Hong Kong Institute of
Certified Public Accountants
香港會計師公會

27 April 2006

Our Ref.: C/CFC, M40908

Corporate Communications Department
Re: Discussion Paper on GEM
Hong Kong Exchanges and Clearing Limited
12/F., One International Finance Centre
1 Harbour View Street
Central, Hong Kong

Dear Sirs,

Discussion Paper on the Growth Enterprise Market

The Hong Kong Institute of Certified Public Accountants has considered the above-referenced discussion paper, which aims to facilitate public discussion of the Growth Enterprise Market (GEM) for the purpose of enhancing its further development and ensuring that its objectives and functions appropriately align with the expectations and needs of the various market stakeholders.

The Institute's comments on the key discussion questions set out in the paper are contained in the Appendix to this letter.

In principle, we do not see anything fundamentally wrong with the GEM that could not be addressed by ensuring (i) the quality of listings and (ii) an effective, although not necessarily more stringent, regulatory regime, with proper enforcement against blatant misconduct by managements, professional advisers and sponsors, as appropriate. At the same time, active marketing and promotion of the GEM could also be stepped up to help build up and maintain its image.

We hope you find our comments helpful. If you have any questions on our submission or wish to discuss it further, please contact me at the Institute on

Yours faithfully,

Peter Tisman

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Appendix

Comments from Hong Kong Institute of CPAs in response to the Discussion Paper on Growth Enterprise Market (GEM)

Need for and Nature of a Growth Company Market

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

Yes, we consider that there is a need for a growth company market in Hong Kong to provide a channel/platform for, e.g., emerging companies and small and medium-sized enterprises, to raise capital for their business development and expansion.

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

We are of the view that the growth company market should not be designed to target companies with specific backgrounds, but should be open to any company that can meet the admission/listing criteria and find a sponsor.

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 would not advocate prescribing any particular stage of development for a company to be admitted to the growth market. The market/investors should be allowed to decide in which types of companies they would like to invest. This decision could depend upon a range of factors, such as the company's business vision, its prospects/growth potential, the background, experience and qualifications of the controlling shareholder(s) and management, etc.

We would suggest that, rather than labelling the second market as a growth company market, which could foster the impression that its focus is limited to emerging companies, consideration should be given to widening the scope of the second market to make it an alternative board for companies that cannot meet the criteria for listing on the Main Board.

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?

We would not wish to prejudge the issue of whether investor participation in the growth company market should be restricted to any specific investor group(s). In principle, investors should be free to decide where they should invest their capital. However, if the market were to be open to retail investors, regulation would need to be tighter than if it were to target, primarily, professional investors. It is a question of finding the right balance. Even if the market is open to retail investors, care should be taken not to make the regulatory regime too heavy handed and costly in terms of compliance. In this respect, we consider that, within reason, the market should adopt a *caveat emptor* or "buyer beware" philosophy and more emphasis should be placed on investor education. In this regard, the existing marketing and promotion of the GEM should be stepped up.

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?

It is not entirely clear whether the reference to "regulatory regime" is intended to mean (i) supervision by the securities market regulators, (in terms of, e.g., pre-vetting of disclosure materials issued by listed entities) or (ii) the requirements for compliance with rules and regulations (e.g., disclosure requirements). In our answer below, we assume that it covers both (i) and (ii).

We consider that there must be a balance between the costs (both entry and on-going compliance) to be borne by companies listed on the growth company market and the requirements of the regulatory and disclosure regime. We would suggest that the regulatory regime of the growth company market should be no less onerous than that of the Main Board. In order to encourage the development of a growth company market in Hong Kong, in principle, we would advocate a reasonably low-cost regime to attract suitable candidates to make use of this market for raising capital from the public, via both initial public offering and post-listing capital market transactions. However, at the same time, it should also be acknowledged that companies intending to list on the second market would tend to be a higher risk investment and they cannot expect to enjoy the lowest cost access to capital. If the regulatory and disclosure regimes are too lax, the risk of failures and possible scandals could increase, which would be detrimental to the reputation of the market as a whole.

Given the success of London's Alternative Investment Market (AIM), we would suggest conducting a more detailed study of AIM and other relevant markets in order to understand more fully the factors and features leading to their success and, in particular, where they strike the balance between reducing costs and ensuring adequate regulation and compliance.

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

This is an option that merits some consideration, but we would not favour positioning GEM essentially as a stepping-stone to the Main Board, otherwise good companies would seek to migrate to the Main Board as soon as possible, leaving only poorly-performing companies as the long-term constituents of the GEM. This in turn could create a negative image for the GEM and reflect badly on those companies that, for whatever reason, do not intend to transfer to the Main Board, or are not capable of doing so within a certain period of time. Nevertheless, there will always be some companies that wish to transfer to the Main Board, just as they do from the NASDAQ to the New York Stock Exchange, for example, and, provided they meet the necessary entry requirements, they should not be prevented from doing so.

