

Date: 29 January 2021

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Hong Kong Exchanges and Clearing Limited
8th Floor, Two Exchange Square
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Central, Hong Kong

[REDACTED]
[REDACTED]
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BY HAND

Dear Sirs,

Re: Profit Requirement CP

We refer to the Consultation Paper on The Main Board Profit Requirement published by the Stock Exchange on 27 November 2020, and enclosed herewith our reply to the Questionnaire to the Consultation Paper for your kind consideration.

Should you have any queries, please feel free to contact our [REDACTED]
[REDACTED]

Yours faithfully,

[REDACTED]

Loong & Yeung

Encl.

In association with 聯營律師行: [REDACTED]

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Part B Consultation Questions

Please indicate your preference by checking the appropriate boxes. Please reply to the questions below on the proposed change discussed in the Consultation Paper downloadable from the HKEX website at:

<https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Consultation-Paper/cp202011.pdf>

Where there is insufficient space provided for your comments, please attach additional pages.

Capitalised terms have the same meaning as defined in the Consultation Paper unless otherwise stated.

1. Do you agree that the Profit Requirement should be increased by either Option 1 (150%) or Option 2 (200%)? Please give reasons for your views.

Yes

No

You may provide reasons for your views.

Please refer to the attached sheet for our reasons.

2. Besides the proposed increase in the Profit Requirement, is there any other alternative requirement that should be considered? Please give reasons for your views.

Yes

No

You may provide reasons for your views.

We propose the Exchange should leave the current Profit Requirement unchanged instead of implementing the proposed increase together with any additional or alternative requirement.

In the event the Exchange upholds its view in spite of the reasonings as set out in our response to question 1 above, we sincerely suggest the Exchange to take into account factors such as the latest uncertain global economic outlook, and the profit requirements of the Exchange's competitors of the Exchange, and adopt a lower increase in the Profit Requirement.

3. Do you agree that the Exchange should consider granting temporary relief from the increased Profit Requirement due to the challenging economic environment? Please give reasons for your views.

Yes

No

You may provide reasons for your views.

Notwithstanding our answer to Question 1 which explains why the Exchange should not increase the Profit Requirement in spite of the challenging economic environment, given the social unrest and political turmoil (for Hong Kong region), the US-China trade war and the COVID-19 outbreak were unprecedented events involving non-economic factors; we believe it is difficult, if not impossible, to predict and assess the time required for full recovery of the economy.

However, the temporary relief illustrated in paragraph 56 of the Consultation Paper seems to assume that the aforesaid market deteriorating factors would be gone after 2020 and the economy will resume to normal by FY2022.

Although we, as legal practitioner, do not have the expertise to challenge such assumption, we believe the better option would be postponing the Exchange's current plan to increase the Profit Requirement, and re-visit the feasibility of such plan with the then up-to-date market information and statistics after the market is substantially recovered.

4. If your answer to Question 3 is yes, do you agree with the conditions to the temporary relief as set out in paragraph 55? Please give reasons for your views.

Yes

No

You may provide reasons for your views.

- End -

Reply to Question 1

We are of the view that the Exchange should not implement the proposed increase of the Profit Requirement for the following reasons:

1. **Lifting the Profit Requirement is not a solution to the Exchange's concerns**

The Consultation Paper states the Exchange proposes the increase of the Profit Requirement because, among others, (i) the implied historical P/E ratio of the listing applicants had increased significantly since the increase of the Market Capitalisation Requirement in 2018, which resulted in a number of such applicants failed to meet their profit forecast made in the IPO application and raised concerns on the reasonableness of their valuations; and (ii) Small Cap Issuers with high historical P/E ratios are presumed to apply for listing with the intention to manufacture shell companies.

(i) Significant increase of historical P/E ratios and failure to meet profit forecasts after listing.

