



CHARTERED
SECRETARIES
特許秘書

The Hong Kong Institute of Chartered Secretaries

Submission:

Consultation Paper on The Main Board Profit Requirement

22 January 2021

By Email Only: response@hkex.com.hk

Hong Kong Exchanges and Clearing Limited
8th Floor, Two Exchange Square
8 Connaught Place
Central
Hong Kong

Dear Sirs

Consultation Paper on The Main Board Profit Requirement ('Consultation Paper')

Terms and expressions used in this letter shall have the meanings set out under the Consultation Paper unless the context requires otherwise.

About HKICS

The Hong Kong Institute of Chartered Secretaries (the Institute) is an independent professional institute representing Chartered Secretaries and Chartered Governance Professionals as governance professionals in Hong Kong and the Mainland of China (the Mainland) with over 6,000 members and 3,200 students. The Institute originates from The Chartered Governance Institute in the United Kingdom with nine (9) divisions and over 30,000 members and 10,000 students internationally. The Institute is also a Founder Member of Corporate Secretaries International Association Limited (CSIA), an international organisation comprising fourteen (14) national member organisations to promote good governance globally.

Maintain *Status Quo*

From the practical governance perspective, we have to consider the extent of the mischiefs being addressed under Consultation Paper's proposal to increase the Profit Requirement; the measures already taken to address them; and the proportionality of the additional measures being proposed under the Consultation Paper in terms of the market impact from the increase in the Profit Requirement. We have not considered the wider context of the global pandemic's shock on the economy which could be addressed by temporary relief measures as mentioned under the Consultation Paper. In all, we do not see a compelling case for changing the *status quo* at this point in time. We submit that the *status quo* should be maintained.

Extent of the mischiefs

Our Institute understands the mischiefs articulated and summarised under paragraph 5 and 6 of the Consultation Paper. They revolve around activities to manufacture shell companies for sale after listing given the perceived premium attached to the listing status. In the context of the need to use a historical P/E of close to 25 times for such purpose, there could be, according to the Consultation Paper reverse

engineering to meet the Market Capitalisation Requirement; investor rebates; and artificial shareholder base. We also note the manifestations of these, as explained under the Consultation Paper, could include significant decrease in share price after listing; thin trading and low liquidity; to speculative trading and excessive market volatility; and pricing concerns. There may even be market manipulation or insider dealing in certain cases.

These mischiefs do occur to some degree in most markets. The issue is the extent or prevalence of such mischiefs and management of the related risk that these bring to the market place. In this connection, under paragraph 119 of the 'Consultation Conclusions on The Review of the Growth Enterprise Market (GEM) and Changes to the GEM and Main Board Listing Rules' published by the Exchange in December 2017, it was stated, as part of the Exchange's 'responses and conclusion' that:

'119. An implied historical P/E ratio of 25 times for a new applicant wishing to list on the Main Board under our proposals would only be required if the applicant met the Profit Requirement and the revised market capitalisation requirement exactly. In practice, most new applicants achieve profits and have market capitalisations that exceed our requirements by varying degrees. So, most applicants could list with an implied historical P/E ratio of less than 25 times. Also, the Profit Requirement and revised market capitalisation requirements are minimum standards that set the floor for the profits and market capitalisation that applicants must have if they wish to list on the Main Board. It is not unreasonable to require an applicant to have a higher implied historical P/E ratio if it is close to meeting only our minimum requirements. This would indicate that, despite this, the market has a high degree of faith in the applicant's future prospects.'

That is, during the time of the Consultation Conclusions back in 2017, it did not appear that listing around 25 times historical P/E ratio was *per se* a serious risk to the market place that needed to be addressed. But under the Consultation Paper in 2021, this is now appearing as a major market risk.

However, what was said under paragraph 4 of the Consultation Paper is that *'the Exchange has seen an increase in listing applications from Small Cap Issuers that marginally met the Profit Requirement but had a relatively high historical P/E as compares with those of their listed peers...in traditional industries'*. Having seen does not indicate a significant increase. Further, in the context of the Consultation Conclusions in 2017, this could well be the function of a high degree of faith in the applicant's future prospects, which may not lend itself easily to a forensic peer-to-peer analysis of what is an appropriate historical P/E ratio for a listing. It is highly dependent on the facts of each case.

The difficulty that our Institute has in assessing the proposal to increase the Profit Requirement under the Consultation Paper is that that there was no explanation of what has happened or changed in the interim between the Consultation Conclusions in 2017 to date from the risk perspective. If in fact, there are issues, these appear to be some issues only and not systemic issues from the Consultation Paper. Unless, our Institute has additional and cogent information, we submit that the *status quo* should be preserved, especially considering the further analysis of the related matters set out below.

