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**BY EMAIL (response@hkex.com.hk) & BY POST**

Corporate and Investor Communications Department  
Hong Kong Exchanges and Clearing Limited  
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Hong Kong

Dear Sirs

**Re: Response to HKEX's Consultation Paper "The Main Board Profit Requirement"**

The Chamber of Hong Kong Listed Companies ("CHKLC") disagrees with the proposed increase of profit requirement of the Main Board as outlined in the HKEX Consultation Paper "The Main Board Profit Requirement" ("consultation paper"). We believe it lacks real justification and the range of increase too big, would decimate the entire corporate finance industry, and leaves no real alternative to local small and medium sized companies ("SMEs") which are denied from the Main Board. It seems that it only serves to resolve the paradoxical problem of high historical P/E ratios of small issuers resulting from the increased required market capitalization of HK\$500 million effective from February 2018.

**1) Nothing has Changed Since the Last Consultation on Profits**

It was stated in the consultation conclusion to "The Review of the Growth Enterprise Market and Changes to the GEM and Main Board Listing Rules" published in December 2017 that there was a wide market consensus that the current profit requirement for Main Board listings should be retained, and that it was on par with the majority of the Selected Overseas Markets. We see no change in that market consensus, except that the business environment has turned bad due to the social unrest in 2019 and the pandemic from 2020. The proposed change is not called for.

**2) The Proposed Change will Make the Stock Exchange of Hong Kong the Hardest to List**

The consultation paper proposes that for Main Board IPO applicants, the profit requirement be increased to \$125 million (Option 1) or \$150 million (Option 2) on an aggregated basis for a three-year track record. In either option, the profit requirement of the Main Board of SEHK on a 3-year aggregate basis would become

the highest of the Selected Overseas Main Markets referred to in the consultation paper. Moreover, the basis of calculating profit requirement of SEHK is also very stringent, using post-tax profit and excluding the contribution of associated companies and other entities whose results are recorded in the new applicant's financial statements using the equity method of accounting. Such high threshold will weaken the competitiveness of SEHK in attracting overseas companies to list or drive smaller local companies to other markets with lower profit requirement. This will result in the Hong Kong market overly-focused on large caps, mainland entities and New Economy companies. Such lack of diversification not only limits investors' choice but also excessively exposes the market to risks from particular sectors.

The current profit requirement for Main Board is already the second highest when compared to the Selected Overseas Main Markets but it cannot be said that other markets with lower profit requirement have lower quality listed companies, nor is there clear evidence to suggest SGX, which has the highest profit requirement at \$170 million of final year profit before IPO, has better quality listed companies.

### **3) The Stock Exchange Has Obligations to Serve All Companies, Big and Small**

SEHK being the monopoly stock exchange in Hong Kong has the duty to facilitate access to market for local businesses, SMEs included, that wish to raise fund for expansion or simply to list for liquidity, especially after the COVID-19 impact. Setting a threshold so high would deny SMEs from such opportunity. (We will discuss in subsequent paragraphs why the Growth Enterprise Market ("GEM") is not a viable alternative to Main Board.) This negates the purpose of the Stock Exchange itself. The Stock Exchange has the obligation to serve all types of companies, not just big businesses, unicorns or New Economy companies, but also local SMEs and traditional businesses as well.

### **4) The Proposed Change will Decimate the Corporate Finance Industry**

The Stock Exchange's analysis pointed out that the proposed IPO profit requirement would have driven out 462 Profit Requirement IPO applications between 2016 and 2019, or 62% of the applications (on average using Option 1 and Option 2 as basis of analysis). A similar impact is forecast for future applications under the proposed higher threshold.