We believe the real concern following the 2018 amendment to the Market Capitalisation Requirement is not the consequential increase in the P/E ratios of the listing applicants. A higher P/E ratio indeed indicates such applicant has a higher development potentials and should be welcomed to join the Main Board. Further, businesses in different industries also have different norms, valuation methods and volatilities of their P/E ratios. In fact, back then in December 2017 when the Exchange published the consultation conclusions on “The Review of the Growth Enterprise Market (GEM) and Changes to the GEM and Main Board Listing Rules”, certain respondents who opposed the proposal to increase market capitalisation requirement already raised the concern that the increase in market capitalisation requirement would potentially increase the implied historical P/E ratio significantly to 25 times. The response of the Exchange back then is extracted as follows:

*An implied historical P/E ratio of 25 times for a new applicant wishing to list on the Main Board under our proposals would only be required if the applicant met the Profit Requirement and the revised market capitalisation requirement exactly. In practice, most new applicants achieve profits and have market capitalisations that exceed our requirements by varying degrees. So, most applicants could list with an implied historical P/E ratio of less than 25 times. Also, the Profit Requirement and revised market capitalisation requirements are minimum standards that set the floor for the profits and market capitalisation that applicants must have if they wish to list on the Main Board. **It is not unreasonable to require an applicant to have a higher implied historical P/E ratio if it is close to meeting only our minimum requirements. This would indicate that, despite this, the market has a high degree of faith in the applicant's future prospects.** (emphasis added)*

It would be unreasonable, if not absurd, to say that a higher implied historical P/E ratio poses a problem for listing on the Main Board in just a few years' time.

The proposed increase is not fair and appropriate to applicants whose industry tends to have a higher or more volatile historical P/E ratio, and the Exchange should assess and evaluate the historical P/E ratios of each applicant on a case-by-case basis as it does currently but not imposing a standard range for all applications.

Therefore, instead of lowering the historical P/E ratios simply by increasing the Profit Requirement, we believe the Exchange should deal with the concern by, for instance, evaluating the screening methods of its IPO team, tightening its requirements on the quality and reliability of the applicant's valuation reports, taking further measures to ensure or follow up on how the applicants meet their profit forecasts after listing.

(ii) Small Cap Issuers are not the source of problem

As set out in Paragraph 21 of the Consultation Paper, the real concern should be applicants' failure to meet the profit forecast after listing and the reasonableness of their valuations made during the IPO instead of a high figure of implied historical P/E ratio. Regardless of the level of profit forecasts, the implied historical P/E ratio, which is computed based on historical figures, would not change. If the valuation is genuinely supported by the market, it appears to us there be no reason why a company which meets the Profit Requirement but simply with a high figure of historical P/E ratio should be labelled with original sin and prohibited from listing on the Main Board.

When proposing the change in Profit Requirement in the Consultation Paper, the Exchange seems to suggest that Small Cap Issuers are the source of problem. It is stated in the Consultation Paper that "*the Exchange has seen an increase in listing applications from Small Cap Issuers that marginally met the Profit Requirement but had relatively high historical P/E ratios as compared with those of their listed peers*" and the Exchange sought to justify its view by referring the public to the figures set out in Appendix III to the Consultation Paper.

The information provided by the Exchange in Appendix III however is biased:

- (a) The Exchange defines Small Cap Issuers as companies with market capitalisation of less than or equal to HK\$700 million, and the Exchange sought to justify this definition by suggesting that the figure of HK\$700 million is close to the average median market capitalisation of the Profit Requirement Applications from 2016 to 2019 (being approximately HK\$730 million). The Exchange however has totally ignored the effect of the change in market capitalisation requirement in 2018 and taken into account figures prior to the change which was effective on 15 February 2018. The Exchange has also failed to elaborate on why using the median figure is justified. Indeed, even assuming the median figure is unbiased, single out listing applicants with or below median market capitalisation would have meant that approximately half of the listing applicants with relatively low market capitalisation would be targeted by the Exchange as unwelcomed applicants.

