SBI CROSBY

BY HAND

26 May 2006
The Listing Division
The Stock Exchange of Hong Kong Limited
11/F, One International Finance Centre
1 Harbour View Street
Central
Hong Kong

Attn: Corporate Communications Department

Dear Sirs,

Re: Discussion Paper on the Growth Enterprise Market: Comments

First of all, we should like to thank you for extending the deadline for comments on the discussion paper. Herewith therefore are some comments that we should like to make on the questions contained in the Stock Exchange's "Discussion Paper on the Growth Enterprise Market".

General comments

GEM's place has been as a second board to provide a platform to raise growth capital and a public market for the shares of small and medium size companies. Originally, it was to have been a disclosure-based "caveat emptor" market, with less vetting than for companies to be listed on the Main Board. However, as the market has developed, it has become as rigorously vetted as the Main Board (maybe more rigorously vetted) – so to small/medium-size companies, the burden in terms of cost and management time of seeking a listing on the GEM has become something that is openly discussed. Very few companies seeking a listing on GEM are able to achieve this within a year of the initial listing application – this has a knock-on effect on these companies, in terms of costs (including legal fees, accounting fees where stub period audits have almost become the norm) and diversion of management time. For intermediaries working on GEM transactions, there is an issue of whether engaging in GEM listings under the current environment is economically viable.

A corollary of this is that tales of a painful, drawn-out process that PRC enterprises and other growth companies have had to undergo in achieving GEM listing status have spread around to other growth enterprises who are considering where is the optimum place to list their shares. GEM's attractiveness as a second board to the Main Board in Hong Kong must be measured against the alternatives, in terms of cost, amount of time required to become listed, the likely valuation reception of shares if they are to be listed on GEM, the post-listing listing liquidity and the ease of returning to the market for a fund-raising at a valuation higher than that achieved at the time of listing. Growth companies in Greater China have other listing options available to them and the Stock Exchange's competitors are moving quickly into this space. Given that the Stock Exchange is regarded as the "Main Board" for PRC enterprises listing their shares overseas and has been attracting huge equity fund-raisings from the large state-owned enterprises and a perception in the market that such enterprises are treated

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preferentially in comparison with other much smaller issuers, there is a question in many intermediaries' minds, fair or not, as to whether there is a place in the Stock Exchange's heart for the SMEs.

Responses to Specific Questions

Need for and Nature of a Growth Company Market

Q1. Is there a need for a growth company market in Hong Kong?

An unqualified "yes".

Q2. If so, should the market primarily serve local Hong Kong companies, or should it target Mainland-based companies or regional/international companies?

The local Hong Kong growth company market is too small to justify having a growth market devoted solely to it. Any growth market should take into account what has happened to Hong Kong's economy, geopolitical reality and its role (and aspiration to continue to act) as a premier international finance centre. While the focus of GEM in the past has been on Greater China SMEs, to broaden the appeal, given the size of the China market, we believe that it would be worth considering broadening the scope of the growth company market to include companies from other Asian countries with respectable regulatory frameworks (Korean and Japanese companies) and also multi-national companies. Consideration should also be given to companies from other Asia-Pacific jurisdictions, including Australia and India.

Q3. At what stage of development should companies be admitted to the growth market – at start-up stage, or at a more mature stage?

We do not think that there is a need to admit companies at the start-up stage – this is the level of so-called "seed capital investors" and the venture capital industry which the growth market should not seek to replace, rather the growth market should seek to provide a potentially earlier exit point than the Main Board. Companies should have an operational history before being admitted to the new market – otherwise, it is difficult to judge whether their business model is a workable one.

Q4 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?

Growth markets are better suited to institutional and professional investors (including high net worth individuals/"sophisticated investors"), who are prepared to take the risk. It follows that listings should be by way of placing, rather than by means of public offer. Consideration can be given to the approach adopted in the London market whereby if shares are placed to a restricted number of investors, 100 or less, then the prospectus regime of the Companies Ordinance need not apply (with lower listing costs a consequence). We understand that this might cause regulatory concerns with the SFC, but for a new growth market to be a viable possibility novel approaches need to be considered.

