

競天公誠律師事務所

JINGTIAN & GONGCHENG

北京市朝阳区建国路 77 号华贸中心 3 号写字楼 34 层 邮编: 100025
34/F, Tower 3, China Central Place, 77 Jianguo Road, Beijing 100025, China

T:(86-10)5809 1000 F:(86-10)5809 1100

BY HAND AND BY EMAIL (response@hkex.com.hk)

Corporate and Investor Communications Department

Hong Kong Exchanges and Clearing Limited

8th Floor, Two Exchange Square

8 Connaught Place

Central

Hong Kong

25 January 2021

Dear Sirs/ Madams,

Subject : Profit Requirement CP

Respondent : Jingtian & Gongcheng

**This submission has been jointly prepared by the Respondents as defined below (whose names are set out in Appendix I) and represents an individual and independent submission from each of the Respondents in its own name and capacity respectively.*

1. INTRODUCTION

1.1. We refer to the consultation paper published by The Stock Exchange of Hong Kong Limited (the “Exchange”) on 27 November 2020 (the “Consultation Paper”) in relation to the proposed amendments on the Profit Requirement. This written response is made in our own name and capacity, and has been jointly prepared, discussed and presented as a composite submission from a list of respondents whose names are set out in the Appendix (“the Respondents”), each in their own name and capacity. For the purpose of assessing the total number of respondents to the Consultation Paper, this submission represents an independent and individual submission for each of the Respondents. *Please note that the Appendix is provided solely for the Exchange’s reference and does not constitute part of the submission. Accordingly, we do not consent to the disclosure of this Appendix to the public.*

- 1.2. According to the Consultation Paper, the Exchange has recently seen an increase in listing applications from issuers that marginally met the Profit Requirement but had relatively high historical price-earnings (“P/E”) ratios as compared with those of their listed peers (“**Small Cap Issuers**”). These Small Cap Issuers were typically small or mid-sized companies in traditional industries, and a majority of these Small Cap Issuers are also classified as Ineligible Applications who failed to meet the profit forecast they had filed with the Exchange during the application process. As the Consultation Paper has repeatedly pointed out, the Exchange’s view is that the valuations of these Small Cap Issuers may have been reversely engineered to meet the Market Capitalisation Requirement in order to manufacture potential shell companies for sale after listing given the premium attached to the listing status. In addition, the Exchange is also concerned whether the IPO offer prices genuinely reflect the expected market clearing prices.
- 1.3. We appreciate the time and efforts put in by the Exchange in preparing the Consultation Paper. Having made due and careful consideration and having consulted fellow peers in the market, we regret to inform the Exchange that we are not supportive of the heightened profit requirement proposal (the “**Proposal**”) as set out in the Consultation Paper. We set out the reasons in support of our position in the following paragraphs for your consideration.
- 1.4. Unless otherwise defined herein, capitalized terms shall have the same meaning as those defined in the Consultation Paper.

2. REASONS IN SUPPORT OF OUR VIEWS

On the following grounds, we respectfully submit that the Proposal is not a necessary means to address the Exchange’s concerns underlying the Proposal, and is detrimental to the continuing prosperity of the Hong Kong capital market.

2.1. Sufficiency of current regulatory regime.

The Exchange’s concern of the possible manipulation of market and reverse engineering for the purpose of backdoor listing have already been well addressed and managed by the current regulatory regime implemented by the Exchange and the Securities and Futures Commission of Hong Kong (the “**SFC**”) from time to time including, in particular, the tightened regulation of reverse takeover.

