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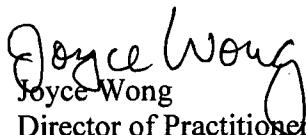
Corporate Communications Department  
Re: Discussion Paper on GEM  
Hong Kong Exchanges and Clearing Limited  
12/F, One International Finance Centre  
1 Harbour View Street, Central, Hong Kong

Dear Sirs,

**Re: Discussion Paper on the Growth Enterprise Market ("GEM")**

I attach copy submissions on the captioned Paper prepared by the Law Society's Securities Law Committee for your further action.

Yours faithfully,

  
Joyce Wong

Director of Practitioners Affairs

c.c. Securities Law Committee  
Encl.

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## **The Law Society's Submissions on the Discussion Paper on the Growth Enterprise Market**

The following is the response of the Securities Law Committee (the "Committee") of the Law Society of Hong Kong to the key discussion questions raised in Chapter 5 of your Discussion Paper on the Growth Enterprise Market dated January 2006 (the "Discussion Paper").

### **Introduction**

In tracing the development of Hong Kong's Growth Enterprise Market ("GEM"), the Discussion Paper notes the finding of the International Committee on Listing of New Enterprises appointed in 2000 that "*the perceived need to make GEM competitive with overseas listing venues should not be overstated. While acknowledging that competition was a factor, the committee noted that enterprises preferred to list at home*"<sup>1</sup>. As detailed in the Discussion Paper, London's Alternative Investment Market ("AIM"), which is a lightly regulated, disclosure-based, caveat emptor market, is now by most measures the leading growth enterprise market in the world. In contrast, GEM had only 10 new listings in 2005<sup>2</sup>. Indeed, the greater regulatory and compliance burdens on GEM companies and the often protracted and expensive listing application process, have meant that AIM is fast becoming the growth market of choice for many Hong Kong and PRC companies. Of perhaps more concern is that AIM, with its lighter regulatory regime and straightforward listing application process, is also coming to be regarded as a preferable listing venue to the Hong Kong Main Board for a growing number of Hong Kong and PRC companies. It should be noted that while supposedly a growth company market, AIM has attracted a number of substantial enterprises: the top 50 companies all have a market capitalisation of more than £100 million. AIM already lists 247 international companies. Its ambition for the coming decade is to establish itself as the market for growth companies internationally. If Hong Kong is to retain its position as the pre-eminent home market for PRC and Hong Kong enterprises, it needs to recognise that it is no longer true today that these enterprises prefer to list at or near home. Such companies are increasingly looking to acquire assets overseas. An overseas listing offers the added attraction of enabling these companies to raise their profile with overseas investors and tap new sources of capital. To retain its position as the leading market for PRC and Hong Kong enterprises, Hong Kong now needs to compete with overseas listing venues and, in particular, with London's AIM.

The Stock Exchange website describes GEM as "A 'Buyers Beware' Market for Informed Investors". As described in the Discussion Paper, it was originally proposed that GEM should

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<sup>1</sup> Page 20 of the Discussion Paper.

<sup>2</sup> Page 23 of the Discussion Paper

be a disclosure-based, lightly regulated market administered separately from the Main Board. It was also intended that GEM would have a more straightforward listing application process than the Main Board and that more reliance would be placed on sponsors. Today however, the regulatory and compliance burden on GEM listed companies is equally as onerous as that on Main Board listed companies. Unless steps are taken to improve the attractiveness of GEM as a listing venue, it will be difficult to stem the flow of growth companies to AIM.

In addition, it is often claimed by Hong Kong's regulatory authorities that the intention is to establish Hong Kong as a truly international finance centre. If this is the case, Hong Kong should actively promote itself as a listing venue for overseas companies. This would however require steps to make it easier for overseas companies to list in Hong Kong. Currently, a company incorporated in a jurisdiction other than Hong Kong, the PRC, Bermuda or the Cayman Islands must satisfy the Exchange that the standards of shareholder protection in its jurisdiction of incorporation are at least equivalent to those provided in Hong Kong<sup>3</sup>. In the case of a secondary listing on the Main Board, the Exchange must also be satisfied as to the equivalence of standards of shareholder protection on the exchange of the company's primary listing<sup>4</sup>. This creates unnecessary uncertainty for listing applicants from well-developed legal jurisdictions. The fact that the burden of proof in establishing the equivalence of shareholder protection is placed on the applicant also means that the listing application process for overseas companies is often unnecessarily drawn-out and expensive. Attempts should therefore be made to ensure that the listing process is equally straightforward for all listing applicants, whatever their domicile.

