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The Proposed New Board and Proposed Changes to the GEM and Main Board Listing Rules

The New Board Concept Paper makes the case that Hong Kong has failed to attract many new economy companies to list here. This is regrettable and it is good that HKEX is looking at ways to make our Exchange more attractive to new economy companies.

New economy companies: What should HKEX be trying to attract to list on its platform?

Of course, what is 'new economy' will change over time (for example, at one time railways were new economy and in the 1920s, the popularization of radio and automobiles led to the emergence of companies such as RCA and Ford - being what we might call the new economy companies of their day). Defining what is 'new economy' is not a worthwhile endeavor. What may be regarded as new economy businesses will change over time; this is a fact that we need to accept. Accordingly, it is pointless to try to define precisely or even to limit it to certain industry sectors – change and innovation are inevitable. It is one of those situations where the regulators should know a new economy company when they see one even if 'new economy' cannot be defined exactly. We would be happy with it being left with the regulators to decide whether an applicant is or is not a new economy company on a case by case basis. What does matter is that Hong Kong Inc. remains competitive as an international financial centre and that our stock exchange is an attractive listing venue for quality companies which are at the forefront of change and new business.

The establishment of GEM was a direct result of the commitment to study proposals for a venture board for smaller and emerging technology companies set out in the then HKSAR Chief Executive's 1998 Policy Address. The May 1998 Consultation Paper on a Proposed New Market for Emerging Companies proposed GEM as an alternative market to the Main Board which would be lightly regulated and disclosure based and would discourage retail investors by setting a high transaction minimum – HK$250,000 (this proposed transaction minimum was eventually not adopted).

GEM was established to attract tech companies (the new economy companies of their day). It was felt that the entry requirements for the Main Board would prohibit many tech companies from listing on it and that Hong Kong needed a new board with different entry requirements for such tech companies. Unfortunately, GEM but has not succeeded in terms of its original objective. In terms of percentages of listed companies from different industry sectors, GEM is not all that different from the Main Board and neither have heavy tech (or indeed, new economy) weightings. Moreover, in recent years there have been a number of well-publicized problems with the GEM market, in particular in the areas of shell creation and market manipulation.

Given that the background to the establishment of GEM almost two decades ago, echoes the current objectives put forward to justify establishing a new board, we should be careful to learn from the experience of GEM.

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Having said that we do not consider it meaningful to try to define exactly what is a 'new economy' company, if the Stock Exchange is going to have special admission requirements or a new board to attract new economy companies to list on its platform, we feel that we should focus identifying what sort of features such companies should have in order to justify being eligible for relaxed eligibility for listing criteria.

We think that Hong Kong should be looking to attract new economy companies which have reached a stage of development or market validation such that they will command a high market value, regardless of whether they have a history of profits or cashflow or other metric. Companies which have not reached this level should rather seek funds from angel investors or venture capital investors. One comment that we have heard in the market is that many small early-stage tech start-ups need a new board in order for them to raise money because they are unable to raise money from angel and venture capital investors. Frankly, this is misguided thinking. There are substantial pools of money managed by angel investors and venture capital investors. Such investors are close to industry developments and it is their profession to try to sort the wheat from the chaff; they are professional risk-takers. If these experienced and skilled investors do not consider a particular early stage tech or new economy company which is looking for early stage investment to be suitable for investment, why should we unleash such a company on the market to try to raise money from investors with far less knowledge, skill and experience? Surely, we should be trying to attract new economy companies (which may well be pre-profit or pre-revenue or even pre-commercial product (for example, with drugs in trials in the pharmaceuticals sector)) which have achieved validation by already having angel and/or venture capital investors on board.

We should not get hung up on thinking that good companies make profits. For many new economy businesses, growing market share is the primary objective and profitability is sacrificed (quite rightly) to achieve that aim. Many household name companies in the new economy sector were seen as successful and attracted large market capitalizations even though they were loss-making for a number of years. Examples are legion – a few such cases are Amazon and Twitter. Requiring a track record of profits in order to be suitable for listing is just not meaningful in such situations. When Amazon applied for listing in the US in 1997 its business was just three years old and Amazon stated that profits were not in sight. Amazon's IPO raised US$54m giving the company a market value of US$438m. – Amazon's market capitalization today is about US$472bn. Twitter, which listed at the end of 2013 (its initial market capitalization based upon the IPO price was about US$18bn), is still not profitable. Snap listed earlier this year on the NYSE raising US$3.4bn and having an initial market capitalization of about US$24 billion based on the IPO price – it is still loss-making.

There are numerous high-profile 'unicorns' which the market is expecting to go public, such as Spotify, Airbnb, Uber, Pinterest, SpaceX, Xiaomi, Didi Chuxing, Toutiao, Ant Financial and so on. These are the types of companies that HKEX should be seeking to attract to list on its platform. There are many such companies and the amounts of money that they will raise in the equity markets will be enormous. It would be tragic if Hong Kong were to miss out on this sector of the market. On the other hand, we can afford to miss out on the low value early stage new economy companies which should really be raising money from angel or venture capital investors before turning to our public market.

Proposed new board with two tiers

New Board Premium

New Board Premium is essentially the same as Main Board save that weighted voting rights and other non-standard governance structures (collectively, "WVR") would be permitted and US-listed companies with standards different from those in Hong Kong would be permitted to list. New Board Premium would have similar entry requirements to the Main Board (and like Main Board will require a minimum 25% public float and minimum 300 shareholders). The vetting process would be the same as it is for applicants for listing on the Main Board –there will need to be a sponsor firm which will carry out the same sponsor due diligence as for a Main Board listing and the application will be tabled before the Listing Committee for approval. Both retail and professional investors could invest and trade in companies listed on this tier. This all begs the question, why have a new board? We could achieve all of this by utilizing the existing Main Board.

