

From: Matthew [REDACTED]  
Sent: Sunday, June 25, 2017 3:06 PM  
To: response  
Subject: Consultation Paper on Review of the Growth Enterprise Market (GEM) and Changes to the GEM, and Main Board Listing Rules

Dear Sir,

I am responding to the above consultation paper. I am a former employee of HKEx, involved for more than twenty years in researching the securities markets, and also involved specifically in the 2006-08 GEM review.

I am concerned at the proposals in the paper, which seem to amount to an abandonment of the Exchange's responsibility for nurturing companies for listing on the Main Board and which seem illogical as well. Together with the New Board proposals (on which I have commented separately), they would, if implemented, result in a contorted market structure which would not serve Hong Kong well.

My main comments are below. A completed questionnaire is attached.

Firstly, the proposed market structure, under which GEM is a stand-alone market without linkage or privileged transfer rights to the Main Board but yet with almost identical regulation, is strange. Given that there would be two further markets (New Board PREMIUM and New Board PRO), again apparently without privileged access to the Main Board, we would be looking at a total of four unconnected markets in Hong Kong - almost, as one commentator has pointed out, a reversion to the pre-1986 era of four competing exchanges. This is surely bizarre.

Secondly, while it is granted that the current GEM has problems (albeit see discussion under fifthly below), the paper proposes substantial solutions to these, in terms of mandated public offering and prospectus, increased thresholds, and so on. Why is it necessary, having implemented these solutions, still to disconnect GEM from the Main Board? That doesn't seem logical.

Thirdly, the solutions implemented on GEM will effectively turn it into the lower stage of the current Main Board. As the paper states, the thresholds for GEM are to be raised close to, or even exceeding, those of the current Main Board, while the Main Board thresholds will be raised to a higher level. GEM regulation will become even more like that of the Main Board. In effect, GEM will become part of the current Main Board. Why under this structure should the Main Board-ised GEM not continue to be a stepping stone to the Main Board?

Fourthly, the paper acknowledges that GEM has had 'limited success' - and then proceeds to use that as a reason for reforming it and disconnecting it from the Main Board. But limited success is still success! GEM currently has some 260 issuers, and has provided graduates to the Main Board every year - a total of 79 of them since the 2008 reforms. This is not something bad, it is something good! Quite a few overseas exchanges would be pleased to have a market like GEM.

Fifthly, the problems identified on GEM appear to boil down to the prevalence of shells and the extreme price movements which might indicate manipulation. However, the shells problem affects the Main Board as well, and could be addressed by, among other measures, a more vigorous approach to delisting. The extreme price movements certainly warrant attention, but if there is manipulation, why has this (apparently) not been prosecuted over the past nine years? There is surely adequate regulatory apparatus to address manipulation, including the Market Misconduct Tribunal. The argument that GEM companies transferring to the Main Board affect the latter's reputation rings hollow when one considers

how many loss-making and defunct companies there are on the Main Board. The GEM graduates are surely not the worst.

The paper leaves one with the unfortunate impression that the real problem of GEM, and perhaps also of the Main Board, lies not with the issuers but with the Hong Kong regulatory approach. This approach relies heavily on the imposition of high merit-based quantitative requirements. But high quantitative requirements, while they act as an effective bar to smaller companies (so reducing the economic usefulness of HKEx's market), are no guarantee of quality or probity. Imposing yet higher requirements, as this paper proposes to do, may yield no better result than the lower ones presently in force. And if so, what then? Would we see in a few years time proposals to raise the market capitalisation requirement for GEM to HK\$500 million, the Main Board to HK\$1,000 million? Some overseas markets, such as London, have no significant quantitative requirements, and yet seem to manage as well, or better, than Hong Kong. Is it not time to rethink our regulatory approach, and perhaps a move towards more disclosure-based and less paternal regulation under which investors take more responsibility for their decisions?