Accordingly, in order to improve the attractiveness of GEM as a market for raising capital, and for GEM-listed companies to continue their presence in the market, the GEM should endeavour to develop its own branding rather than align itself too closely with the Main Board. It would be more appropriate for GEM to be operated independently (e.g., as a subsidiary of the Stock Exchange with a separate governance board, management team and staff, independent from those of the Main Board) and as an alternative market to the Main Board.

(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;

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 option is not preferred. Since GEM companies and Main Board companies have not been required to meet the same listing criteria, it would be inappropriate to grandfather all GEM companies onto the Main Board without any distinction between them and Main Board companies. As regards a two-tier Main Board, we believe that this would not be the best option from a presentational point of view, apart from anything else, as it would be more likely to engender the perception of there being first-class and second-class companies on the Main Board.

(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.

As indicated in (b) above, we consider that it would not be appropriate for GEM to merge with the Main Board. Nevertheless, we agree that there should be an alternative market for companies that do not meet the criteria for listing on the Main Board, but which are otherwise good companies with positive business prospects.

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

We consider that GEM should be positioned as an alternative board for companies with good prospects but which may not meet the criteria for listing on the Main Board. As such, it is more appropriate for GEM to be operated independently from the Main Board, e.g., as a subsidiary of the Stock Exchange managed by a separate governance board and management team, and operated by a team of staff, who are separate from those directly involved in the Main Board.

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

(a) the targeted issuers (e.g., type of business, stage of development) and investors (e.g., retail, professional, institutional),

Please refer to our answers to Q2, Q3 and Q4.

(b) the regulatory approach,

Please refer to our answer to Q5.

(c) the initial listing requirements and the listing process,

The initial listing requirements should be designed to fill the gap and cater for companies that are currently unable to meet the criteria for listing on the Main Board. As such, the GEM initial listing requirements should be less restrictive than those of the Main Board in order to make it easier for smaller companies to gain access to public capital. The risks of investing in GEM companies could be mitigated by way of additional disclosure.

The initial listing requirements need not differ substantially from the requirements currently adopted by GEM, except that the requirement for listing applicants to have "one focused line of business" should be reviewed. In addition, we suggest that the GEM rules should specify experience criteria for compliance officers of GEM companies, given the importance of their role and responsibilities in ensuring the companies comply with the GEM Listing Rules and other relevant laws and regulations.

As regards the listing process, we consider that it should be no less onerous than that of the Main Board. Reference could be drawn from other successful markets, e.g., AIM and NASDAQ.

(d) the process of ongoing regulatory supervision, and (e) the disclosure and corporate governance requirements, and

We are of the view that these should be no less onerous than those of the Main Board. Given the inherent risk of the growth company market, we consider that, within reason, the market should adopt a *caveat emptor* or "buyer beware" philosophy.

We would suggest that the role of the compliance officer in GEM companies should be more clearly spelled out and supervision improved.

(f) the roles of sponsors and other professionals?

In respect of company failures, we are of the view that largest share of the blame should fall, where it is due, which will often be, firstly, on the company's management. Sponsors and professional advisers and other professionals, on the other hand, who are not involved in the day-to-day management of the company, and who may not have access to all the relevant information about the company, should be answerable primarily for their own misconduct or negligence in performing any due diligence work that is clearly within their sphere of expertise and/or reasonable responsibility. At the same time, there should also be safe harbour rules for sponsors and advisers who perform their roles with due competence and act in good faith.

It is suggested that there should be a more robust regime for regulating sponsors/ advisers and other professionals. Securities market regulators should be given more teeth in carrying out their regulatory role and should be prepared to take necessary enforcement action, e.g., by imposing more severe sanctions on non-compliance and wrongdoing. It is believed that effective application of the rules/ regulations, and the imposition of strong sanctions against the "bad apples", would encourage greater vigilance in relation to due diligence work and more selectivity in bringing good quality companies to the market. This should help to improve the overall quality of companies listed on GEM and thus improve the standard of the market as a whole.

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?

Not applicable.

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

No specific view.

<u>Other Issues</u>

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

There is scope for more effort and resources to be devoted to promoting the growth company board to potential markets and listing candidates, as well as to professional and institutional investors, and to the public. We believe that listing of more internationally-recognised companies on the growth company board would help improve the overall profile and standing of the board.

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

No specific view.

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?

No specific view.