

**MARKET CONSULTATION ON
THE RULES GOVERNING THE LISTING OF SECURITIES
ON THE GROWTH ENTERPRISE MARKET OF
THE STOCK EXCHANGE OF HONG KONG LIMITED**

May 2000

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Growth Enterprise Market



The Stock Exchange of Hong Kong 香港聯合交易所
(A wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited)

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1. Introduction

- 1.1 The Growth Enterprise Market (“**GEM**”) operated by The Stock Exchange of Hong Kong Limited (the “**Exchange**”), a subsidiary of Hong Kong Exchanges and Clearing Limited, was officially launched on 25 November 1999. Since that launch and up to end of April 2000, a total of 23 companies has been listed on GEM.
- 1.2 The Exchange and the Securities and Futures Commission (the “SFC”) approved the Rules Governing the Listing of Securities on the Growth Enterprise Market of the Exchange (the “**GEM Listing Rules**” or the “**Rules**”) in July 1999. Since then, there have been three revisions of the Rules. The first two revisions were made before the formal establishment of the market. These relate to the increase in size of the GEM Listing Committee (Update No. 1 dated 1 September 1999) and the reduction of the public float requirements and acceptance of US GAAP (Update No. 2 dated 17 November 1999). The third revision was effected in March 2000 only to introduce changes to the Rules as a result of the de-mutualisation and merger of the stock and future exchanges and clearing houses and the creation of Hong Kong Exchanges and Clearing Limited.
- 1.3 After the second revision was made in November 1999, the original intention of the Exchange, as agreed with the SFC, was to gain experience from the administration and operation of the Rules during the first six months of the establishment of the market and to conduct an overall review of the Rules based on such experience at the end of such period. As GEM is a new market for Hong Kong, it has been recognised at the outset that the GEM Listing Rules may need to be adjusted in light of market needs at some stage after its establishment. It was intended that the six-month period would allow the market a reasonable time within which to develop and would provide regulators with sufficient information and experience to conduct an overall review of the Rules. However, based on its experience in administering the GEM Listing Rules in the past five months, the Exchange believes that there are a number of requirements in the Rules which have hindered the development of GEM. As set out in the joint press announcement of the Exchange and the SFC dated 11 March 2000 (The **Appendix**) (the “**Joint Announcement**”), the Exchange has, with the agreement of the SFC, decided to conduct the rule review at present.
- 1.4 The review is being undertaken to ensure the continuing competitiveness of GEM. It is also undertaken against a background where compliance with certain requirements of the GEM Listing Rules has been waived by the Exchange in relation to certain applications for listing on GEM. These waivers were granted in order to develop the market and to compete with other markets.

1.5 The Joint Announcement indicated that waivers from compliance with specific rules would be granted to listing applicants pending finalisation of this review. The Joint Announcement was made pursuant to an exchange of letters between the SFC and the Exchange under which the SFC consented to the granting of waivers with general effect by the Exchange in relation to four specific rules. The SFC's consent constitutes consent given under Rule 2.07 of the GEM Listing Rules. The Exchange has now conducted a review of the GEM Listing Rules. Following from this, the Exchange seeks comments from the public on the proposed changes set out in this Consultation Paper.

2. Proposals arising from the Review

2.1 The Exchange invites market participants and the public to express views or give comments on the proposals in relation to the GEM Listing Rules as summarised below. The rationale for the proposals and other details are set out in the latter parts of this Paper.

(i) Moratorium period for the initial management shareholders

The GEM Listing Rules currently include a moratorium on the sale of shares held by initial management shareholders for two years after listing. The Exchange now proposes that the moratorium period should be reduced to 6 months after listing. A further limit would also apply on disposals in the second 6 months after listing: for controlling shareholders, they would be prohibited from disposing of shares which would result in them ceasing to have control over 35% of voting rights, and for initial management shareholders who are not controlling shareholders, they would be prohibited from disposing of more than half of their shareholding interest in the issuer. The Exchange is also consulting the market on who should be regarded as "*initial management shareholders*" and be subject to the moratorium provisions. The Exchange proposes that all directors and members of senior management of a GEM issuer and all investors with board representation who hold shares immediately before the listing date be also subject to the lock-up provisions as initial management shareholders.