- (1) The current regulatory regime is generally regarded by the market participants as an effective way to ensure quality of listing applicants. The Listing Division, the SFC and the Listing Committee already have wide authority, at different stages of the listing application, to reject the listing applications that do not satisfy listing eligibility requirements or are not suitable for listing.
- (2) Under the current regulatory practice of the Exchange, listing applications could be rejected for various reasons rendering the relevant listing applicants unsuitable for listing. Listing Decision HKEX-LD126-2020 highlights that where an applicant has failed to substantiate its commercial

- rationale for listing, the Exchange may consider its valuation as part of the determination on suitability.
- (3) In the past few years since the increase of the market capitalization threshold, a number of listing applications were rejected when they failed to justify why the forecast P/E ratios were higher than those of industry peers, the basis on which the peers were chosen, and how such valuations were reasonable in light of the applicants' historical financial performance and profit forecasts.
 - (4) To ensure a share offer of a listing applicant had a genuine market demand, the SFC and the Exchange had issued a joint statement in January 2017 on price volatility of stocks listed on GEM and provided guidelines to sponsors, underwriters and placing agents on the standards of conduct that are expected of them in the listing and placing of GEM IPO stocks to ensure that conditions exist for an open market as well as for orderly, informed and fair trading to develop at the time of listing. If the Exchange is concerned with the reasonableness of valuation of listing applicants on the Main Board, instead of raising the profit requirement for the Main Board, the above-mentioned current guidelines could be further extended to Main Board as well.
 - (5) Whether the valuation of a company is justifiable or not is ultimately determined by whether there is sufficient market interest at such valuation. Unless circumstances suggesting market manipulation exist during the IPO (e.g. (a) possible offering of rebates to investors to entice them to take up shares, and (b) manufacturing of an artificial shareholder base), we do believe that whenever the share offer of a listing applicant is fully/ over-subscribed, there is no valid reason to question the reasonableness of valuation.
 - (6) The Exchange's concerns about the reasonableness of valuations can be easily addressed by further enquiring the reasonableness of basis and assumptions adopted by the listing applicants in preparing their profit forecasts during the vetting process. Whenever the Exchange had no further comment on the profit forecast submitted by the listing applicant during the vetting process, there should be no valid reason to raise concern on the failure of the listing applicant to meet the profit forecast after listing, not to mention the fact that whether a listing applicant is able to meet its profit forecast is subject to various factors which might be out of its control (e.g. the risks disclosed in their prospectuses and failure of the general assumptions disclosed in the profit forecast).
 - (7) Over the past five years, we have seen the Exchange tightening its vetting requirements to limit its approval for listing applications which fail to demonstrate genuine funding needs. Together with the tightening of the reverse-takeover requirements and guidance over the enforcement of cash companies related rules and delisting procedures, the market has seen significantly less back-door listing activities, which in turn has significantly discouraged shell companies manufacturing activities. These efforts have been hugely effective and have been greatly appreciated by market practitioners.

2.2. **Marginal impact on Potential Shell Companies Manufacturing Activities among Small Cap Issuers**

As we mentioned above, the Exchange's tightened regulation on reverse takeover has effectively discouraged shell companies manufacturing activities. The incremental benefit from the Proposal in terms of further deterring shell companies manufacturing or the related back-door listing activities and market manipulation would be marginal.

- (1) There is no direct logical relationship between profit level of a company and its willingness or likelihood to engage in shell companies manufacturing activities. The truth is that when exit through sale of shell companies has become far more difficult under the new regime of reverse takeover, the incentives for shell companies manufacturing has significantly dampened. Although "shell companies manufacturing" and back-door listing activities are inherently driven by "demand and supply" economics and cannot be totally eliminated in any capital market in the world, given the market for shell companies has totally cooled down and significantly shrunk, we believe the incremental benefit, if any, brought by the Proposal would be very marginal and not worthwhile measured against its potential adverse impact on the Hong Kong capital market on the whole as elaborated on below.
- (2) Valuation is essentially a forward-looking exercise. In addition to historical earnings, when assessing whether a listing applicant's valuation or P/E ratio is reasonable, sponsors and regulators should consider a matrix of other factors including market comparables, projected earnings, and market sentiment. In particular, given the significant local and international market disruptions over the past two years, it would be unfair to refer to examples of recent listed companies failing to meet valuations and simply conclude that such valuations were unrealistic in the first place.
- (3) We also believe there is no empirical evidence in the market demonstrating that more established and/ or larger cap companies with profit (for the last financial year) above HK\$50 million (i.e. Option 1) or above HK\$60 million (i.e. Option 2) are any less likely to engage in shell companies manufacturing activities than those with lower profit levels that meet the current profit requirement. The truth is companies at any profit level can engage in reverse engineering and manipulative market behaviours to manufacture shell companies.
- (4) Therefore, we are of the view that the Proposal would only stop small-sized companies with genuine listing intentions from applying for listing, but would do almost nothing to help ensure listing applicants' valuation and profit forecasts being reasonable, nor does it stop abusive and manipulative behaviours in the stock offering, underwriting and trading. To effectively protect investors' interest in the market from such behaviours, we recommend the Exchange and the SFC to initiate separate consultation to explore means to step up requirements for demonstrating reasonableness of profit forecasts and forward-looking valuation, and initiate enforcement actions against unreasonable forecasts and market manipulation as aforementioned.