Other comments on specific paragraphs of the paper are below:

Para 12(d) The GEM streamlined process runs counter to the sponsor regime. The sponsor regime is not an end in itself but merely a means to an end; other means may suffice. The point is that the period (5.4 years on average) that the company has spent on GEM under its Main Board-like regime is supposed to nurture and prepare it for graduation to the Main Board. That tutelage period - which begins with the appointment of a sponsor with limited due diligence responsibilities, and includes the retention of a Compliance Advisor for at least two years - is an alternative to the one-time appointment of a sponsor with full due diligence responsibilities at the point of listing on the Main Board. Arguably it is a good alternative; it may even be better - 5 years of tutelage compared with one-off scrutiny. Certainly, it should not be dismissed without analysis of why (if at all) it is less adequate.

Para 21. Negative market comments not justified. This analysis, and other reassuring data in the following paragraphs, is welcome, but it leaves one wondering why all the reforms are still considered necessary.

Para 34. The LD processing GEM applications, 'some of which have involved more complex issues than most applications to the Main Board'. This seems extraordinary; further explanation is surely needed. In any event, the delegation of approval power to the LD was an important strategic experiment and should not lightly be reversed. The fact is that most if not nearly all overseas exchanges have long moved away from regulation by practitioner committee, with all the conflicts of interest, inconsistencies and sell-side bias it entails, to a system of regulation applied by executive staff who are properly trained and disciplined and who follow precedent. Hong Kong should move into line with international practice, not move away from it.

Para 41. 'placing to the "friends and family" of connected persons, collusion with "professional speculators" and "connected investors" through intermediaries may not be easily detected.' One wonders, if it is such concern, why the SFC has not done more to investigate with the rather substantial powers that it has?

Para 46. The introduction of a mandatory public offer and prospectus would indeed constitute a major expense, not only at the point of listing but ongoing because of the need to service the resultant body of small retail shareholders. It is a point of complaint for some issuers seeking to list on the Main Board as well. It is surely wrong to impose on all issuers a costly process that has little economic benefit for most

of them (in terms of capital raised) merely to reduce the risk of price movements on some issuers; other regulatory measures are, or should be, available to address the risks.

Overall, one is left with the impression that GEM is the unwanted child, moved from one foster home to another by authorities who neither know nor care how to look after it. More importantly, the proposals set out in this paper represent a further retreat by the Exchange from provision of a structured pathway or stepping stone to the Main Board, widening the funding gap. This is surely detrimental to the market, indeed to Hong Kong society as a whole.

I hope these comments are helpful.

Regards,

Matthew Harrison

## 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:

<http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2017062.pdf>

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

1. Do you agree with the proposal to re-position GEM as a stand-alone board and hence remove the GEM Streamlined Process for GEM Transfers and re-introduce the requirements to (a) appoint a sponsor to conduct due diligence for GEM Transfers; and (b) publish a "prospectus-standard" listing document such that GEM Transfer applications are treated as a new listing application (without requiring the applicant to conduct an offering)?

Yes

No

Please give reasons for your views.

With the proposed reforms (arguably, even without the reforms), there is no need to remove the Streamlined Process. The co-called concerns are either not concerns at all, as demonstrated by the paper's findings, or can be addressed by other means. It is important to keep the Streamlined Process; otherwise GEM becomes a cul-de-sac.

2. Do you agree with the proposal to require all GEM Transfer applicants to have (a) published and distributed at least two full financial years of financial statements after their GEM listings; and (b) not been subject to any disciplinary investigations by the Exchange in relation to a serious breach or potentially serious breach of any Listing Rules for 24 months before they can be considered for a GEM Transfer?

Yes

No

Please give reasons for your views.

The proposals are not objectionable. But surely, if they are in place, the Streamlined Process can be retained. Otherwise, it makes no sense.

3. Do you agree with the proposal to retain the current track record requirement under the GEM Listing Rules (i.e. two financial years)?

Yes

No

Please give reasons for your views.

To increase it would equate GEM with the Main Board, which is pointless.

4. Do you agree with the proposal to retain the current practice of not requiring a GEM applicant that can meet the Main Board admission requirements to list on the Main Board instead of GEM?

Yes

No

Please give reasons for your views.

The decision where to list should be up to the issuer.

5. Do you agree with the proposal to increase the Cashflow Requirement from at least HK\$20 million to at least HK\$30 million?

Yes

No

Please give reasons for your views. We invite suggestions on other potential quantitative tests for admission to GEM.

