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7 November 2023

Hong Kong Exchanges and Clearing Limited,
8/F, Two Exchange Square,
8 Connaught Place,
Central,
Hong Kong

Dear Sirs,

Consultation Paper on GEM Listing Reforms

We refer to the captioned consultation, and enclose the Law Society's submissions on the subject matter for your attention.

We thank you for your time extension for us to reply.

Yours faithfully,

[redacted]

Encl.

CONSULTATION PAPER ON GEM LISTING REFORMS

The Law Society's Submissions

The Stock Exchange of Hong Kong Limited (the "**Exchange**") issued the "Consultation Paper on GEM Listing Reforms" on 26 September 2023 ("**Consultation Paper**").

In response, the Law Society provides the following submissions. The same abbreviations and definitions appearing in the Consultation Paper are used in this paper.

Q1. ***Do you agree that an alternative eligibility test should be introduced to enable the listing of high growth enterprises substantively engaged in R&D activities on GEM?***

Please give reasons for your views.

Law Society's response:

I. We welcome the Exchange's initiative to address the concerns of the market regarding GEM. While the effort is commendable, it is important to consider measures that address the structural problems of GEM. These measures should go beyond merely introducing a new alternative eligibility criteria in order to meet the objective of revitalising the GEM market.

When GEM was first introduced in 1999, it aimed to replicate the success of NASDAQ and provide a platform for emerging companies in Hong Kong and the Mainland. Over time, GEM has primarily become associated with SMEs. To revamp the GEM market and align it with its original vision, it is crucial for the Exchange to embrace a broader perspective that accommodates companies of various sizes, diverse sectors and growth potential. The Exchange should re-position GEM and move away from the fixated perception that it is predominantly a market for SMEs, and that GEM is simply a launch pad for the Main Board. By embracing a broader vision and re-defining its purpose, the overall appeal of GEM will be enhanced:

- eligibility requirements should be sufficiently flexible to cater for companies of different sectors, sizes and growth potential

- one of the key factors that attract companies and investors to a market is liquidity. Measures that facilitate market-making mechanisms and promoting active participation of institutional investors should be considered and be the subject matter of another detailed consultation

- vetting process should be streamlined – one significant hurdle hindering the growth of GEM is the lengthy vetting process. Part of the reason for the lengthy vetting process appears to have arisen from subjective requirements (such as those set out under HKEx-GL-68-13A (*Guidance on IPO vetting and suitability for listing*) which are aimed at deterring "shell activity" but are not conducive to an efficient and clear listing process (instead adding to uncertainties over the vetting process which detract from real issues and have limited implications from investor protection or disclosure perspectives). Further, the characteristics of listing applicants singled out by the Exchange under HKEx-GL-68-13A that would "bring into question" their suitability for listing unfairly and pre-emptively discriminate those applicants without proper examination of their business nature.

- This is also the main reason why listing expenses were considered high (see paragraph 56 of the consultation). It is not uncommon for a vetting process to span over 12 months. To improve GEM's appeal, it is imperative to streamline the vetting process with objective and clear criteria with questions/comments raised aimed at clarification and disclosures required under the Listing Rules. It is worthwhile to consider a disclosure-based vetting process focusing on comprehensive disclosure requirements that was initially in place when GEM was first introduced in 1999. Investor protection is unlikely to be compromised as Hong Kong has over the years developed a stringent sponsor-regime. The regulators can implement robust post-vetting checks to verify an applicant's compliance with disclosure requirements.

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We consider that the Exchange should be more ambitious in revamping GEM. Hong Kong should leverage its position as an international financial hub that provides unique opportunities to attract applicants not only from the Mainland but also from countries participating in the One Belt One Road initiative. A lack of flexibility in GEM's listing criteria and rigidity in the vetting process will make GEM lose its competitive edge to other markets that have greater liquidity.