2.3. **Adverse impact on the Hong Kong equity capital market**

- (1) As with any policy making, a cost-and-benefit analysis is necessary. Weighing the benefit of the Proposal, which is marginal, against its cost as discussed below, we believe that the potential adverse impact of the Proposal on the Hong Kong stock market is not reasonably justified.
- (2) Inclusivity and depth are crucial to a capital market's success and continuing prosperity. A capital market is not a winners' club or elites' club, but a vast breeding bed to enable companies of different scales to grow and thrive so long as there are sound corporate governance measures, information transparency in the form of prospectus disclosure as well as legally-bound accountability of the issuers' directors and professional parties (e.g. sponsors, auditors, valuers, etc.) in place.
- (3) The investors of all types have been willing to invest in companies in different industry sectors and different sizes at the investors' own risks (including the business prospects and the share price performance), which is indeed the fundamental element of the equity capital market in every market economy system.
- (4) Listing eligibility requirements like profit requirement are fundamental to a stock market's listing regime and should be kept stable and predictable, and should not be changed easily for convenience and without strong empirical evidence to its outdatedness and defects. It is dangerous to rely on a simple tool to solve issues that should better be solved by other regulatory measures, hoping it would fix the problem once for all. Under the Proposal, listing applicants with great potential may be deprived of the opportunity of being considered under the Proposal.
- (5) The Proposal would result in the capital market of Hong Kong missing the opportunity to exercise its equity financing function to nurture a pool of quality companies (with profit ranging between HK\$20 million to HK\$50 million at this moment) as well as losing the huge investor base who often invest in small/ medium cap listed companies, which would in turn lead to the overly-narrowed investment choice of the equity capital market of Hong Kong. As time goes by, the accumulated effect of the above would potentially jeopardize the entire competitiveness of the Hong Kong capital market.
- (6) On the other hand, the performance of GEM over the past years has not demonstrated a significant improvement. GEM was re-positioned in July 2008 from an alternative board for emerging and growth companies to a "stepping stone" to the Main Board. As a result, most of the original features of GEM were repealed and many of the GEM Listing Rules were amended to align with those of the Main Board. It is our view that the repositioning of GEM to a general listing board in the absence of unique characteristics such as those of the PRC's ChiNext market on the Shenzhen Stock Exchange ("ChiNext") and the Science and Technology Innovation Board on the Shanghai Stock Exchange ("SSE STAR") (some features of which are outlined in

the paragraph below), has effectively resulted in a loss of attractiveness of GEM to high quality and/ or emerging innovative companies with considerable growth prospects. As admitted and highlighted in the Exchange's consultation paper in June 2017, GEM's "stepping stone" positioning has achieved limited success. Furthermore, it is noted that with effect from 15 February 2018, the Exchange has introduced a further restructuring of GEM as a standalone board, removed the streamlined process for GEM issuers to be transferred to the Main Board, and transferred the authority to approve GEM listing applications from the Listing Division to the Listing Committee. While we appreciate that such move might have strengthened protections to investors and public shareholders, such change however has further resulted in GEM becoming less appealing to small-to-medium sized listing applicants seeking to list on GEM, not even taking into account the increasing attractiveness of the overseas market.