(ii) Shares issued within six months of listing

The GEM Listing Rules currently prohibit newly listed companies from issuing shares in the six-month period after listing. The Exchange now proposes to ease this prohibition. Share issues will be permitted in the six months following listing. Such share issues will only be limited to acquisitions that are complementary to the issuer's focused line of business. The share issue should not have the effect of changing the control of the company after completion of the acquisition. A lock-up requirement will apply to such shares

issued and the share issue must be the subject of independent financial advice and of independent shareholders' approval. Further, the circular to shareholders must disclose certain prescribed information regarding the proposed acquisition and the subscribers of shares. The Exchange also wishes to consult the public on whether a maximum limit should be imposed on the amount of new shares to be issued during the first six-month period after listing.

(iii) Active business pursuits

The GEM Listing Rules include a so-called "*Track Record Period*" requirement that for applicants to be suitable for listing, they must have operated the relevant focused line of business for a minimum of 24 months before applying for a listing. The Exchange now proposes that the minimum Track Record Period be reduced to at least 12 months. If the issuer concerned has a longer period of business pursuits, disclosures in its initial listing document should cover the full period subject to a maximum of 24 months.

(iv) Accountants' report

The existing GEM Listing Rules require the accountants' report included in the listing document of a new applicant to include the consolidated results of the applicant covering at least the 2 financial years immediately preceding the issue of the listing document. Following the proposed reduction in the "*Track Record Period*" mentioned above, it would be necessary to reduce the minimum period to be covered by the accountants' report. Therefore, the Exchange proposes that the period to be covered by the accountants' report be reduced to at least 12 months corresponding with the minimum 12-month "*Track Record Period*". If the issuer concerned has carried on business for more than such 12-month period, the accountants' report should be made up for and cover the full period of its operation up to the maximum of two financial years.

(v) Share option schemes

The GEM Listing Rules currently have various restrictions on the share option schemes. The principal restrictions include limiting the number of shares over which options may be granted to no more than 10% of an issuer's outstanding shares and restricting the participants to full-time employees. The Exchange proposes to amend the share option provisions along the same line as that proposed for the Main Board. Such proposals are set out in a separate consultation paper issued by the Exchange on 8 May 2000 – Consultation Paper on Chapter 17 (Share Schemes) of The Rules Governing The Listing of Securities on The Stock Exchange of Hong Kong Limited. In summary, it is suggested that the limit on the number of shares over which companies may

grant options should be increased from 10% of total outstanding shares to 30% of outstanding shares which is also the limit specified in the Joint Announcement. The granting of options over more than 10% of outstanding shares would require the approval of shareholders in a general meeting. Additional provisions will apply where options are to be granted to connected persons and additional disclosures are to be included in interim and annual reports. The Exchange also proposes to remove the restriction on the condition that additional disclosure relating to share options granted is made in the issuer's annual and interim reports.

(vi) Revenue or profit requirement

The existing GEM Listing Rules do not include a specific requirement in relation to the listing applicant's revenue or profit. Although the Exchange does not propose to include such a requirement, it notes that some market participants may take a different view. Accordingly, the Exchange would like to seek the market's comment on the need for any revenue or profit requirement for GEM.

(vii) Offering mechanism

The existing GEM Listing Rules do not include a requirement for new listings to include a public offer tranche; hence shares may be listed entirely by way of placing. It is now proposed to introduce requirements that would allow the Exchange not to permit a new applicant to be listed by way of placing if there is likely to be significant public demand for the securities. In light of retail demand on some of the GEM stocks during recent initial public offerings, the Exchange also proposes to require a compulsory public offer tranche together with a clawback mechanism which would allocate additional shares to the public offer tranche in the event that it is oversubscribed. The Exchange wishes to seek the market's comments on such proposals.

(viii) Others

The Exchange would welcome comments on any aspect of the GEM Listing Rules which is not specifically addressed in this Consultation Paper.

3. Consultation period

3.1 Market participants and the public are invited to submit comments on the above proposals to the Exchange. These comments should be received no later than 30 June 2000.

3.2 Comments may be submitted by mail or by fax to:

Growth Enterprise Market
The Stock Exchange of Hong Kong Limited
11/F, One International Finance Centre,
1 Harbour View Street,
Central,
Hong Kong

Fax : (852) 2295-3599

Comments may also be submitted by E-mail to gem@sehk.com.hk

3.3 Additional copies of this paper are available from the Exchange at the above address and also from the GEM Website at <http://www.hkgem.com>.