II. We agree that an alternative eligibility test should be introduced, albeit that it is a small step forward. The thresholds of this new criteria will need to be re-examined:

(a) given that this criteria is targeted at entities substantially engaged in R&D activities, the combined turnover requirement of HK$100 million (for the two most recent financial years) will pose a significant obstacle for new start-ups that may not have achieved significant turnover yet;

(b) the Exchange should consider different tiers of alternative financial requirements for new start-ups engaging in R&D that may not have achieved meaningful turnover in their early stages of business lifecycle as these companies usually rely on mezzanine financing, venture capital and angel investors for their R&D expenses. For example, a higher proportion of R&D expenditure in relation to operating expenses for new start-ups without significant turnover should be allowed. In an era of rapid technological advancements and changing business models, it is crucial for the alternative listing criteria to be dynamic and has an element of adaptability so that GEM can attract innovative companies that are the driving future of the market.

III. It would appear that the new alternative eligibility test would create yet another class of eligible listing applicants that are heavily engaged in R&D to fill the existing "gap" for applicants which are not yet sufficiently substantial to qualify for, or do not fall squarely within prescribed definitions, under the existing Main Board listing rules for biotech or specialist technology companies (for example, biotech companies the core product(s) of which fall within the "other biotech products" category rarely accepted by the Exchange but are welcomed by and subsequently listed on markets such as NASDAQ), and to facilitate their transfer to the more premium Main Board subsequent to listing on GEM. Whilst there appears to be a significant focus on innovation and emerging technologies which is consistent with prevailing policies of the HKSAR Government, there appears to be limited support for SMEs that are engaged in genuine yet traditional businesses and industries (many of which the Exchange is entitled to deem as "sunset industries" – an undefined and subjective term used by the Exchange to reject applicants) without clear rationale as to why these listing applicants should be marginalised or restricted from legitimate capital raising activities through the facilities of the Exchange. There appears to be a general perception that the Exchange and its existing rules and guidances have an inherent bias towards industries which are perceived to be likely to generate liquidity and clearing revenue for the Exchange, whereas start-ups and other SMEs possibly with promising prospects (some may have limited debt financing options due to "asset-light" nature of business) are unfairly excluded from public fund raising via the Exchange platform.

Whilst the Exchange has previously publicly expressed that more support for start-ups and SMEs is warranted; for example, it touted the concept of a registration based "Private Market" for unlisted pre-listing companies under its 2017 concept paper and the proposed the introduction of a "Third Board" as alternative to a GEM listing in its 2017 consultation (of which the former Chief Executive of the Exchange, likened the path to a GEM listing as akin to mountain climbers in their "path to Mt. Everest"[1] during a speech concerning relevant consultations), it would appear that the proposed alternative eligibility test (despite being a small step forward) is narrowly tailored and falls short of promoting diversity or offering assistance to those start-ups and SMEs which are not considered new-economy or R&D intensive (although support for new economy companies and Mainland issuers have persistently been the dominant focus of Exchange initiatives). For now, it would appear that only GEM listing applicants who are already well resourced (i.e. have market capitalisation and valuations that are already likely capable of raising alternative capital) and fall squarely within narrow definitions or listing criteria of the Listing Rules would dare to embark on the uncertain, lengthy and costly climb to "Mt. Everest".

[1] "Third board mustn't be seen like an unruly casino" China Daily (HK Edition), 2017-06-09, pg. 9. HKEX Chief Executive Charles Li Xiaojia noted concerning proposal to create a third board for companies that do not qualify for GEM: "*How can Hong Kong help people on that path to Mount Everest? Hong Kong needs to do something because it's a long, hard, lonely road*".

Q2. ***If your answer to Question 1 is "Yes", do you have any comments on the proposed thresholds for the alternative eligibility test as set out in paragraphs 63 to 75 of the Consultation Paper?***

Please give reasons for your views.

Law Society's response:

Please see our response to Q1.