- (b) The Exchange suggested that the proportion of Profit Requirement Applications with historical P/E ratio above 15 times increased significantly in 2018. But the very same chart produced by the Exchange also suggested that approximately 63% of Profit Requirement Applicants in 2019 had a historical P/E ratio of less than 15 times (compared to 68% and 68% in 2016 and 2017, respectively). The one-year exceptional figure in 2018 does not seem to be statistically significant.
- (c) Again even assuming the distinction between Small Cap Issuers and non-Small Cap Issuers is not without merit, the charts and tables in Appendix III fail to illustrate why Small Cap Issuers *per se* is a problem. Charts and tables in paragraphs 5 and 6 of Appendix III show that:

	Small Cap Issuers			Non-Small Cap Issuers		
	15x to 20x	Equal or above 20x	Aggregate (Equal or above 15x)	15x to 20x	Equal or above 20x	Aggregate (Equal or above 15x)
2018	38%	13%	51%	19%	47%	66%
2019	17%	7%	24%	12%	43%	55%

Profit Requirement Applications of non-Small Cap Issuers had a significantly higher historical P/E ratio than Small Cap Issuers.

It would therefore appear that the Exchange's accusation against Small Cap Issuers is not supported by the figures provided by the Exchange.

We also wish to draw to your attention that the analysis of impact of the proposed options by the Exchange as set out in paragraph 9 of the Consultation Paper is problematic. It is said that "*Option 1 and Option 2, on average, would have eliminated 62% (462) of the Profit Requirement Applications*" but that "*approximately 30% of these Ineligible Applications would not have been eligible under the current regime because these applications had proposed market capitalisation of less than HK\$500 million and relied on the previous Market Capitalisation Requirement of HK\$200 million to submit their listing applications*". This analysis, with respect, is not useful at all. To properly analyse the impact of the options, the Exchange should have provided statistics showing percentage of Ineligible Applications that would not have passed the new Profit Requirement only. By including figures prior to the introduction of revised market capitalisation requirement in 2018, the public and market practitioners would not be given sufficient and meaningful information to assess the impact of the options.

The arbitrary definition of Small Cap Issuers and proposed elimination of Small Cap Issuers in the name of addressing regulatory concern is in fact a typical Texas sharpshooter fallacy. Such unfair treatment to Small Cap Issuers is unwarranted and unjustified.

(iii) Shell companies should be eliminated by improving the rules on post-listing transfer

We believe it is not reasonable to deem high historical P/E ratio or failure to meet IPO profit forecast as a direct indicator of potential shell companies because shell companies are existed long before the increase of the Market Capitalisation Requirement in 2018, which at such time the historical P/E ratios of the listing applicants were deemed to be normal and acceptable to the Exchange.

While shell companies may historically tend to be Small Cap Issuers but we could not ignore that statistically, the majority of the listed issuers on the Exchange is Small Cap Issuers which fairly explain why there are more shell companies to be Small Cap Issuers. It would not be surprised that the proposed increase of the Profit Requirement will lower the number of shell companies not because of the huge increase in the costs for manufacturing a shell company but due to the expected sharp decrease in the number of listing applications for the high entrance barrier to be set by the proposed amendment. Nonetheless, this does not mean Small Cap Issuers, whether their IPO P/E ratios were high or not, are equivalent to shell companies.

Similarly, we believe the solution to shell companies is not increasing the Profit Requirement, but by tightening the post-listing measures in relation to the transfer of controlling stake of the listed issuers, disposal of original business or acquisition of new business by the issuers, etc.

We believe the Exchange's attempt to tackle problems by increasing the Profit Requirement will unable to supervise and prohibit applicant or issuer with strong financial power and may create an unfair listing environment to those Small Cap Issuers. It is not uncommon to see Large Cap Issuers also perform poorly in their financial results and share price shortly after their listing which cause far more damages and adverse impact on the investor public as those issuer Large Cap Issuers usually have a much broader spectrum of shareholders, especially minority shareholders from the public than those of Small Cap Issuers. Following the same logics, any wrong prediction or misconduct by the Large Cap Issuers will cause more harm than the Small Cap Issuers. It is our view that the current proposed increase of Profit Requirement does not in any way remedy the wrong prediction or misconduct by any issuer, whether the Large Cap Issuers or Small Cap Issuers especially when the Exchange has the long-established discretion and authority to deem any listing applicant unsuitable for listing.

