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Our Ref : [redacted]
我所檔案
Your Ref :
貴司檔案

Please Contact : [redacted]
Direct Line : [redacted]
E-mail : [redacted]

BY EMAIL ONLY (response@hkex.com.hk)

27 JANUARY 2021

Corporate and Investor Communications Department
Hong Kong Exchanges and Clearing Limited
8/F, Two Exchange Square
8 Connaught Place
Central, Hong Kong

Dear Sir/Madam,

Re: Profit Requirement CP

We are writing to express our views on the proposed amendments to Rule 8.05 of the Listing Rules of the Main Board of The Stock Exchange of Hong Kong Limited ("**Proposed Amendments**"). Capitalised terms which are not defined in this letter shall have the same meaning as those defined in the consultation paper released by the Exchange in November 2020 ("**Consultation Paper**").

Established in mid-2016, we are a small and medium-sized law firm primarily focuses on corporate finance practice, and our core businesses include acting as legal advisers to Sponsors or potential listing applicants' initial public offerings in Hong Kong. Kindly note that we do not wish our name to be disclosed to the general public in the consultation conclusion.

The Proposed Amendments will drastically raise the profit requirement for the three financial years from HK$50 million to either HK$125 million or HK$150 million. We shall set out our responses to the four questions raised in the consultation paper herein below.

Question 1

Do you agree that the Profit Requirement should be increased by either Option 1 (150%) or Option 2 (200%)? Please give reasons for your views.

Question 2

Besides the proposed increase in the Profit Requirement, is there any other alternative requirement that should be considered? Please give reasons for your views.

[redacted]

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For Questions 1 and 2, we do not agree that the Profit Requirement should be increased by 150% or 200% and our proposed alternatives are to either remain the status quo or raise the Profit Requirement for no more than 50%.

From our perspective, Option 1 is premised on synchronising with the increase in the Market Capitalisation Requirement back in 2018 ("**2018 Amendments**"). While the effectiveness of the 2018 Amendments in tackling creation of listed shells remains to be seen, it apparently forced all genuine small-cap listing applicants to find ways to justify for higher valuation.

We believe that a year-to-year comparison on the impact of the two proposed options on the 745 Profit Requirement Applications submitted between 2016 and 2019 (both inclusive) should be disclosed for the general public to assess the effect of the 2018 Amendments. Without a meaningful comparison for assessing the effect of 2018 Amendments, it may be pre-mature to further introduce the more draconian Proposed Amendments.

Likewise, Option 2 is based on the approximate percentage increase in the average closing price of the Hang Seng Index from 9,541 in 1994 when the Profit Requirement was introduced to 27,569 in 2019. There is no justification offered as to why 27,569 shall be used as the reference point, especially when in the first half of 2020, the Hang Seng Index recorded its recent low since July 2016 at 21,139. Obviously, the current constituent companies of the Hang Seng Index is significantly different from the companies back in 1994, with quite a number of technological companies possessing a relatively high P/E ratio. It follows that by simply using the percentage increase in Hang Seng Index as the benchmark to increase the Profit Requirement may not be an ideal justification for the drastic increase in the Profit Requirement.

Further, the analysis supporting the rationale for raising the Profit Requirement does not appear to justify the Proposed Amendments. According to Table 3 of the Consultation Paper (on p.17), although over 63% of the Ineligible Applications showed a shortfall from profit forecast, indeed only 18% amongst 247 Ineligible Applications showed a shortfall of over 30% and it was in very extreme cases (i.e. 8%) that the shortfall from profit forecast exceeded 50%.

It follows that over 82% of these Ineligible Applicants were either able to meet or exceed profit forecast or with a shortfall of less than 30%. This, when compared with results of Eligible Applications (totalled at 93%) as set out in Table 4 of the Consultation Paper (on p.19), the difference appears to be relatively insignificant, noting that any profit forecast carries an inherent nature that it would not be 100% accurate. For better illustration, we have remade Table 3 and Table 4 using the same data as in the Consultation Paper, which is produced hereinbelow as Table A and Table B respectively. These shortfalls can be explainable, when considered against the backdrop that, in recent years, the Sino-U.S. trade war, the social unrest in 2019 and COVID-19, which altogether contributed to the economic downturn of Hong Kong. Further, smaller-sized companies are considered to be more vulnerable to these events and changes in such macroeconomic backdrop.