- (7) We are of the view that, Small Cap Issuers with profit ranging HK\$20 million to HK\$50 million shall not be superficially labelled by the Exchange as lower quality investment products. It would be unhealthy to the capital market and the market economy if it is the regulators to direct or limit what the investors should invest in.
- (8) Since the implementation of the 2017 GEM Reform, the status, image and financing function of GEM has been further worsened as compared with its "stepping stone" position before the reform, as evidenced by the tragically dropped market value and trading volume of the GEM listed companies.
- (9) As such, further to the abovementioned discussion on the foreseeable negative impacts of the Proposal to the variety of investments opportunities and the interest of the active investor community, it would be impractical to fantasy that the potential issuers with profit ranging between HK\$20 million to HK\$50 million would consider to apply for listing on GEM as an alternative board when they are no longer eligible for listing on the Main Board following the Proposal.

2.4. **Increasing competitiveness of overseas market against GEM**

- (1) We appreciate that one of the kind objectives of the Exchange proposing to raise the Profit Requirement is to promote the popularity and liquidity of, and to attract more applicants to consider listing on GEM. However, due to the efforts made by overseas markets targeting at small-to-medium sized listing applicants from the PRC and taking into account the share price performance and trading liquidity of GEM issuers in Hong Kong over the recent years, we are inclined to take the view that the Proposal, if implemented, would not necessarily achieve the objective of the Exchange to increase the number of listing applications on GEM.
- (2) Instead, we are of the view that there is a real possibility that the total number of applicants seeking for listing in Hong Kong would be significantly reduced if the Exchange proceeds with

the Proposal, especially taking into account the unsuccessful reform made by the Singapore Stock Exchange (the “SGX”) in recent years to tighten its listing criteria. Many small-to-medium sized applicants with genuine intentions to grow and expand over the long run may consider that they are no longer welcomed by the capital market in Hong Kong and may hence consider other options available to them, including those markets that may offer the opportunities of further flexibilities on qualifications for listing, more liquidity and higher valuation at the time of IPO.

- (3) We have, in the recent months, come across situations where high quality clients with growth potential have already expressed their concerns with respect to the implications arising from the issuance of the Consultation Paper and indicated their intention to change their original plan to list in Hong Kong and seek professional advice to list elsewhere.
- (4) In particular, during recent years, rapid development and heightened market competitiveness has been noticed in overseas markets which target to attract small to medium-sized companies such as the ChiNext, the SSE STAR and overseas listing platform being standard listing on the New York Stock Exchange (“NYSE”) via a special purpose acquisition company (“SPAC”). It is of the view that the increasing competitiveness of overseas markets against GEM reflects in the following two areas.
- (5) **Comparison on Listing requirements** – the listing requirements in ChiNext and the SSE STAR are much more lenient than GEM listing requirements. Please refer to the table below for a brief summary comparing major listing requirements among GEM and other overseas markets for your perusal.

Summary of listing requirements on GEM and other comparable markets

GEM	ChiNext	SSE STAR	SPAC at NYSE
1. At least HK\$30 million aggregate positive operating cash flow for two years;	<p>Red chip companies</p> <ul style="list-style-type: none"> - Positive net profit in the latest year; and - For companies with fast growth rate, they must satisfy at least one of the following: <ul style="list-style-type: none"> i. Not less than RMB10 billion expected market value; or ii. Not less than RMB500 million operating revenue and not less 	<p>Should meet one of the following criteria:</p> <p>Type 1</p> <ul style="list-style-type: none"> - Estimated market value of no less than RMB1 billion (approx. HK\$1.2 billion); - Positive net profit for the last 2 years and the cumulative net profit is no less than RMB50 	<ol style="list-style-type: none"> 1. Aggregate market value of at least USD\$250 million (approx. HK\$1.9 billion); 2. Requires a market value of publicly held shares of at least