Measures already taken

In relation to the risk relating to manufacture of shell companies, both the Exchange and the SFC have already taken strong measures to deal with this. Without belabouring the point, and keeping the discussions at a high level, these include enhanced vetting of IPO applications; hefty fines and license

suspensions of sponsors who fall below the expected standards required for due diligence under PN21, and the name and shame for returned proofs under PN22; the adoption of the front-loaded approach, using of the Securities and Futures (Stock Market) Listing Rules (SMLR), and the formation of 'ICE' workgroup for coordinated surveillance by the SFC in respect of monitoring and enforcement; enhanced sponsor's personal liabilities; and enforcement, for example, under Section 213 SFO. Post-listing there are also the Exchange's discipline; disclosures of inside information regime; and market misconduct cases (civil and criminal alternatives). These can relate back to disclosures made under the listing documents.

We submit that if the Exchange is concerned with an IPO candidate that is seeking to list to create a shell for re-sale at a premium, the risk can be managed through vetting and raising questions with the IPO candidate. The SFC can, and have on occasions, slammed the brakes on IPOs under the SMLR. There are also the arsenal of the other powers and regulatory approaches mentioned above available to regulators. In addition, it is open to the Exchange and/or the SFC to collaborate with the Commercial Crimes Bureau (CCB) (as in Du Juan's case) and the Independent Commission Against Corruption (ICAC) (especially where there is suspected conspiracy to defraud).

For the purposes of discussions, assuming that there are some extensive mischiefs (and hence systemic risks) that needs to be addressed, we need further to understand how and why the above-mentioned regulatory tools and approaches are not sufficient to deal with the underlying malice, that is, the manufacturing of shell companies for re-sale at a premium. There have to be strong justifications as to why there is need to remove the opportunity for small and medium companies to list on the Main Board where they approach a historical P/E of 25 times.

Proportionality of the additional measures

As explained under paragraph 9 of the Consultation Paper, on average 62%, or 462 IPOs, between 2016 and 2019 would not have been able to list had the Profit Requirement been applicable during the period. From the proportionality perspective, under a risk management analysis, we have to take into consideration that the increase in Profit Requirement '*might be expected to have a similar impact on future potential applications*', or namely, a material reduction in the number of companies listed on the Main Board.

While our Institute recognises that in terms of market cap, those affected would constitute a small part of the overall market cap of the Main Board (around 3% based on historical analysis), we submit that the absolute number of potential IPOs being affected by the Profit Requirement does matter. It matters because it affects the ecosystem of the market and the governance industry. For example, it affects the employment of directors and senior management, including the company secretary, lawyers, accountants, valuers, consultants, and sponsors, etc. It also affects the opportunities for the development of the future big cap. We have to remind ourselves that some of the major listed companies themselves were initially small cap companies. We submit that the *status quo* should be preserved.

Other Observations

Under paragraph 11 of the Consultation Paper, it is stated that the increase in the Profit Requirement will further distinguish issuers listed on GEM and the Main Board and is in line with the Exchange's objective of positioning the Main Board as the main market to attract sizeable companies that can meet high market standards.

This assertion is based on the assumption under paragraph 10 of the Consultation Paper that small or mid-sized companies can still access the capital market by listing on GEM, which is intended to be a capital raising platform for early development companies and small or mid-sized companies that are not able to meet the Main Board eligibility requirements. With respect, we have to add ourselves to the chorus of commentators that the GEM Board has been portrayed as being problematic by market participants. You can refer to the happenings in this regard in or around 2016 which led to the GEM Board review and the Consultation Conclusions in 2017 which closed off the potential migration of GEM Board listed companies to the Main Board. We do not see the GEM Board as a real alternative to a Main Board listing.

Whether Option 1 or Option 2 is adopted, this will result in the Exchange having the highest profit requirement when compared with the profit requirements of the Selected Overseas Main Markets on an aggregated basis for the three years of a track record period, as compared with being third under the current Profit Requirement (lower than NYSE and NASDAQ). The Exchange will also have the second highest profit requirement for the final year of the track record period (lower than SGX). The related question to ask is whether Hong Kong should be focused only on large caps and new economy companies, and not afford the opportunity for the listing of small or medium companies on the Main Board. Will it not have missed opportunities by preventing and driving these companies to list elsewhere, or not at all?

There was also the assertion under paragraph 11 of the Consultation Paper that the proposal to increase the Profit Requirement will therefore improve the overall quality of Main Board issuers, which will be conducive to promoting post-listing liquidity. This will also increase investors' confidence in the market and strengthen Hong Kong's position as an international financial centre. In this connection, we do not have information under the Consultation Paper to form a view. For example, are the most egregious breaches of rules and regulations related to smaller cap listed companies? Are they the riskiest components of the market?

We can only add that we have seen well-run smaller cap listed companies where our members are part of senior management and acting as governance advisers. Our Institute will do our part in promoting the appropriate learning and training to our members, graduates and students, and those seeking higher learning in applied governance.

Questions Raised

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.

We submit that the *status quo* should be maintained for the reasons set out herein.

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.

We submit that the *status quo* should be maintained for the reasons set out herein.

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 give reasons for your views.

The question is not relevant as we subscribe to the preservation of the *status quo*.

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.

Please see answer to Question 3.

Should you have any questions, please feel free to contact [REDACTED]
[REDACTED] [REDACTED] [REDACTED].

Yours sincerely

For and on behalf of
The Hong Kong Institute of Chartered Secretaries

[REDACTED]

[REDACTED]
[REDACTED]