### **Question 1: Is there a need for a growth company market in Hong Kong?**

The Committee agrees with comments reflected in the Discussion Paper that Hong Kong should have a comprehensive and diversified capital market and should provide facilities for both smaller growth companies and larger, established companies to access public capital. A growth enterprise market is particularly important in providing an exit route for venture capitalists and a venue for further fund raising for venture capital investments. It also has a significant role to play in allowing entrepreneur and family-owned companies to expand and in facilitating management buy-outs and buy-ins.

The Stock Exchange should adopt a clear policy for the small company sector. If it does not wish to serve this sector, the SFC should nominate a separate exchange to do so. To not provide for the SME sector, which will potentially be the most dynamic sector of the market in the long term, would be to the detriment of Hong Kong in the longer term. It needs to be appreciated that the establishment of a successful growth market is a long term proposition. As noted in the Discussion Paper, AIM was widely considered to be a failure four years after its launch. Today it has eclipsed its rivals, the Europe-wide Easdaq and Germany's Neuer Markt.

### **Question 2: If so, should the market primarily serve local Hong Kong companies, or should it target Mainland-based companies or regional/international companies?**

As already noted in the introduction above, if Hong Kong is to become a truly international finance centre, it should, like London's AIM, be more open to listings by overseas companies.

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<sup>3</sup> Rule 19.05(1)(b) of the Main Board Listing Rules and Rule 24.05(1)(b) of the GEM Listing Rules.

<sup>4</sup> Rule 19.30(b) of the Main Board Listing Rules.

This would necessitate amendments to the listing rules to make it easier for overseas companies to list.

Hong Kong should then offer an equally streamlined listing application process for companies from all jurisdictions and not target companies from any particular jurisdiction. London's AIM welcomes companies from all jurisdictions and has been particularly successful in attracting companies from the growth markets of China, India and Russia.

**Question 3: At what stage of development should companies be admitted to the growth market - at start-up stage, or at a more mature stage?**

There were divergent views among members of the Committee on this issue. Some members considered that only those companies that have developed to a certain stage and size should be permitted to list on the new board and that start-up companies (ie. those with no trading records) should be funded by venture capital funds, angels, banks and incubators rather than being allowed to list. The suitability criteria for the new board would need to be the subject of a separate consultation.

Other members felt that the new growth market should be a "buyers beware" market as was originally intended for GEM. Start-up companies should therefore be allowed to list so long as the investment risks are clearly disclosed in admission documents. The commercial viability and investment merits of individual listing applicants would then be assessed by the market. If start-ups were to be allowed to list, this might strengthen the argument for restricting the market to sophisticated investors.

Committee members agreed however that restrictions should be imposed on "cash shell" companies. These could be based on the AIM requirements for investing companies to raise a minimum amount on listing and to have a detailed investment strategy which must be approved by shareholders annually.

There was also agreement that a certain degree of responsibility for ensuring applicants' suitability for listing could also be placed with sponsors who could fulfil a similar role to that assumed by nominated investment advisers ("nomads") on AIM.

The Committee also agrees with the comment that, on any growth board, it must be expected that a certain proportion of companies will fail. Such failures should not however be considered to be a failure of GEM itself, nor should they affect the reputation of the Hong Kong main market. Indeed, the latter concern could be addressed by ensuring that the new growth market is entirely separate from the Main Board. It also needs to be recognised that, if sponsors are to assume the role of AIM's nomads, some growth companies will fail, however assiduous the sponsor and however stringent the regulation of sponsors. In summary, the Exchange should not attach too much importance to the risk of growth company failures.

**Question 4: 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?**

This was another issue on which there were differing views among Committee members. It was felt by some members that shares of companies listed on the new growth company market

should, at least initially, be offered to and traded by suitably sophisticated investors only. Anti-avoidance measures would also be required to prevent retail investors gaining indirect access to the market, for example through over-the-counter derivatives. The issue of greater access could be revisited after the market has been running for, say, two years.

