimum Public Float

The minimum public float requirement will follow the Main Board requirement, i.e. it will be 25% or 15% to 25% for companies with a market capitalisation of more than HK$10 billion. The market capitalisation of the public float will however be set at HK$30 million (compared to HK$50 million for the Main Board).

#### D. Minimum Scale of Operation

If the above requirements are introduced, companies applying to list on GEM will have to be of a certain size. Certain GEM requirements which relate mainly to the circumstances of very new companies will no longer be necessary. Accordingly, HKEx proposes:

* to drop existing GEM requirements imposing lockups on management shareholders and significant (5%) shareholders;
* to drop the requirement for the initial management and significant shareholders to hold in aggregate 35% of the issued share capital at the time of listing; and
* to allow employee shareholders to be included within the required minimum of 100 shareholders. The term "public" shareholders would be deemed to include employee shareholders but exclude connected persons, as per the Main Board formulation.

#### E. Annual Reports

Issuers will be required to report on the achievement of their business objectives (as stated in their listing document) in their first two annual reports after listing.

#### F. Other Requirements

Issuers will also be required to meet the following admission requirements:

* the latest two financial years must be under substantially the same management;
* the issuer can decide the offering mechanism used (including 100% placing); underwriting would not be compulsory; and
* ownership continuity and control will be required for at least the most recent financial year in line with Main Board practice.

### 2. Listing Division To Approve Listing

In order to streamline the GEM admission procedure, and so reduce the cost of listing, the power to approve new listings will be delegated from the Listing Committee to the Listing Division. GEM applicants will have a right of appeal to the Listing Committee against the Listing Division's initial decision on an IPO.

### 3. Continuing Obligations For GEM And The Main Board To Be Brought Into Line

#### A. Relaxation of requirements

Alignment of the two boards' requirements would entail relaxation of certain existing GEM requirements. Relaxation is justified because GEM applicants would be required by the admission standards to be of a certain minimum business size. GEM rules currently prohibit fundamental change in business activity until two years after listing (unless SEHK waiver and shareholders' prior approval are obtained), whereas the prohibition lasts for only one year for Main Board issuers. The GEM requirement would be reduced by one year to match the Main Board.

#### B. Public float

Bringing existing GEM requirements into line with those of the Main Board would result in a more stringent regime for GEM in the area of minimum public float. As discussed above, it is proposed to bring the GEM regime into line with that of the Main Board. Existing GEM companies would be given a three-year period to comply with the new regime.

#### C. Continued Differences in GEM and Main Board Requirements

In three areas, pending further consideration, it is proposed that the requirements of the two boards will diverge for the time being.

1. Periodic financial reporting. At present, GEM requires quarterly reporting, to relatively tighter deadlines than the Main Board. The issue of financial reporting on both boards will be subject to separate policy review.
2. Compliance Officer. At present, on GEM one executive director must be a compliance officer, while there is no requirement for a compliance officer on the Main Board. HKEx considers that as GEM companies will typically be in an earlier stage of development, the requirement for a compliance officer on GEM should be retained.
3. Compliance Adviser. At present GEM rules require a compliance adviser to be retained until dispatch of the annual report for the second full financial year after listing, whereas the Main Board requires the compliance adviser to be retained only until after dispatch of the annual report for the first full financial year. It is proposed to retain the GEM requirement of two years since these are early-stage companies which would benefit from the compliance adviser's input.

### 4. Existing GEM Issuers Continue To Be Listed On GEM

Issuers listed on GEM when the proposed revised GEM rules come into effect will be required to comply with the new rules with immediate effect, except that a grace period of three years will be given in the case of the public float requirement (see point 3B above).

### 5. Streamlining Of Process Of Transfer Of Listing From GEM To The Main Board

#### A. Simplified Transfer Procedures

At present, GEM companies that wish to transfer to the Main Board have to go through the full normal application process, in the same way as other Main Board applicants. They are additionally required to go through a formal process of delisting from GEM.

It is proposed that GEM companies may apply to the Main Board if they:

* meet the Main Board quantitative requirements;
* have been listed on GEM for two years; and
* have a "good behaviour" record, i.e. no material rule breaches for the past two years.

#### B. No Sponsor Requirement

GEM companies would not require a sponsor and HKEx's review would be based as far as possible upon the issuer's existing recent public disclosures.

#### C. Notification of Transfer to Suffice

A notification of transfer from GEM to the Main Board will replace the current formal process of delisting from GEM.

#### D. Reduced HKEx Scrutiny

HKEx scrutiny would be reduced. It will however check that publicly disclosed information meets the Main Board admission requirements and that there has been no rule material breach in the past two years.

In respect of admission requirements for which no existing public disclosures are available, such as number of shareholders, HKEx could either seek to rely upon the directors' assurances or require confirmation by a licensed financial adviser.

#### E. Financial Adviser's Opinion

A financial adviser's confirmation of compliance with requirements for which publicly disclosed information is not available would provide HKEx with greater confidence and reduce HKEx's need to raise questions and the time taken. However, the financial adviser would have to rely on the directors - who would normally conduct an investigation of shareholdings under section 329 of the Securities and Futures Ordinance - raising the question of whether much is added by the appointment of a financial adviser. HKEx invites views on whether or not a financial adviser should be appointed to confirm items which are not already the subject of public disclosures.