From a regulatory and investor protection perspective, retail investors should be protected from the risks of such a market (I am sure that the SFC would agree!) – but should have the opportunity to participate initially through specialist funds. Only if the "new" growth market is developed on a sound basis, should retail investors be allowed to participate without limitation. We understand that this may be somewhat controversial with some retail brokerage houses who may consider that the retail investors would be deprived of high return opportunities, but a new model for a growth market should be allowed to develop without the worry of being stunted through political pressure as a result of retail investors suffering losses through being exposed to the higher risk of corporate failures that characterizes growth markets. A separate issue worth bearing in mind is that, for share issues by growth companies, requiring a minimum of 100 placees, irrespective of the issue size (and leaving aside the shareholder spread issue), has the potential to lead to a "minimum headcount" approach whereby intermediaries in order to meet this requirement have to secure orders from lower quality placees, very short-term investors who are most likely to exit at the earliest possible opportunity thereby creating pressure on the secondary market.

Q5. 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?

By their nature, growth companies have tight cashflow and so the beneficial type of market for such companies would be a market that provides relatively low-cost access to capital and has a streamlined vetting/approval process. Maybe Hong Kong is not yet ready for the AiM approach where there is minimal regulatory vetting and the responsibility is completely placed on the intermediary sponsoring the issue – in the Hong Kong case, I believe that investors derive some comfort from the vetting of the SFC/HKEx, so this could not be abandoned altogether at the outset. In addition, the quality of some intermediaries involved in sponsoring listing applications has been variable – in some cases due to individuals within the sponsoring entity. So there may be a case for a staged liberalization of the regulatory regime governing the vetting of issues for the growth market – this liberalization could go hand-in-hand with a "probation"-based approach towards intermediaries that would seek to act as sponsors for such a market.

Possible Structural Options

Q6. 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 (see Chapter 4 for details on these options):

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

GEM's logical place is to act as a second board to provide a fund-raising and trading platform for growth companies, which are unable to meet the Main Board's profit test and 3-year track record requirements. This would imply that the types of companies seeking to list on GEM would be potentially at an earlier stage in their growth/expansion cycle to those companies seeking to list on the Main Board. As indicated above in our general comments, GEM was originally to have been a disclosure-based "caveat emptor" market, with less vetting than for companies to be listed on the Main Board, but has become at least as heavily pre-vetted as the Main Board. This has resulted in significantly greater than anticipated expense for the SMEs seeking to come to GEM – and the tales of the painful, drawn-out process that PRC enterprises and other growth companies have had to undergo in achieving listing status have spread around to other growth enterprises who are considering where is the optimum place to list their shares. GEM's attractiveness as a second board to the Main Board in Hong Kong must be measured against the alternatives, in terms of cost, amount of time required to become listed, the likely valuation reception of shares if they are to be listed on GEM, the post-listing listing liquidity and the ease of returning to the market for a fund-raising at a valuation higher than that achieved at the time of listing. Growth companies in Greater China have other listing options available to them.

(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;

Notwithstanding the poor quality of many of the 3rd tier companies on the Main Board, I think that it would be a backward step for the reputation of the MB to merge GEM and the MB into a single board. It is better to keep the 2 classes of listing separate, while allowing companies who have performed well following listing and who meet the MB criteria to migrate (or be "promoted") to the MB. There should be a time lag between such companies listing on GEM and moving to the MB, otherwise GEM might be regarded as an easy way to the MB.

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.

This blurs the distinction that the MB should have of being the "Official List" of the Stock Exchange and any major scandal in the proposed lower tier should taint the "upper tier" – the contagion effect of such a scandal would be greater if GEM and the MB were to merge and such scandal occurred subsequently. As it is, I sense that the problem cases involving companies that were listed on GEM have not affected the reputation of the MB, since they are 2 clearly different boards (the MB has been largely isolated from the negative impact of these cases, although there has been some albeit very minor collateral damage to the reputation of the HKEx).