Other members considered that the growth company market should be open to all investors, including retail, provided that there is clear disclosure of risks. Different groups of investors would then determine for themselves whether the potential for higher returns is worth the greater risk. These members considered that, as the current GEM market is open to retail investors, there would have to be good reason for stepping backwards from this position.

**Question 5. 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?**

There were again differing views on the on-going regulatory regime for growth companies and it was felt that this should be the subject of a separate market consultation. It was however generally felt that there should be some relaxation of the current listing rule requirements to make a GEM listing more attractive to listing applicants which should be achievable while maintaining the integrity of the market. If a new market is to be established, it needs to be distinguishable both from the current GEM market and the Main Board.

The Committee also considered that the function of sponsors/compliance advisers should be strengthened by requiring a sponsor to be appointed for so long as the issuer's shares are listed on GEM. The issuer should be required to consult and take the advice of its sponsor on any matter governed by the listing rules. The sponsor would also act as the main conduit for the passage of information between the issuer and the Stock Exchange. If an issuer ceases to have a sponsor, its shares should be suspended immediately and, if a new sponsor is not appointed within a specified period, its shares should be delisted. The market should be consulted regarding the new sponsor and delisting regimes.

It was also felt that the new market should be a true alternative market which would compete against the Main Board in the same way as NASDAQ competes against the New York Stock Exchange. It should be administered entirely separately from the Main Board and should have its own staff and rules.

The listing application process should be simpler, faster and therefore less costly than that for the Main Board. The current approval process for listing GEM applicants imposes significant costs on applicants relative to the size of their business operations and the amounts they raise and delays their access to public capital. A more streamlined listing application process should be adopted to provide growth companies with faster, low cost access to the market.

**Question 6: 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:**

(a) GEM as a second 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.**

**(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.**

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

The Committee favours option (c), namely the establishment of a new alternative growth company market. As outlined in the response to Question 5 above, this should be an alternative market with a lighter regulatory regime than the Main Board which would be administered separately from the Main Board.

**Question 7: Based on your preferred structural option for GEM, do you have any specific views or recommendations concerning the following?**

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

As outlined above in the responses to questions 3 and 4, there were differing views among Committee members on these issues. It was however felt that while the market should be open to companies from all business sectors, the Stock Exchange should be conscious of the risks of any one sector becoming dominant.

In any event, investment risks should be dealt with by clear disclosure in the listing documents. AIM's insistence on plain language should also be emulated by the growth board. Another suggestion is to make the commissioning of a long-form report (ie. a detailed due diligence report) by listing applicants mandatory. While long form reports are typically requested by AIM nomads, there is no regulatory requirement for an AIM listing applicant to commission such a report.

**(b) the regulatory approach**

Please see the response to Question 5 above. In general, the Committee favours a lighter regulatory regime than that for Main Board companies and an enhanced role to be played by sponsors.

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

Please see the response to Question 3 above.

As already noted, the question of suitability for admission could, to a certain extent, be

answered by the sponsor. The Stock Exchange needs to recognise, however, that the sponsor cannot, and should not, be required to guarantee the success of any individual listing. As already stated above, it is inevitable that a certain proportion of growth companies will fail and this will remain the case however meticulous the sponsor's due diligence and however demanding the regulation of sponsors.

Risks should be disclosed in clear, plain English. This could be backed up by a requirement for a directors' statement as to the sufficiency of working capital and, as mentioned above, for a regulatory requirement that the listing applicant commissions a long form report.

The listing process should be more straightforward and quicker than that for the Main Board to allow growth companies low cost access to public capital.

**(d) the process of ongoing regulatory supervision**

Please see the response to (b) above.

**(e) the disclosure and corporate governance requirements**

As highlighted in the response to Question 5, there were different views as to the on-going regulatory regime for companies listed on the new board. As a general comment, however, the new board needs to be made more attractive to companies than the existing GEM board and the Exchange needs to ensure that the new board does not end up following the same path as the existing GEM, that is starting out as a lightly regulated board but ending up as a heavily regulated market whose compliance costs make it unattractive to issuers.