Therefore, if the Exchange really increases the Profit Requirement for the reasons as set out in its Consultation Paper, it may also send out the wrong impression that the Exchange, being the frontline regulator of the Hong Kong stock market, does not value the importance of maintaining a fair market and exercise its duty to act impartially, favors larger size applicants; regards financial power as the primary indicator of the quality of an issuer; and chooses to turn a blind eye on the flaws of the existing rules and adopt a fast-fix and palliative measure to tackle the problems while sacrificing the interest of the Small Cap Issuers.

2. Affect the Exchange's competitiveness as one of the leading global listing platform

We note the Exchange is well aware that the proposed increase of the Profit Requirement would result the Exchange having the highest profit requirement (on the basis of aggregating the 3 years track record period) when compared to the Selected Overseas Main Markets, and the Exchange deems those potential applicants who cannot meet the new Profit Requirement may choose the alternative at the GEM platform.

We believe such prediction is a bit over-optimistic. After the re-positioning of GEM as a stand-alone board (instead of being treated as a stepping stone to Main Board) in 2018, GEM tends to be regarded by the market as a listing platform for new and pre-profit companies, and its attractiveness has also been reflected by the 80% drop in the number of new listed GEM companies in 2019.

From the perspective of those ineligible applicants under the new Profit Requirement, given they already have accumulated a considerable profit throughout the track record period, it is unlikely that they are willing to rank themselves as and listed with other pre-profit stage companies on GEM. The real alternatives to them are the main board of the other foreign exchanges.

From the perspective of the Exchange, even if it chooses to adopt the lower Profit Requirement (i.e. Option 1 at HK\$125 million), it will still be far much higher than the next two exchanges with the highest profit requirement (higher than NYSE's requirement of HK\$93 million by 34.4%, and Nasdaq Global Selected Market's requirement of HK\$85 million by 47.1%). The amendment will result in the Main Board and GEM can only attract potential applicants at highest level or the lowest level of the market, while the remaining majority with a middle level profit records will choose to apply listing at other foreign exchanges.

3. Detrimental impact on local professional intermediaries

Despite the Exchange owes no strict obligation towards the professional intermediaries working in the IPO industry, such as local small to medium size sponsor firms, law firms, accountant firms and valuation companies whose businesses are heavily dependent on the IPO of Small Cap Issuers, we believe the Exchange, as the only stock exchange in Hong Kong, should bear its social responsibility and take into consideration the potential impacts on such parties when it proposes to implement any changes to the existing rules.

Paragraph 9 of the Consultation Paper states that based on data between 2016-2019, 82% of the applicants applied listing via Profit Requirement Applications, and the proposed increase of the Profit Requirement will eliminate 62% of the Profit Requirement Applications. Given such figure does not fully reflect the impact brought by social unrest in Hong Kong began in the second half of 2019 and the global pandemic began in 2020, it can be foreseen that if the

Profit Requirement is increased as planned, the actual number of potential applicants who cannot meet the new requirement will be even more overwhelming than the above figure.

We hereby humbly submitted that the aforesaid local professional intermediaries are already facing fierce competition and great difficulties, and have been striving hard to maintain their businesses and operations amid the current economic environment. If the Exchange persists to increase the Profit Requirement, many of such local professional intermediaries will need to be downsized or closed down inevitably, and worsen the unemployment situation in each of the aforesaid professions, which will hold back the pace of economic recovery of our society.

In light of the above reasons, we sincerely recommend the Exchange to withhold the proposal of increasing the Profit Requirement.