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Table A: Post-listing performance of the 247 Ineligible Applications under Option 1 that were listed as of 30 June 2020 and which have published results post listing:

Market capitalisation at the time of listing *(HK$ million)*	No. of issuers	Met or exceeded profit forecast or with a shortfall of less than 30%	Shortfall from profit forecast *(No. (%))*	
			30%-50%	>50%
<500	69	54(79%)	9 (13%)	6 (8%)
500-700	120	105 (88%)	9 (7%)	6 (5%)
>700	58	44 (76%)	7 (12%)	7 (12%)
Total	**247**	**203 (82%)**	**25 (10%)**	**19 (8%)**

Table B: Post-listing performance of the 208 Eligible Applications under Option 1 that were listed as of 30 June 2020 and which have published results post listing:

Market capitalisation at the time of listing *(HK$ million)*	No. of issuers	Met or exceeded profit forecast or with a shortfall of less than 30%	Shortfall from profit forecast *(No. (%))*	
			30%-50%	>50%
<500	5	4(80%)	-	1 (20%)
500-700	14	12(86%)	1 (7%)	1 (7%)
>700	189	178 (94%)	5 (3%)	6 (3%)
Total	**208**	**194 (93%)**	**6 (3%)**	**8 (4%)**

It should further be highlighted that, even for Eligible Applicants, there were still 4% of them which had a shortfall of over 50% from the profit forecast. If the Exchange has concern on the profit forecasts submitted by listing applicants, it should face the problem direct and consider the ways of tackling those listing applicants failing to prepare the profit forecasts prudently, for example, strengthening the requirements regarding the contents of the profit forecasts, strengthening the vetting process and/or requiring the listing applicants to include the profit forecast figures into the prospectuses so that directors and parties involved in the preparation of the prospectuses will be liable to the accuracy of such profit forecast figures. We therefore take the view that in order to tackle the above issue relating to profit forecasts (in particular those extreme cases, despite limited in number), the Exchange should find the right antidote instead of shutting all small-cap companies from the Main Board by raising the Profit Requirement.

Extra attention should be given to those listing applicants which adopted unrealistic assumption and qualifications in compiling the profit forecast and the Exchange should also take an active role to penalise any responsible officers who intentionally compiled a too optimistic and/or unrealistic forecast for listing applications. The current measure to increase the Profit Requirement with an aim to shut out all less profitable small-cap companies is certainly not a wise move to tackle the problem caused by those

companies with unrealistic or deceptive profit forecasts. Pausing here, other than the Proposed Amendments, we suggest that the Exchange may consider requesting the controlling shareholders of listing applicant with high P/E ratio to give undertakings with a lengthened lock-up period in the event that a listing applicant fails to meet its profit forecast. This approach, together with the enhanced vetting on the profit forecast, shall serve as a powerful tool to deter "listed shell company" creation.

Furthermore, there are certain other reasons to say that the Proposed Amendments may not be appropriate under the current circumstances:

(1) The Proposed Amendments may cause anti-competition concern and obstruct the development of Hong Kong's Corporate Finance Service

By introducing the Proposed Amendments, be it Option 1 or Option 2, the small and medium-sized sponsors, law firms, accounting firms or other professional parties normally need to be engaged for the purpose of IPO will be significantly deprived of the ability and opportunity to compete with the major market players in their respective fields. This may in turn be an indirect cause of increase in listing expenses for future issuers. The major market players in the respective professional fields can therefore continue to exploit their market dominance and the Proposed Amendments simply acted as an accomplice to anti-competition in the respective professional fields and contributed to the monopoly of certain major market players.

According to an unofficial source (https://www.ryanbencapital.com/2021/01/05/f5ac095bf3/), in the past 24 months (2019-2020), there were 83 sponsors participated in 308 new successful listing projects (305 of which was by way of initial public offering) in Hong Kong. According to the same source, the top ranking market players in terms of deal number were as follows:

Ranking	Name of Sponsor	No. of successful IPO participated in the past 24 months	Market Share in the past 24 months
1	China International Capital Corporation Limited	31	10.2%
2	Morgan Stanley Asia Limited	24	7.9%
3	CLSA Capital Markets Limited	23	7.5%
4	Goldman Sachs (Asia) L.L.C.	19	6.2%
4	Haitong International Capital Limited	19	6.2%
6	ABCI Capital Limited	16	5.3%
7	Merrill Lynch Far East Limited	14	4.6%
7	CCB International Capital Limited	14	4.6%
9	Citigroup Global Markets Asia Limited	13	4.3%
10	Huatai Financial Holdings (Hong Kong) Limited	12	3.9%
10	Guotai Junan Capital Limited	12	3.9%
Total		197	64.6%

[redacted]

Assuming the effect of joint sponsors is insignificant for our current analysis, these top market players accounted for approximately 65% of the market share in sponsoring the successfully listed companies in the past 24 months. The remaining approximately 35% of the market share was primarily shared by the small and medium-sized sponsors, though there are a limited number of sponsors which primarily focus on mega-sized deals, the majority of which primarily focus on small-sized deals will be seriously affected by the increase in Profit Requirement. These small and medium-sized sponsors are the primary customers of smaller and medium-sized law firms which primarily focus on corporate finance practice due to normal market matching process.