(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 companies.

GEM should be kept separate from the MB - the companies listed on GEM that have developed to the extent that they are able to meet the entry requirements of the MB should be permitted to migrate to the MB, subject to clearance from the HKEx/SFC on the basis of their meeting the listing criteria of the MB and having no material compliance breaches during their time as GEM-listed companies (for example, no suspected fraud or misfeasance, and no serious breaches of the GEM Listing Rules, including no material undisclosed connected transactions). There is no point in allowing "serious offenders" automatic admission to the MB as part of a reorganization of the market, as this would impact on the perception of quality of the MB itself.

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

The AiM model is now widely regarded internationally as a highly successful platform, which, inter alia, offers much faster time-to-market, significantly less regulatory involvement (notwithstanding hands-on involvement and vetting by the nominated adviser), a much bigger pool of investment funds that treat AiM on similar terms to the Official List of the London Stock Exchange, and greater prospects of secondary fund-raising post-listing. While GEM is by its nature a second board, it is difficult to see the HKEx adopting the AiM model as a structural option for GEM in the future unless there is a radical change in the regulatory approach here in Hong Kong with respect to GEM

Q7. Based on your preferred structural option for GEM, do you have any specific views or recommendations concerning:

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

We think it is better not to have start-ups and not to permit cash shells with nothing but a business plan, since this would leave the system open for abuse and in the latter case might have implications, for example, relating to money-laundering.

(b) the regulatory approach

Given the existing regulatory framework and the rigorous supervision of intermediaries in Hong Kong following the passing of the SFO, we believe that it would be difficult to change the regulatory culture in Hong Kong quickly into that more akin to that employed by the LSE in its administration of AiM. In addition, there are political pressures here that the HKEx faces (as does the SFC) that are not faced by the LSE to anything like the same extent. A key issue for regulators to consider calmly is whether they consider that they can trust intermediaries to the same extent that the LSE "trusts" intermediaries in London and could consider the behind-the-scenes dissuasive means that appears to be the mode of regulation in the City of London. Perhaps a starting point for the Hong Kong regulators is to decide whether they could consider an approved list of "sponsors" for the revamped GEM.

(c) the initial listing requirements and the listing process

To a substantial extent, the initial listing requirements and listing process must be a function of how far the Hong Kong regulatory bodies are prepared to move in the direction of what is being practiced with marked success by the LSE with AiM. AiM of course has had its difficult moments in the early years but the relatively light-handed regulation and close working relationship between the NOMADs and the LSE, when combined with the need of growth companies for access to the capital market within a manageable timeframe and growing appetite from financial institutions for new growth stories, has evolved into a great success.

Shareholder lock-up: this should remain a maximum of 12 months (if, as suggested by some interviewees in the pre-consultation exercise, the HKEx were to increase the lock-up to 2 years, this would be a significant additional disincentive to companies to list their shares on GEM)

(d) the process of ongoing regulatory supervision

Clearly, intermediaries involved in a new "growth" market must continue to be subject to the supervisory regime of the SFC as intermediaries engaging in regulated activities under the SFO. However, if an AiM-style growth market is to have a chance of success, then there will have to be some serious study of the approach of the regulators in the UK in supervising the activities of NOMADs.

(e) the disclosure and corporate governance requirements, and

Quarterly reports should be continued as they are a good corporate practice.

There should be greater requirements in relation to corporate governance – so that the "new" growth market has an opportunity to be regarded as something different from its precursor.