Reducing 62% of new listing applications will decimate the entire corporate finance value chain, including sponsors, lawyers, accountants, valuers, investor and public relations professionals, many of them would be driven out of business, causing significant unemployment. The Hong Kong stock market will effectively be served only by international investment banks, lawyers and accountants. Most, if not all, local professional firms will be downsized to a minimal operation. This dampens the

economic growth prospects of Hong Kong and also its position as a human capital centre of legal, accounting and corporate finance professionals. The large reduction of IPO applications and subsequent post-listing monitoring work will also result in excess capacity of the professional staff in the Listing Division.

At a time when Hong Kong's economy is in doldrums, we doubt it is a wise move for the Exchange to deal another blow to the high income bracket professionals in the corporate finance industry.

#### **5) Small Issuers Should Not be Singled Out for Misconduct**

The consultation paper pointed out misconduct surrounding small issuers, such as reporting inflated profit forecasts at the time of IPO to justify their high historical P/E ratio and failing to meet them afterwards, share price volatility after listing, offering rebates to investors who subscribe to the IPO shares, etc. Our views remain that if there is clear evidence of market misconduct, the Stock Exchange should invoke disciplinary actions or refer the cases to authorities for prosecution on an individual case basis rather than ruling all small issuers as cronies and ban them from the market.

In addition, we cannot arrive at the same conclusion that small issuers recorded significantly higher historical P/E ratio. About 51% and 24% of Small Cap Issuers recorded historical P/E ratio of 15 times or above in 2018 and 2019 respectively, while about 66% or 55% of non-Small Cap Issuers had historical P/E ratio of 15 times or above in 2018 and 2019 respectively.

At the same time, we notice that missing profit forecast is not uncommon across listed companies. Table 4 under paragraph 39 of the consultation paper indicates that of the 208 companies listed between 2016 and 2019 that would have been eligible for the new profit requirement under Option 1, 40% failed to meet the profit forecast. This is still a very high percentage. It suggests that raising the profit requirement threshold would not solve all the perceived market quality issues. The missing of profit forecast, which is submitted as a supporting document during the IPO applications and reviewed by the Stock Exchange, could well be a result of the uncertainty involved in the preparation but not necessarily intentional.

#### **6) Large Companies are Equally Susceptible to Misconduct**

It has been pointed out by CHKLC's members in the corporate finance business that malpractices of funds misappropriation, price rebate and false pricing have also been found in sizable listing applicants, and the amount involved are substantially larger than small cap IPO applicants. For example, in an IPO case sponsored by one of the top international investment banks, advised by top international legal advisers and

audited by a top international firm, the applicant raised HK\$1 billion only to siphon it all off within six months after listing. The misappropriation was possible only because the newly-listed company had given one person unlimited bank signing authority. It was an obvious and fatal governance deficiency and internal control weakness that should have had easily caught the eyes of the Stock Exchange, the sponsor, the legal advisers and the auditors during the year-long prospectus vetting process. Nonetheless, this has gone unnoticed.

When it comes to risks, large pre-revenue or pre-profit companies present significant risks to investors as well and they are not necessarily having better quality than Small Cap Issuers. Take 18A companies as another example, of the 26 listed biotech companies on SEHK, as at 30 November 2020, the share price of 12 were below their IPO price, with one having dropped even nearly 80%.

The above illustrate small issuers are not the only culprit of wrongdoing or harming shareholders' interests. They should not be blamed entirely for the market quality issues and be banned from the IPO market.

#### **7) "Shell" Companies Issue Has Been Dealt with**

We notice one of the intended objectives of the proposal is to address the "shell company" issue. However, in our view, this issue is no longer prevalent. In its Guidance Letter 68-13A issued in April 2018, the Stock Exchange lays down seven criteria for suitability of listing with which it can exercise discretion to reject listing applications from deemed "shell" companies. The Securities and Futures Commission has also invoked power under the Securities and Futures (Stock Market Listing) Rules to object listing applications under its front-loaded regulatory approach. In addition, the Exchange implements stringent rules of prohibiting back-door listing via shell companies. The "shell" market has died down significantly.