Q3. ***Do you agree with the proposal to reduce the post-IPO 24 month lock-up period imposed on controlling shareholders of GEM issuers to 12 months as set out in paragraph 76 of the Consultation Paper?***

Please give reason for your views.

Law Society's response:

Yes, this will bring GEM generally in line with other overseas markets (some of which have even shorter lock-up periods, e.g. 6 months for NASDAQ and Neuer Market). We also agree that given the largely reduced shell activities with safeguards from the Exchange and the SFC, a longer post-IPO 24-month lock up period is not necessary for further hindering shell activities). There do not appear to be strong empirical support that GEM issuers with longer lock-up periods experience more stable share price post-IPO.

Q4. ***Should any other existing eligibility requirement for a listing on GEM be amended?***

If so, please state the requirement(s) that should be amended and give reasons for your views.

Law Society's response:

The HK$30 million positive cashflow requirement should be lowered. By lowering the requirement, more new start-ups and innovative companies with promising potential can access the market for fund raising. This would lead to a more diverse range of sectors represented on GEM. A larger number of applicants can also contribute to trading activities and improved market liquidity. Having a higher positive cash flow requirement does not necessarily guarantee better quality companies. A number of factors, including business model, management team and market potential all contribute to the overall quality and potential of a company.

Over 46% of the companies listed on GEM derived their revenue from Hong Kong (paragraph 31 of the Consultation Paper). As the financial performance of local companies were severely hampered by pandemic-related disruptions, adhering to the existing cash flow requirement will not give the market the much needed boost. Lowering the cash flow requirement would signal the Exchange's commitment to the growth and development of Hong Kong's local business community. There are also long-term benefits in fostering a capital raising environment that supports new start-ups, innovation and entrepreneurship.

Q5. ***Do you agree with the proposed consequential and housekeeping amendments to the reverse takeover and extreme transaction Rules as set out in paragraphs 81 and 82 of the Consultation Paper?***

Please give reasons for your views.

Law Society's response:

Yes.

Q6. ***Do you agree with the Exchange's proposal to remove GEM's compliance officer requirement as set out in paragraph 85(a) of the Consultation Paper?***

Please give reasons for your views.

Law Society's response:

Yes. It will lower ongoing compliance costs and make GEM more attractive. This will bring GEM generally in line with other overseas markets such as the BSE and SGX Catalist in this regard.

GEM remains out of "line with other overseas markets" in many other respects, e.g. cost and process of listing.

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Q7. ***Do you agree with the Exchange's proposal to shorten the period of engagement of GEM issuers' compliance advisers and to remove the additional obligations currently imposed on a GEM issuer's compliance adviser as set out in paragraphs 85(b) and 86 of the Consultation Paper?***

Please give reasons for your views.

Law Society's response:

Yes. Please see our response to Q6.

Q8. ***Should any other continuing obligation currently applicable to a GEM listed issuer also be removed?***

If so, please state the requirement(s) and give reasons for your views.

Law Society's response:

We consider that other continuing obligations are appropriate and help to safeguard investors' interest and market integrity.

Q9. ***Do you agree with the Exchange's proposal to remove quarterly financial reporting as a mandatory requirement for GEM issuers and instead introduce it as a recommended best practice in GEM's Corporate Governance Code?***

Please give reasons for your views.

Law Society's response:

Yes. The requirement to publish quarterly results is onerous on GEM issuers. A GEM issuer is required by statute to disclose timely inside information and the removal of quarterly financial reporting is unlikely to compromise the protection of investors.

Q10. ***Do you agree with the Exchange's proposal to align the timeframes for GEM issuers to publish their annual reports, interim reports and preliminary announcements of results for the first half of each financial*** *year with those for the Main Board, as set out in paragraphs 94 and 95 of the Consultation Paper?*

Please give reasons for your views.

Law Society's response:

Yes.