The proposal may not be very objectionable individually, but it is unreasonable then to raise several other quantitative requirements and then still deny GEM companies a streamlined process of transfer to the Main Board. Also, continually raising merit-based quantitative requirements cannot be the ultimate answer; some markets, like London, appear to have dispensed with them altogether. Somehow, another regulatory approach has to be found

6. Do you agree with the proposal to increase the minimum market capitalisation requirement at listing from HK\$100 million to HK\$150 million?

Yes

No

Please give reasons for your views.

As per 5 above, it is overkill.

7. Do you agree with the proposal to increase the post-IPO lock-up requirement such that controlling shareholders of GEM issuers:

(a) cannot dispose of any of their equity interest in a GEM issuer within the first year of listing; and

(b) cannot dispose of any interest in the subsequent year that would result in them no longer being a controlling shareholder as defined under GEM Listing Rule 1.01?

Yes

No

Please give reasons for your views.

See answer to 5 above.

8. Do you agree with the proposal to introduce a mandatory public offering mechanism of at least 10% of the total offer size for all GEM IPOs?

Yes

No

Please give reasons for your views.

It imposes substantial costs on all issuers for little economic benefit (in terms of capital raised). This is lazy regulation; another approach that targets any genuine problems more precisely, should be considered.

9. Do you agree with the proposals to align the GEM Listing Rules on:

(a) placing to core connected persons, connected clients and existing shareholders, and their respective close associates with those under Appendix 6 to the Main Board Listing Rules and Guidance Letter HKEX-GL85-16 "*Placing to connected clients, and existing shareholders or their close associates, under the Rules*"; and

Yes

No

Please give reasons for your views.

(b) the allocation of offer shares between the public and placing tranches and the clawback mechanism with those in Practice Note 18 to the Main Board Listing Rules?

Yes

No

Please give reasons for your views.

The whole public offering mechanism is cumbersome and costly to issuers. It should be reviewed.

10. Do you agree with the proposal to increase the minimum public float value of securities from HK\$30 million to HK\$45 million?

Yes

No

Please give reasons for your views.

See answer to 5 above.

11. Do you agree with using the Profit Requirement to determine eligibility to list on the Main Board?

Yes

No

If not, what alternative test should be used? Please give reasons for your views.



12. If you agree to retain the Profit Requirement, do you agree that the current level of profit under the Profit Requirement should remain unchanged?

Yes

No

Please give reasons for your views.

13. Do you agree with the proposal to increase the minimum market capitalisation requirement at listing for Main Board applicants from at least HK\$200 million to at least HK\$500 million?

Yes

No

Please give reasons for your views.

This amounts to a fundamental restructuring of the market, in effect replacing the lower tier of the current Main Board by GEM. This would not be a good thing.

14. Do you agree with the proposal to proportionately increase the minimum public float value of securities for Main Board applicants from HK\$50 million to HK\$125 million?

Yes

No

Please give reasons for your views.

See answer to 5 above.

15. Do you agree with the proposal to increase the post-IPO lock-up requirement such that the controlling shareholders of Main Board issuers:

(a) cannot dispose of any of their equity interest in a Main Board issuer within the first year of listing; and

(b) cannot dispose of any interest in the subsequent year that would result in them no longer being a controlling shareholder as defined under Main Board Listing Rule 1.01?

Yes

No

Alternatively, do you believe that it is not appropriate to extend the post-IPO lock-up requirements for Main Board applicants, given that they are less likely to have the characteristics identified in the 2016 Suitability Guidance Letter because of their larger size and our proposal to raise the minimum market capitalisation requirement to HK\$500 million.

Please give reasons for your views.

I am not sure that a period of one year is long enough to make much difference.

16. Do you agree that the proposals for the Main Board should be considered independently irrespective of the outcome of the proposals for GEM?

Yes

No

Please give reasons for your views.

The structure of the market, which includes the two proposed segments of the New Board, should be considered as a whole first; once that structure is decided, the detailed rule amendments can be considered next. Otherwise individual amendments with strategic implications may be enacted willy-nilly leaving a whole that makes little sense.

- End -