(f) the roles of sponsors and other professionals:

In general, the obligations currently imposed on sponsors under Practice Note 2 of the GEM Listing Rules (which mirrors that of Practice Note 21 of the Main Board Listing Rules) are already regarded by investment banks as a significant burden – it is likely that there would be a negative reaction from investment banks if the Hong Kong regulators would seek to impose additional obligations (over and above those already contained in Practice Note 21) in respect of sponsors of issues on any new "growth" market. As a former securities regulator turned practitioner, I feel that the regulatory spotlight should also turn on accountants in respect of the thoroughness of their audit work. There may be a case for considering requiring accountants to prepare long form reports (of a due diligence nature) for the sponsors of listings on such a market (similar to those prepared in London). Existing requirements imposed on "compliance advisers" for post-listing advice to listed companies are regarded as a necessity to help "season" a company so that it becomes used to the responsibilities of a public listed company. Such services are not regarded as the "bread and butter" business of investment banks – there is considered to be more risk than reward and it would take time for investment banks here in Hong Kong to become used to the idea of potentially being a listed company's "compliance adviser" for more than the periods currently stipulated under the Listing Rules (as would be the case if a system akin to the NOMAD approach used in London were to be used).

Q8. 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?

N/A

Q9. What, if anything, should be done with delisted companies? Should there be a separate market for trading these companies?

We do not think that there is a need to put time and effort into creating a "special treatment" section for trading of delisted companies. It is better for the HKEx to dissociate itself from delisted companies (i.e. keep them at arms' length) once their securities are no longer traded through the HKEx's platform – having such a section, especially if it becomes a significant platform may draw attention to the poor quality of some of the companies that have listed their securities on the HKEx in the past. This would appear to run counter to the Hong Kong regulators' wish to focus on enhancing the "quality of the market".

Other Issues

Q10. Do you have any suggestions on how to raise the profile of companies listed on the growth company board?

A possible solution would be to have an HKEx sponsored road show of selected success stories of companies listed on GEM which have gone from strength to strength following their listing (i.e. the thrivers, not just the survivors). Perhaps a focus of such marketing activity can also be to highlight some companies whose success following listing on GEM has enabled them to migrate successfully to the Main Board as well as those companies which are among the top performers, yet at this point in time are content to remain the leading stocks on GEM. Companies from different business segments would be selected but before such roadshow would be prepared, the geographic target for such growth company board should be borne in mind. Currently, the vast majority of companies listed on GEM are HK, PRC or Bermuda/Cayman Islands-incorporated companies whose business activities are predominantly within Greater China, so it is logical that success stories would for the most part come from this pool of companies – if the HKEx wants to stress the diversity of GEM, it may also want to consider including success stories of companies whose business operations are located in areas other than Greater China.

Q11. Should more information be provided on growth companies? If so, what information, and who should provide it?

Perhaps the HKEx could consider having a link to research reports on the companies listed – or provide a "consensus research" viewpoint on the companies.

Q12. Should market making be permitted on the growth company board? If so, what should be the obligations of and incentives provided to market makers?

We are not sure whether there is a need for a market-making mechanism, since the HKEx's existing trading mechanism provides bid/offer If the HKEx and the SFC decide to make a bold move towards an AiM style market, then some technical study will need to be done on the feasibility of a market-making system – and the legal ramifications of market-making for such a market properly considered by the SFC to ensure that appropriate guidance and exemptions from the market misconduct provisions of the SFO are put in place.

In summary, it is timely to have a review of the approach to a market in Hong Kong for growth companies, given that the existing growth market in Hong Kong has lost a significant amount of its attractiveness, and it is useful to have seen the alternative suggestions proposed by the parties consulted during the pre-consultation phase that preceded the issue of the Discussion Paper. Clearly, there is something about the AiM model in its present highly successful form, which is attractive to issuers, intermediaries and institutional investors. But it must be understood that this success took time and was after some setbacks and difficulties (throughout this process the London Stock Exchange stood by AiM and facilitated the evolution of this market into the force it is today) – acceptance of AiM by institutional investors took time and was not taken for granted. It follows that, if there is commitment to a new approach in Hong Kong, then for such approach to have an opportunity to succeed, expectations of the financial community in Hong Kong and other observers and commentators must be managed so that overnight success is not expected and so that any new growth market in Hong Kong is given a chance to succeed without the burden of unrealistic expectation.

If you have any questions in relation to the foregoing, please do not hesitate to contact me at or on my mobile phone

Yours sincerely,

Simon Harding

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