GEM	ChiNext	SSE STAR	SPAC at NYSE
<p>2. At least HK\$150 million market capitalisation;</p> <p>3. Two-year management continuity; and</p> <p>4. One-year ownership continuity.</p>	<p>than RMB5 billion expected market value</p> <p>- By being companies with fast growth rate, they must satisfy one of the following:</p> <p>i. Not less than RMB500 million operating revenue in the latest year and the compound growth rate for the latest three years' operating revenue is 10% or above;</p> <p>ii. The operating revenue in the latest year is lower than RMB 500 million and the compound growth rate for the latest three years' operating revenue is 20% or above; or</p> <p>iii. Being affected by seasonal fluctuation common in the industry, but with a compound growth rate for the latest three years' operating revenue higher than its peers for the period</p> <p><u>PRC companies</u></p> <p>- Does not have differential voting arrangements; and satisfy one of the following:</p> <p>i. Positive net profit for the two latest years and accumulated revenue not less than RMB50 million;</p> <p>ii. Not less than RMB1 billion expected market value, with</p>	<p>million (HK\$59.9 million); and</p> <p>- No less than RMB 100 million (approx. HK\$120 million) operating revenue in the latest financial year.</p> <p><u>Type 2</u></p> <p>- Estimated market value of no less than RMB1.5 billion (approx. HK\$1.8 billion);</p> <p>- No less than RMB200 million operating revenue in the latest financial year; and</p> <p>- With R&D investment accounts for no less than 15% in the accumulative operating revenue in the latest three financial years.</p> <p>*Three other types of listing thresholds for companies with higher market value</p>	<p>US\$200 million (approx. HK\$1.5 billion);</p> <p>3. Requires an IPO price per share of at least US\$4 (approx. HK\$31) at the time of initial listing; and</p> <p>4. Does not require SPACs to have a prior operating history.</p>

GEM	ChiNext	SSE STAR	SPAC at NYSE
	positive net profit and not less than RMB100 million operating revenue in the latest year; or iii. Not less than RMB5 billion expected market value and not less than RMB300 million operating revenue in the latest year		

- (6) **Listing timetable and Flexibility** – Turning back to the competitiveness of the overseas market, apart from the differences in listing requirements, the average time required for listing on ChiNext, the SSE STAR and SPAC listing on NYSE is approximately six months; whereas the average approval time for listing on the Main Board and GEM in recent years ranges from six to over 14 months, with a general understanding among market practitioners that the small-to-medium sized listing applicants tend to suffer a much longer vetting period than the larger cap listing applicants. As such, listing on these alternative listing platforms presents a faster alternative for small-to-medium sized companies to tap funds from the capital markets and expand their business. Further, potential listing applicants may find the flexible listing requirements in these alternative listing platforms more in line with their own unique financial and operation situations particularly for newly established businesses with shorter financial and operation history available.
- (7) To conclude for the purposes of this paragraph, as a positive movement to attract small-to-medium sized listing applicants, the competitors of the Exchange have over the past years made enormous efforts to introduce various flexible and practical measures and policies, some of which are summarized above based on our limited studies. We are proud to have witnessed the success of the Exchange being one of the leading stock markets worldwide over the past many years attracting and retaining high quality listing applicants and listed issuers from a wide diversity of industries with different business scales. We believe that one of the key factors to the continuing success of the Exchange is the openness, confidence, flexibilities, opportunities and professional guidance the Exchange has been willing to offer to the applicants seeking to list on the Main Board of the Exchange. Such invaluable culture has been long established over the past twenty years and has been well perceived and recognized by the applicants, listed issuers as well as the market players like us, for which we have developed a strong sense of pride when advising our clients on the choice of venue for listing. We would therefore very much

appreciate if the Exchange could continue with such positive momentum and unique culture of its Main Board business (based on which it has achieved enormous success and popularity worldwide over the past many years), especially in view of the increasing attractiveness in the fast growing alternative listing platforms in the recent years, the unsuccessful reform to tighten its listing criteria by the competitor (i.e. SGX) as well as the current performance of GEM despite the respectable efforts made by the Exchange over the recent years.