Taking a more in-depth look into the legal industry, according to the same source, in the past 24 months (2019-2020), there were 96 Hong Kong law firms participated in the 308 new successful listing projects (305 of which were by way of initial public offering) in Hong Kong, and the top ranking market players in terms of deal number were as follows:

Ranking	Name of law firm	No. of successful IPO participated in the past 24 months	Market Share in the past 24 months
1	Sidley Austin	43	14.0%
2	Deacons	34	11.0%
3	Clifford Chance	23	7.5%
4	Freshfields Bruckhaus Deringer	22	7.1%
5	Davis Polk & Wardwell	15	4.9%
5	Skadden, Arps, Slate, Meagher & Flom	15	4.9%
5	Simpson Thacher & Bartlett	15	4.9%
8	Herbert Smith Freehills	14	4.5%
9	O'Melveny & Myers	13	4.2%
9	King & Wood Mallesons	13	4.2%
9	ONC Lawyers	13	4.2%
9	William Ji & Co. LLP	13	4.2%
Total		233	75.6%

Most of the above-named law firms are of international background and/or large in size, and 13 of them together already accounted for over 75% of the market share in the past 24 months and less than 25% of the IPO projects were shared by the remaining market participants.

Pursuant to the Exchange's analysis on the impact of the proposed options as set out in the Consultation Paper, the Proposed Amendments on average, it would have eliminated 62% of the Profit Requirement Applications and expected to have a similar impact on future potential applications, this is essentially killing

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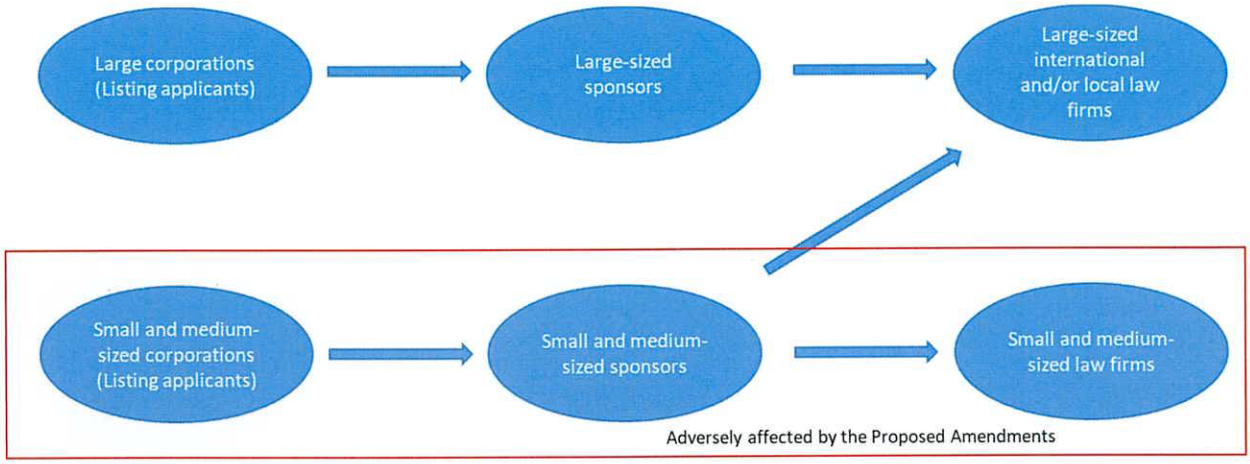
almost all (at least approximately 40 to 50 law firms) of the remaining market participants (other than those less active but large-sized market players which primarily focus on big size projects or have a practice across multiple areas of law) because in normal matching process under a well-functioning market, large-sized corporations will obtain services from large-sized law firms only and smaller corporations will obtain services from both small and medium-sized law firms and large-sized law firms. However, large sized corporations in general will not engage small and medium-sized law firms and hence the small and medium-sized law firms are the ones which will be seriously affected by the Proposed Amendments.