Q11. ***Do you agree that a streamlined mechanism should be introduced to enable qualified GEM issuers to transfer their listing to the Main Board?***

Please give reasons for your views.

Law Society's response:

We support the Exchange's proposal to re-introduce the streamlined transfer mechanism. We, however, have grave concerns about the new and stringent requirement that an applicant has to be listed on GEM for three full financial years prior to its transfer. This creates unnecessary restrictions. In comparison, other markets like NASDAQ, BSE and SGX Catalist have far less onerous requirements for transfer (see Appendix II-10 of Consultation Paper). One of the primary criticisms of GEM is its failure to attract new applications in recent years. This stagnation is an indication that the market is not keeping up with the evolving needs of companies seeking to go public. By imposing a three-year listing period on GEM before transfer, this effectively restricts the growth potential of SMEs and discourages new applications. In order to revitalise GEM, the Exchange needs to take advantage of the success of the Main Board to foster an effective ecosystem for transfer and capital fundraising: the extended three-year waiting period hampers companies from accessing the larger pool of investors and resources available on the Main Board. It will deter companies (especially fast-growing innovative or technology companies) from choosing GEM as a listing platform in the first place as these companies may prefer other markets that are less restrictive on transfers.

It may also send a negative signal to the market that a company listed on GEM is inferior in terms of investor protection and regulatory compliance compared to a company listed on the Main Board: hence the three-year waiting period. This perception may undermine investor confidence in GEM companies.

Q12. If your answer to Question 11 is "Yes", do you agree with the removal of the requirement for the appointment of a sponsor for the purpose of a streamlined transfer as set out in paragraph 108 of the Consultation Paper?

Please give reasons for your views.

Law Society's response:

Yes.

Q13. If your answer to Question 11 is "Yes", do you agree with, for the purpose of a streamlined transfer, the removal of the requirements for a "prospectus-standard" listing document and other requirements as set out in paragraphs 111 to 114 of the Consultation Paper?

Please give reasons for your views.

Law Society's response:

Yes.

Q14. If your answer to Question 11 is "Yes", do you agree with the track record requirements for a streamlined transfer applicant as set out in paragraphs 117 to 118 of the Consultation Paper?

Please give reasons for your views.

Law Society's response:

We have grave concerns about the three-year waiting period before transfer. Please refer to our response to Q11.

Q15. If your answer to Question 11 is "Yes", do you agree with the daily turnover and volume weighted average market capitalisation requirements for a streamlined transfer applicant as set out in paragraphs 120 to 133 of the Consultation Paper?

Please give reasons for your views.

Law Society's response:

We consider that the Reference Period of at least 50% of the trading days over a period of 250 trading days prior to the transfer is excessively long. It seems more reasonable to shorten the Reference Period from 250 to 120 trading days. This compares unfavourably with the requirement of BSE which imposes a turnover requirement of 60 trading days prior to the transfer.

Q16. ***If your answer to Question 15 is "Yes", should the Minimum Daily Turnover Threshold for the Daily Turnover Test be set at:***

(a) ***HK$100,000;***
(b) ***HK$50,000; or***
(c) ***another figure (please specify)?***

Please give reasons for your views.

Law Society's response:

Subject to our comments on Q15, we do not have strong views on the proposed threshold.

Q17. ***If your answer to Question 11 is "Yes", do you agree with the proposed compliance record requirement for a streamlined transfer applicant as set out in paragraph 134 of the Consultation Paper?***

Please give reasons for your views.

Law Society's response:

Yes.

Q18. ***Do you agree with the proposed modification to the existing compliance record requirement for a transfer from GEM to the Main Board as set out in paragraph 136 of the Consultation Paper?***

Please give reasons for your views.

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Law Society's response:

Yes.

Q19. ***Do you agree that the Exchange should exempt GEM transferees to the Main Board from the Main Board initial listing fee?***

Please give reasons for your views.

Law Society's response:

Yes.

The Law Society of Hong Kong
7 November 2023

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