2.5. Negative impact on potential investors

- (1) We believe that the success of the capital market of Hong Kong has been largely attributable to its inclusive free market economy system with wide variety of choices of investments, abundant funding opportunities, and dominating sophisticated institutional investors of different scales and with diverse risk-return preferences.
- (2) While large international mutual funds used to invest in large and medium cap listed companies, medium/ small sized hedge funds and high net worth individuals are often very keen to invest in medium and small cap listed companies. Moreover, there are also a significant number of private equity and venture capital investors who are specialized in investing in medium and small sized private companies at pre-IPO stage.
- (3) By aggressively raising the Profit Requirement as mentioned in the Consultation Paper, the number of listing applicants on the Main Board is expected to be significantly reduced, which would in turn (i) unnecessarily narrow the variety of the capital market investment products and limit the potential choices of a significant number of investors', and (ii) negatively affect the exit opportunities and accordingly the investment value for a number of private equity and venture capital investors who have already invested in private companies with profit ranging from HK\$20 million to HK\$50 million and the potential to go public on the Main Board.

2.6. Appropriateness of introducing the Proposal immediately after the difficult year as a result of COVID

- (1) We would also be grateful if the Exchange could reconsider the timing of introducing the Proposal. In particular, it is noted from the Consultation Paper that the Listing Committee had in 2017 reviewed the profit requirements. After due and careful inquiries, the Exchange decided to increase the market cap but not the profit requirements with a view to providing maximum flexibilities to listing applicants seeking for listing on the Exchange.
- (2) Compared with the market condition in 2017, the current market sentiment and condition have worsened due to the outbreak of COVID-19 and uncertainties to the macroeconomic and political situation brought by recent Sino-U.S. conflicts. These material adverse changes have led to uncertainties to the market in general that it could hardly be said that the current market warrants the implementation of the Proposal when such approach was considered unsuitable

even under a much more stable market back in 2017. Hence, it is respectfully submitted that the previous decision duly made by the Listing Committee three years ago remains valid.

- (3) The most apparent difference between the market back in 2017 and the current market is that the financial performances of many listing applicants and listed issuers have been severely affected by the unfortunate and prolonged situation of COVID-19. Coupled with the worsen Sino-U.S. relations, it is noted that many investors and listing applicants have become more reserved, if not pessimistic towards the upcoming business environment. Although we truly appreciate that the Exchange has taken into account the situation of COVID-19 in proposing temporary relief to certain number of listing applicants, we are nevertheless not fully convinced with the necessity and prominence under the current market sentiment to reintroduce the Proposal which had been duly considered and rejected by the Listing Committee not long ago.

3. TEMPORARY RELIEF AND TRANSITIONAL ARRANGEMENTS

- 3.1. In light of the market uncertainty and adverse impact on the businesses of potential listing applicants arising from the prolonged COVID-19 situation, the Exchange's efforts and consideration in current market situation to propose the Temporary Relief and transitional arrangements are highly appreciated. However, in light of our reasons against the Proposal as outlined above, we are currently not in a position to comment on the temporary relief and transitional arrangements.
- 3.2. We would be extremely grateful if the Exchange could initiate a consultation process on temporary relief and transitional arrangements as a separate and independent consultation in response to the situation of COVID which has resulted in many potential listing applicants not being able to meet the minimum profit requirement for the financial year ended 31 December 2020. Prior to the conclusion of such separate consultation the current profit requirements as set out in the Listing Rules should in our view remain effective (even if the Listing Committee decides to approve the Proposal, whether with modifications or not).

4. DISCLAIMER AND POINTS OF CONTACT

- 4.1. This submission has been jointly prepared by the Respondents and represented as an independent submission for each of the Respondents for the purpose of assessing the total number of respondents to the Consultation Paper.
- 4.2. The Appendix does not constitute part of the submission and it is provided for the Exchange's reference only. We do not consent to the disclosure of the Appendix to the public.
- 4.3. We consent to disclose our name as a respondent to the public.

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4.4. Should you have any queries in relation to the above submission, please do not hesitate to contact Jingtian & Gongcheng.

Yours faithfully,



Jingtian & Gongcheng