As a minimum, there should be disclosure of price sensitive information, dealings by directors, changes to significant shareholders and substantial and related party transactions. Provided that issuers are obliged to disclose price sensitive information about changes in financial condition, sphere of activity, business performance or expectation of business performance, financial results should be required half-yearly rather than quarterly.

As to corporate governance, companies should be required to use best efforts to comply with the provisions of the Code on Corporate Governance Practices.

As a general comment, if the Exchange wishes to see more PRC companies (or indeed companies from other growth markets such as India) listing in Hong Kong, whether on a new growth company market or on the existing Main Board, it needs to acknowledge the gap in corporate governance standards between companies from developing countries and those from developed jurisdictions and the risks associated with the former. These risks are perhaps best dealt with by way of disclosure and the adoption of a "let the buyer beware" philosophy.

**(f) the roles of sponsors and other professionals**

A degree of AIM's success is attributed by the Discussion Paper to its nomads whose performance is explained by the LSE's supervision and the importance of reputation<sup>5</sup>. Hong

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<sup>5</sup> Page 44 of the Discussion Paper.

Kong is however also served by a highly-regarded community of professionals, in particular sponsors, accountants and legal advisers. The Practice Note on Due Diligence and related listing rules implemented in January 2005 already impose stringent obligations on sponsors. While there have been reservations regarding the competency of a handful of sponsors, any doubts as to the competency of Hong Kong's sponsors to fulfil a similar role to that assumed by AIM's nomads should be removed on the implementation of stringent new eligibility criteria and on-going obligations for sponsors and compliance advisers with effect from January 1, 2007. It should also be noted that there have been few disciplinary actions against Hong Kong sponsors. For the overwhelming majority of sponsors, bringing good companies to the market is essential to maintaining their professional reputation.

As noted in the response to Question 5, the Committee favours an enhanced role for sponsors/compliance advisers. Companies listed on the new growth market should have a sponsor/compliance adviser at all times who would perform a similar role to AIM's nomads. As noted above, however, the regulation of sponsors and compliance advisers is already extremely stringent and the Exchange needs to recognise that some growth companies will fail however meticulous their sponsors in performing due diligence and their on-going obligations. In particular, sponsors cannot and should not be required to assume the responsibilities of the issuer's directors, who should remain primarily responsible for the issuer's compliance with the listing rules, or those of other professionals, in particular the accountants who must be responsible for the accuracy of financial statements.

If continued listing on the new market is to depend on the retention of a nomad-type adviser, the adviser's obligations should be framed along the lines of existing GEM Listing Rules 6A.23 and 6A.24. That is to say that the circumstances in which an issuer must consult its adviser should be set out and the adviser's own obligations should then be conditional upon having been consulted by the issuer.

**Question 8: 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?**

A growth enterprise market is necessary in Hong Kong.

**Question 9: What, if anything, should be done with delisted companies? Should there be a separate market for trading these companies?**

Trade in these stocks should be facilitated.

**Question 10: Do you have any suggestions to raise the profile of companies listed on the growth company board?**

The key to raising the profile of companies listed on the growth company board is to change the regulatory approach to growth companies as described above so that a new growth enterprise market can be successful in the long term.

**Question 11: Should more information be provided on growth companies? If so, what information, and who should provide it?**

Efforts should be made to ensure that information in prospectuses is presented in clear, plain



English so that it can be easily understood by investors. As regards on-going disclosure of financial information, half-yearly (instead of quarterly) reporting should be required.

**Question 12: Should market making be permitted on the growth company board? If so, what should be the obligations of and incentives provided to market makers?**

The Committee considers that there should be a market maker or liquidity provider regime so as to provide liquidity to the market whereby a seller wishing to sell, or purchaser wishing to buy, can find a counterparty. The criteria for being a market maker and business practices should be the subject of a separate consultation which should take into account the existing safeguards against insider dealing and other forms of market misconduct under the Securities and Futures Ordinance.

As a final comment, the Committee would add that the regime for the new market should be kept under constant review by the Exchange and should probably be the subject of a further public consultation once it has been in operation for a period of, say, two years.

**The Law Society of Hong Kong**  
**The Securities Law Committee**  
**28 April 2006**

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