Below diagram will better illustrate how the matching process operates:



The drastic increase in Profit Requirement may somehow cause certain reduction in business for these large-sized law firms but it is believed that the duration of such adverse impact on them would be limited because their loss can be compensated by an increase in fees after reduced competitions. Nevertheless, in another world of small and medium-sized law firms, the drastic increase in Profit Requirement will "kill" them, for sure. It is highly likely that it will cause serious laid off issue in these small and medium-sized law firms and might even cause the small and medium-sized law firms which primarily focus on corporate finance practice to close down.

By raising the Profit Requirement, it will in effect be depriving the small and medium-sized corporation of the chance to get listed on the Main Board and hence wiping out the small and medium-sized Sponsors and law firms from the market.

And yet, the above analysis is only a tip of the iceberg by using the legal industry as an illustration. It is reasonable to foresee that, if many of the small and medium-sized firms in other professions are being eliminated, serious unemployment in Hong Kong will occur. As stated in the Exchange's website, its purpose is to "*promote and progress our financial markets and the communities they support*". The Proposed Amendments will not only cause serious problems to the recovering economy of Hong Kong, but also stifle the IPO-related industry in Hong Kong and cause brain-drain problem which will curtail the development of Hong Kong's corporate finance industry, and bring long term irrecoverable damages. No doubt small and medium-sized enterprises as well as professional firms are the major pillars supporting Hong Kong's economy and that is why the Government of HKSAR has been imposing measures including Employment Support Scheme to assist them. Therefore, the increase in Profit Requirement is against the current public policy.

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(2) Inappropriate timing in proposing the Proposed Amendments and the incapability of GEM as an alternative fund raising platform

The social unrest in 2019 and COVID-19 adversely affected the financial performance of many businesses in Hong Kong. In this trying time, the introduction of the Proposed Amendments will bar many potential capable companies' access to the Main Board, which is the primary market for businesses to raise capital and get access to the public in Hong Kong. Although being an alternative, these companies (which are qualified to be listed on the Main Board under the current regime) can get access to the market through GEM, but in reality GEM market is not an attractive platform for these companies because the listing expenses and the listing requirements of GEM are comparable to the Main Board and yet disproportionate with the capital raised. These companies will become reluctant to get a listing status on GEM and eventually choose not to apply for listing at all.

Given the increase in Profit Requirement is proposed in a haste, it potentially has the effect of vitiating the effort of quite a number of potential listing applicants in that these companies might have spent years in preparing for their listing application by carrying out feasibility studies (including assessing their suitability for listing as well as whether or not they meet the profit requirement), improving their internal control and compliance mechanism, group re-structuring, etc.. These works were done with the expectation that once they are completed, the companies would be eligible to apply for listing on the Main Board. With the increase in Profit Requirement likely be launched on or after 1 July 2021, all these efforts will become wasted.

From our recent discussions with different professional parties or other stakeholders whom we cooperate with, after the publication of the Consultation Paper, those on-going projects which may not become eligible under the new Profit Requirement tend to take the last opportunity to have their listing applications submitted before 1 July 2021, and for those companies which may not be able to submit their listing applications before 1 July 2021, if significant work has already been done for the purpose of submitting listing application, they may consider to submit GEM listing applications instead.

However, for those companies with no substantive work done for the purpose of listing and which are no longer eligible after the increase in Profit Requirement, these potential listing issuers may simply give up the idea to get a listing status at all without even considering making an application for listing on GEM. This will obviously become a survival issue for many small and medium-sized professional parties because the backlog of the projects may not sustain the continuation of their operation.

(3) Potential removal of a ladder for local small and medium-sized enterprises to nurture and become a big corporation

Being the only stock exchange in Hong Kong, the Exchange should not only focus on serving unicorn companies, companies with large market capitalisation or engaging in the new economy but should at the same time consider its social responsibilities in assisting the development of local companies. In September 2020, there were over 340,000 small and medium-sized enterprises in Hong Kong. They accounted for more than 98% of the total number of enterprises and provided job opportunities to more than 1.2 million employees, representing approximately 44.5% of the total employment (excluding civil service) of Hong Kong[1]. Financing has all along been a crucial part of many company's development, especially for those medium-sized companies whose operation grew into certain scale where the

[1] https://www.success.tid.gov.hk/english/aboutus/sme/service_detail_6863.html

companies' financial needs may no longer be sufficiently funded by the limited number of shareholders and external borrowings.