BACKGROUND AND REASONS LEADING TO THE RULES REVIEW

1. The Exchange and the SFC approved the GEM Listing Rules in July 1999 in preparation for the launch of GEM in November 1999. The Rules are partly the product of the Exchange's proposals contained in its Consultation Paper issued in May 1998¹ and partly the product of further discussion and comments of the Second Market Working Group formed by the Exchange in September 1998 to develop the listing rules and related infrastructure for GEM. The Second Market Working Group consisted of representatives of the Exchange and the SFC as well as a number of active market participants, some of whom have become members of the GEM Listing Committee which is the authority responsible for all listing related matters on GEM. When the Rules were adopted in July 1999, they represented the consensus of market opinion, and those of the Exchange and the SFC regarding the regulation of GEM.
2. Since GEM was launched in November last year, the Exchange has found that certain requirements of the GEM Listing Rules are not sufficiently flexible to compete with other markets and to accommodate the needs of some of the hi-tech and larger capitalisation companies. To gain entry into GEM, quite a number of issuers have also asked the Exchange to grant waivers from compliance with these requirements as conditions precedent to seeking a listing on GEM. In some cases, the Exchange has granted waivers in order to enhance the attractiveness of GEM to issuers and to compete with other markets.
3. The Exchange, however, notes that the grant of waivers to individual issuers on a regularly recurring basis would be tantamount to a rule change and would create opaqueness and an uneven playing field in the application of the GEM Listing Rules. This has proved to be a cause for public concern. The Exchange is, nevertheless, of the view that if the GEM Listing Rules remain in their present form, further development of the market might be hindered. Accordingly, it has obtained consent from the SFC effective from 11 March 2000 to grant waivers with general effect on four specific rules as referred to in the Joint Announcement. The SFC's consent has been given on the basis that a full market consultation of the relevant issues and proposed rule changes would be conducted and finalised as soon as possible so that fairness and transparency of the market would not be prejudiced.
4. This consultation exercise is conducted against the above background. It is recognised in the Joint Announcement that the amendments to the rules resulting from this consultation exercise may be more or less restrictive than the existing

¹ *Consultation Paper on a Proposed New Market for Emerging Companies issued by the Exchange in May 1998.*

provisions of the GEM Listing Rules and the general waivers provided for in the Joint Announcement. In deciding whether and how the GEM Listing Rules should be revised, principal considerations will be given to striking a sensible balance between investor protection, market integrity, market development and competitive issues. It is important to recognise that investor confidence is the ultimate test of the success of a market. Different factors have bearing on a company's decision to list in a particular jurisdiction or exchange. Hence, the lowering of listing standards or requirements, whilst desirable in some situations, cannot be regarded as the most appropriate or expedient answer to address competition. Further, the competitive pressure cannot be over-stressed as not all companies are prepared to list, or are suitable for listing, on overseas exchanges. However, it is also recognised that GEM has to develop a critical mass in order for the market to be liquid and attractive to institutional investors.

AREAS OF CONSULTATION

I. Moratorium period for the initial management shareholders

1. Rule 13.16 of the GEM Listing Rules imposes restrictions on the sale of shares by initial management shareholders during the two-year period from the listing date (the “**Moratorium Period**”). Each initial management shareholder, who immediately prior to the listing date is entitled to exercise or control the exercise of 5 per cent or more of the voting power at general meetings of the new applicant, is required to undertake to the applicant and the Exchange that he will not (subject to certain exceptions²) dispose of any of his direct or indirect interest in the new applicant during the Moratorium Period. The Exchange has the discretion to grant exemptions from this requirement under “*exceptional circumstances*” (see Rule 13.17(5)). It is important to note that under the current rule, not all existing shareholders are subject to the Moratorium Period. It only applies to those shareholders who immediately before listing hold 5% voting rights of the issuer and who are able, as a practical matter, to direct or influence the management of the issuer. A person (or group of persons) who controls 35% or more of the voting rights of a listed company (the “*controlling shareholder*” as defined in the GEM Listing Rules) is deemed to be an “*initial management shareholder*” and be subject to the Moratorium Period.
2. The two-year moratorium rule was a proposal of the Exchange in its May 1998 Consultation Paper. This requirement was included “*to demonstrate continuing commitment to the business which the Exchange believes is vital to the success of emerging companies*”³. Analysis of public comments showed that the market was supportive of such a requirement in 1998.
3. Since the adoption of the GEM Listing Rules in July 1999, however, the Exchange has received a number of requests from listing applicants to reduce the Moratorium Period from 2 years to 6 months. The principal arguments advanced to support these requests are:
 - i. Stock exchanges in other developed markets do not have a two-year lock-up requirement.

² The current rule allows Initial Management Shareholders to pledge their interests to authorised institutions under the Banking Ordinance as security for commercial loans at any time during the Moratorium Period. They are also allowed to sell all their shares under a general offer made by an independent party at any time after the first anniversary of the listing date (see Rule 13.17).