New Board Pro

New Board Pro would be for new economy companies only. There would be no financial track record requirements – it is aimed at attracting companies which are pre-profit and/or pre-revenue (as GEM originally was). The regulatory regime is positioned as light-touch. There is proposed to be no requirement to have a sponsor (just a financial adviser) and so the existing sponsor due diligence regime would not apply, disclosure will instead be based upon the judgment of the financial adviser as to what investigations are appropriate. This must be lead to major concerns about the likely quality and depth of the disclosure in the listing documents. Applications will not be submitted to the Listing Committee for approval but rather will be approved by the Listing Department. There are existing views in the market that GEM listing applications should be tabled before the Listing Committee for approval (GEM is considered a higher risk market for investors than Main Board yet applications are not subject to scrutiny by the Listing Committee). Having an even higher risk market where applications are not subject to scrutiny by the Listing Committee seems counter-intuitive. Surely, the Listing Committee adds the most value in high risk cases.

New Board Pro would only be open to professional investors and there would be a minimum market capitalization requirement of HK$200m. However, with a market capitalization of HK$200m and a proposed minimum 25% public float would mean that we could see such companies seeking to raise a mere HK$50m from professional investors. Obviously, institutional investors will not be interested in such companies with such small market capitalizations and even smaller public floats. For these smaller cap listings on New Board Pro, it will most likely be so-called 'professional investors' who will take up the shares. Professional investors for these purposes are essentially individual investors with portfolios totaling at least HK$8m or corporate professional investors – such persons/entities do not need to invest as their professional occupation and are not necessarily skilled in the investment field. (It was not that long ago that we witnessed many professional investors in Hong Kong buying mini-bonds and accumulators without fully understanding what they were investing in and what risks they were taking.)

One of the problems that we have seen, with GEM in particular, is the concern in the market that many companies which have applied for listing have been done so to create a 'shell' to enable the listing status to be sold. We should be careful not to establish a new board which would be ripe for this type of activity which is damaging to Hong Kong Inc.'s international reputation as a financial centre.

By and large, Main Board works very well. The sponsor regime imposes rigorous due diligence obligations on sponsors who themselves have to be accredited by the SFC to carry out sponsor work. Sponsors are expected to act as a first line gatekeeper. Rather than establish a new board with two tiers, one of which will have no sponsor requirement, we believe it would be better to attract quality new economy companies to list on the Main Board. The key to this, in our opinion, is to restrict the relaxations of the existing new listing eligibility requirements to new economy companies with large market capitalizations – we would propose that such applicants should have a minimum market capitalization of US$1 billion. The three year profit requirement could be waived (or abolished) for such applicants to allow early stage but high-value companies to list. WVR should be permitted for such companies listed on the Main Board and they should be given a special designation on their stock codes so that it is very visible to investors which companies have WVR structures and which do not.

There would be more safeguards this way and it is far harder to manipulate trading in really large capitalization stocks - the trading prices of such stocks will be determined by institutional shareholders.

The idea of a 'professionals-only' market with companies listed having a market capitalization as small as HK$200m which implies a public float of as low as HK$50m will result in companies with no real liquidity or, even worse, manipulated trading. Further, one has to wonder what the spread of shareholders in such a company will likely be. Further, it may not be an attractive platform - one only has to look at what has happened to the IPO market for Chapter 21 investment companies following the introduction of the requirement that the shares of such companies cannot be offered to the public in Hong Kong but can only be offered to professional investors here (or to investors offshore) - there have been no IPOs by Chapter 21 investment companies in Hong Kong in the last 5 years. The disclosure levels will also be less and without a sponsor there will be an unacceptably low level of gatekeeping and due diligence. Adding it all up, New Board Pro does not seem the way to go; enhancing Main Board is a much better alternative.

If we set the minimum market capitalization high enough for whatever measures/relaxations (such as WVR and so on) are introduced to attract new economy companies to list in Hong Kong, it will make it prohibitively expensive for miscreants to try to use any new relaxation of the rules or new board to create shells. Further, listing applicants with large market capitalizations will need to attract institutional investors – they will undoubtedly need to raise money from this sector in order to be successful in raising the relatively large IPO proceeds that will reflect their market capitalizations. For companies in this situation, trading in their shares on the Exchange will as a result be liquid and the market price will be set by the trading of institutional investors (who should be better placed to know what they are doing) not by retail investors.

Secondary listing of Mainland companies

A good proposal is the one to allow the secondary listing of Mainland companies. Presently, HKEX forces companies with their centre of gravity in China to make a binary choice between listing in Hong Kong or listing overseas. If they choose to list overseas, then they are prohibited from applying for a secondary listing on HKEX. It is proposed to allow Mainland companies to apply for secondary listing on both tiers of the new board. Whilst we have reservations about the establishment of the new board, we are very much in favour of abolishing the prohibition against permitting the secondary listing of Mainland companies. We would welcome many of the overseas-listed new economy Chinese businesses to list on the Main Board by way of a secondary listing.

GEM

The abandonment of the ill-judged re-positioning of GEM as a stepping stone to Main Board is to be welcomed. This was not the original intention behind the establishment of GEM and its subsequent re-positioning as stepping stone has created many of the problems which cloud the GEM market.

Summary

To sum up, we totally support the objective of making the HKEX more attractive to new economy stocks, we just cannot see this proposal as the best way in which to achieve this aim. We believe that we should focus on enhancing the Main Board as the venue to attract such companies. To that end, we should be working to develop a ring-fenced WVR category of Main Board listed quality new economy companies with large minimum market capitalizations which will add liquidity to Hong Kong's market.