At that moment, going public becomes one of the very limited ways for these kind of medium-sized enterprises to further grow into big corporations and hence the Exchange, given its unique status as the only stock exchange in Hong Kong, is the venue which these companies can look into for the purpose of getting access to the capital of the public. It is therefore flawed to suggest that the Small Cap Companies only accounted for 3% of the total market capitalisation and to use this as a reason to justify that these Small Cap Companies are unimportant. It may somehow be true that these companies are unimportant in terms of market capitalisation calculation, but these medium-sized enterprises, their suppliers, employees and related business partners altogether, supported and contributed to the economic stability and development of Hong Kong.

By cutting off their access to the Main Board, it is essentially removing a ladder for them to climb up from being a medium-sized corporation to a big-sized corporation. In the long run, this will hurt the development of Hong Kong's local economy and local businesses. We verily believe that part of the reason for there being no change to the Profit Requirement since 1994 is because there is a general consensus amongst the different stakeholders that keeping the status quo can provide better support and opportunity to local medium-sized enterprises, and hence allow them to continue to use the Exchange as a fund raising platform.

(4) Obstructing development of industries with high degree of fragmentation and our business diversity

In the industries with high degree of fragmentation, the market itself contains numerous market players where the competition amongst them are very keen. It follows that the profit margin in such industries are very slim and only a limited number of top market players with excellent performance would be able to meet the current profit requirement of the Main Board. If the Proposed Amendments are being put into force, even the top market players in these industries would find it difficult to meet the new Profit Requirements. The Proposed Amendments will in effect discriminate companies in these industries to be listed on the Main Board. In the long run this will affect the development of these industries and may further affect Hong Kong's business development in terms of diversity.

Being an alternative to the Proposed Amendments, we consider the regulators should focus on adopting effective ways to shut down all the "shell manufacturing" activities instead of killing all the Small Cap Issuers. From our perspective, the Proposed Amendments amount to a universal discrimination to characterise all the Small Cap Issuers as "shells". Please also be referred to our above discussion on the importance of keeping the door of Main Board listing open for the Small Cap Issuers who are small-to-medium size companies in Hong Kong that contribute nearly half of the employment in Hong Kong.

One of our paramount reasons for objecting the Proposed Amendments is that it is against the free-market doctrine. A company with a high P/E ratio does not necessarily mean it is a "shell" upon listing. Further, what is high or low should be judged by the market rather than the regulator, pursuant to the free-market doctrine. The investors will have their reasons to invest and should therefore take their own risks.

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Let's have an example. In the Consultation Paper, the Exchange has indicated that there were cases of offering rebates to investors in book building process. No doubt such activity will create a false market and contravene the law. In such case, should the regulator focus on how to prohibit these activities such as imposing more stringent reporting requirements on the book building process to ensure that all investors are genuine and on an arm's length basis? Or should the regulator impose a more severe legal consequences on the offenders?

We therefore humbly urge the Exchange to adopt an explicit and effective way of fighting against the "black sheep" in the market and should not paint the entire industry with the same brush.

Question 3 Do you agree that the Exchange should consider granting temporary relief from the increased Profit Requirement due to the challenging economic environment? Please given reasons for your views. Question 4 If your answer to Question 3 is yes, do you agree with the conditions to the temporary relief as set out in paragraph 55? Please give reasons for your views.

For Questions 3 and 4, we agree with the Exchange unreservedly that it should consider granting temporary relief from the increased Profit Requirement. Nonetheless, we indeed have reservations as to the mode of relief granted because the proposed relief regime do not relax the profit requirement under the Proposed Amendments. In that circumstances, all the issues that we have raised in answering Question 1 and 2 above remained unresolved.

We therefore propose that the Exchange should allow a grace period of one to two years so that thought-through consultation can be done and a more optimal Profit Requirement can be compromised amongst the different stakeholder. Even if the Exchange is so determined to raise the Profit Requirement, we believe that an increase of not more than 50% from the current Profit Requirement should be a more appropriate level in view of the fact that (1) it is already a very significant increase in terms of percentage increase; and (2) in reality for any local business, it is uneasy for any company to achieve a HK$75 million operating profit in three financial years and that such a company is yet to be listed.

Diversity, collaboration and engagement are values promoted by the Exchange in recent years with a prominent vision to become "*the global markets leader in the Asian time-zone: connecting China, connecting the world*". The achievement of such vision will be dependent upon wide recognition, collaboration and support from a strong, diverse and vibrant corporate finance industry. We hope the Exchange will seriously consider the comments raised by us and withhold the Proposed Amendments such that the local corporate finance industry will not be stifled by these rush decisions and that companies with good growth potentials could still have access to the capital they required for their robust development.

Yours faithfully,

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