Likewise, under its suitability test, the Stock Exchange already has the authority to reject an application if it is unsatisfied that the applicant can achieve the Market Capitalisation Requirement. There is no need to introduce further measures to deal with unsuitable applicants.

#### **8) Existing Companies Suffer Collateral Damage**

The proposed higher profit requirement does not only affect IPO applicants but also existing listed companies. A holding company that contemplates a spin-off of a subsidiary business to unlock value would find it harder to do so. This weakens our market effectiveness in value discovery and fund raising.

Listed issuers who do not fulfil ongoing listing requirements, aka 13.24 companies,

would have much greater difficulty in identifying businesses or assets profitable enough for a reverse takeover so as to re-comply with listing requirements, and would face delisting. Many 13.24 companies are long-established companies, only experiencing a business downturn. Denying them the chance to maintain their listing status is grossly unfair to their shareholders.

### **9) Why GEM is Not a Viable Alternative to Main Board?**

The Exchange proposes that small companies unqualified for the Main Board under the new profit requirement can seek a listing on GEM, but in our view that is not a viable option. In recent years, the image of GEM is much tarnished and GEM companies are labelled or perceived as potential shells or lacking investment value. As a result, GEM as a listing platform has all but dwindled. The removal of the position of GEM as a stepping stone to the Main Board further hindered investors' interest in GEM companies and also applicants' interest to list on GEM. As of December 2020, there were only 368 companies listed on GEM, decreased by 10 compared to 2019. In the whole of 2020, there were only 8 newly listed companies coming to GEM, compared to 15 in 2019 and 75 in 2018. The downward trend is irreversible. With such bad reputation and meagre performance, GEM lacks the traction to attract companies and investors. Many fund managers are mandated not to trade on GEM stocks.

The positioning of GEM is also ambiguous. GEM was established at the beginning of the first Internet bubble to cater for emerging companies and its framework is not suitable for smaller business in traditional industries. The operating cash flow requirement for GEM is in some ways more stringent than profit requirement for the Main Board. As there is no profit requirement for GEM listings, it is seen to be a market catered for emerging, pre-profit companies (other than those from the biotech sector which can be listed on the Main Board under Chapter 18A). We can foresee that companies with a three-year profit of \$50 million (the current Main Board profit requirement) would be quite reluctant to list on GEM for image consideration.

### **Our Recommendation: A Holistic Review of Market Structure**

CHKLC recommends the Stock Exchange puts on hold the current proposals and undertakes a holistic review of our market structure. The profit requirement of the Main Board can only be revised upward when there is a viable alternative for local SMEs. GEM at its present form is degraded and not an alternative listing venue for SMEs. The Stock Exchange should look into developing a genuine tiered-market structure to provide real solutions to SMEs wishing to come to the stock market. As the operator of the sole stock exchange, HKEX must fulfil its requisite duties, particularly to local businesses and practitioners.



As part of its expedited delisting mechanism, the Stock Exchange should also review whether Hong Kong should introduce a “pink-sheets” system to allow companies delisted from the Stock Exchange to continue to trade over-the-counter. This gives minority shareholders a last chance to trade themselves out of their position and salvage any remnant share value while majority shareholders could continue to seek and devise company resurrection plans.

Ultimately, the Exchange should move towards a disclosure based regulatory regime. Companies should be allowed to list as long as they fulfil prescribed conditions and abide by adequate disclosure requirements. Hong Kong investors are sophisticated enough to make informed-investment decisions based on their own risk appetite. The role of the Exchange and SFC is not to make decisions on what is good investment or not on behalf of investors but to uphold an effective enforcement and disciplinary regime to deter and penalise wrongdoings. This is the best way to maintain a healthy market and offer investor protection. With ChiNext Board of the Shenzhen Stock Exchange also adopting a registration-based IPO system that emphasises transparency and eases enterprises’ burden, Hong Kong must not lag too far behind in this worldwide trend.

Yours sincerely  
For and on behalf of  
The Chamber of Hong Kong Listed Companies