#### F. The Application

The application would be in the form of an announcement by the issuer of its transfer to the Main Board. The announcement would have to be supported by the following:

1. documentation vetted by the Listing Division and approved by the Listing Committee; and
2. the application form, the initial listing fee, and Form B (the director's declaration), other required forms, and (if applicable) confirmation by a financial adviser of the issuer's compliance with relevant admission requirements (see E above).

#### G. Reduced Listing Fee

The Main Board initial listing fee for companies transferring from GEM would be reduced by 50%.

#### H. Exemptions

Applicants that transfer from GEM to the Main Board will be exempt from the following restrictions that apply to new Main Board applicants:

1. the ban on new share issues within 6 months of listing;
2. the ban on fundamental changes in principal business activities within 1 year of listing;
3. the ban on the controlling shareholder selling its shares within 6 months of listing (and the requirement to disclose any pledges or charges within 12 months of listing); and
4. the ban on changes in control during the subsequent 6 months.

### 6. Trading Mechanism On GEM Remains Unchanged

Several respondents to the Discussion Paper suggested introducing market makers on GEM. However, HKEx proposes to retain the existing trading mechanism on GEM (which is the same as that for the Main Board) as it does not consider that changes to the trading mechanism would fundamentally improve the liquidity of the stocks.

## III. Possible Implications Of GEM Proposals For Main Board

HKEx intends to bring the GEM and Main Board rules into line with one another as much as possible, with the exception of the markets' respective admission requirements. Ultimately, it intends to have a single rule book with separate parameters or sections applying to GEM.

In certain areas, HKEx believes that GEM requirements (either the existing or proposed new requirements) may be worth considering for the Main Board as well. These include the proposal to make operating cash flow the core requirement for admission to GEM, rather than profit as on the Main Board. HKEx believes that cash flow is a better indicator of business sustainability in smaller companies than profit. While it recognises that the greater size and established nature of Main Board companies makes this issue less significant and that cash flow is already incorporated in the Main Board Market Capitalisation/Revenue/Cash Flow test, it welcomes preliminary views on whether operating cash flow should become more of a core requirement for the Main Board.

GEM applicants are required to state their business objectives. It is proposed that GEM companies should additionally be required to report on the achievement of those business objectives in the first two annual reports after listing. Current Main Board listing rules however require applicants to make a statement regarding prospects for the current year only. While this would seem sufficient for mature business, the Consultation Paper invites comments on whether it might be desirable to require the fuller formulation required for GEM companies for recently-established Main Board companies, for whom there would normally be a business plan for development and growth.

The HKEx would conduct specific consultation on these issues before introducing any change to the Main Board Listing Rules. HKEx however invites preliminary views on these suggested changes to the Main Board Listing Rules.

The purpose of this note is to provide a summary only of the proposals set out in HKEx's '"Consultation Paper on the Growth Enterprise Market". Specific advice should be sought in relation to any particular situation.

## Annex A

### Key Consultation Questions

1. HKEx welcomes responses to the question below. These questions are framed in the context of option (a), repositioning GEM as a second board. Where possible, please provide justification such as supporting arguments or information with your responses.

**Q1.**
Do you agree with, or have any suggested modifications to, the following proposed admission requirements for GEM:

1. Positive operating cash flow from operating activities of HK$20 million in aggregate for the latest two financial years?
2. The latest two financial years under substantially the same management?
3. Market capitalisation of at least HK$100 million?
4. Public float of at least HK$30 million and 25% (or 15%-25% if the issuer has a market capitalisation of more than HK$10 billion)?
5. Ownership continuity and control for the most recent financial year?
6. A minimum of 100 public shareholders?
7. Retaining the present free choice on offering mechanism and underwriting?
8. Retaining the requirement for a sponsor?
9. Reporting on achievement of business objectives in first two annual reports after listing?
10. Keeping the requirement for GEM issuers to retain a compliance adviser (until after the dispatch of the annual report for the second full financial year after listing)?
11. Reduction of the bar on fundamental changes in business activity by one year, ie from two years after listing to one year?

**Q2.**
Do you agree that GEM listing applications should be approved by the Listing Division on its own, without the involvement of the Listing Committee?

**Q3.**
Do you have any suggestions on further streamlining the new admission process for GEM?

**Q4.**
Do you agree with the proposed revised continuing obligations for GEM?

**Q5.**
Do you agree that existing GEM issuers should be required to comply with the proposed revised continuing obligations (except the public float requirement) immediately? Is the proposed three-year "grace period" for complying with the public float requirement appropriate?

**Q6.**
Transfer from GEM to Main Board.

1. Do you agree with the following criteria for transfer of listing from GEM to the Main Board: (i) meeting Main Board admission requirements; (ii) listing status on GEM for two years; (iii) no material rule breaches for two preceding years?
2. Do you agree that the process for transfer of qualified companies from GEM to the Main Board should be streamlined?
3. Do you agree that the process of transfer should be treated as an announcement by the issuer, to be pre-vetted and approved by SEHK's Listing Committee?
4. Should HKEx require confirmation by a licensed financial adviser of the company's compliance with Main Board admission requirements (such as shareholder spread) where such compliance is not evident form already-published information? Or should HKEx seek to rely directly upon the assurances of the directors?
5. Do you have any other suggestions in respect of the transfer process?

**Q7.**
Do you agree that the Main Board and GEM Listing Rules should eventually be merged into a single rule book?

**Q8.**
Do you have any other comments or suggestions on the further development of GEM as a second board?

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**Charltons - Hong Kong Law Newsletter - Issue 50 - 06 August 2007**