³ Page 11 of the Consultation Paper on a Proposed New Market for Emerging Companies issued by the Exchange in May 1998.

- ii. A lock-up period of 2 years is too long and restricts the flexibility of the initial management shareholders in managing their investment in the new applicant. For example, in some cases, the initial management shareholders may be offered opportunities to exchange shares with other investors whose investment is beneficial to the new applicant.
4. The lock-up requirements of various international markets are summarised below:

Market	Country	Lock-up period
NASDAQ National Market	USA	None, but as a matter of practice, U.S. underwriters of IPOs require major and substantial shareholders to undertake not to dispose of their shares for a period of 6 months after listing. Underwriters have the power to reduce the lock-up period if they so wish.
NASDAQ Small Cap Market	USA	Same as above.
Neuer Markt	Germany	All existing shareholders are prohibited from offering or selling shares directly or indirectly within 6 months from the date of listing and from announcing or taking any action that is economically equivalent to a sale ⁴ .
SESDAQ	Singapore	Controlling shareholders ⁵ and their associates and executive directors having 5% or more interest in a listed company's issued share capital are prohibited from disposing of any of their shareholdings in the first 12 months after listing. In the second 12 months after listing, all these persons are prohibited from disposing of more than 50% of their shareholdings ⁶ .

⁴ Rule 2.2(1) of the Rules and Regulations of Neuer Markt.

⁵ "Controlling shareholder" is defined in the Singapore Stock Exchange Listing Manual as "a person or persons exercising control over a company, unless rebutted, a person who controls directly or indirectly a shareholding of 15% or more of a company's issued share capital shall be presumed to be a controlling shareholder of that company."

⁶ Rule 503(1)(b) of the Singapore Stock Exchange Listing Manual (in relation to SESDAQ i.e. The Stock Exchange of Singapore Dealing and Automated Quotation System).

5. The Exchange accepts that reducing the lock-up period would bring GEM more into line with the U.S. and German markets and would also provide management shareholders with added flexibility. Against this, the lock-up arrangements are seen as a means of ensuring the “*commitment*” of initial management shareholders to the development of the listed business. One of the important elements in analysis of a GEM investment is the identity of the management and their level of commitment to the company, particularly in light of the absence of a track record of profitability applicable to GEM issuers. To permit controlling shareholders and management an opportunity to cash in at an early stage after listing and leaving public investors with the shares would run counter to this. The objective of GEM is to provide a market for fund raisings by growth-oriented companies and not to serve as an “*exit route*” for founders of businesses to realise the value of their business shortly after listing.
6. In framing rules in relation to the lock-up requirement, the Exchange recognises that it is necessary to strike a balance between the flexibility provided by the absence of a lock-up requirement and the elements of investor protection that a lock-up can provide. The Joint Announcement indicates that pending the completion of this consultation exercise, the Exchange has the discretion to grant waivers to listing applicants to reduce the Moratorium Period to six months. This waiver is subject to the further condition that no controlling shareholder or a group of persons consisting of the controlling shareholder is allowed to dispose of shares in the second six months after listing if this would reduce his/their voting rights to below 35%.
7. This waiver in the Joint Announcement mirrors the requirements which are applicable to companies listed on the Main Board. The intention is to at least ensure that there will be no change in the control of the listed company during the first year of public investment in the company. It might also be thought of as representing a “*graduated approach*” to lock-up arrangements by requiring a full lock-up for the first six months followed by an easing of the restrictions in the second six months after listing. This approach is more restrictive than that adopted by NASDAQ and the Neuer Markt but more flexible than that adopted by SESDAQ. Of the exchanges listed above, SESDAQ has also adopted a graduated approach – it permits controlling shareholders, their associates and executive directors with 5% interest or more to dispose of up to half of their interest in the company in the second 12 months after listing.
8. There are, therefore, a number of options open to GEM apart from adhering to the existing 24-month Moratorium Period. One option is simply to reduce the lock-up period to 12 months or to six months. Alternatively, one can follow the Main Board’s approach as currently provided for under the Joint Announcement. Another option is to adopt a “*graduated approach*” similar to that used by Singapore – for example, a lock-up period of 24 months (or 12 months) in total with no disposal permitted in the first 12 months (or 6 months) but allowing disposal of up to a fixed

percentage of shares in the second 12 months (or 6 months). A further alternative is to combine the Main Board's approach and the Singaporean approach – i.e. lock-up of the first 6 months to apply to all initial management shareholders and for the following six months (12 months or 18 months) period, (a) no initial management shareholders are allowed to dispose of more than a fixed percentage of their shareholdings; and (b) no controlling shareholders are allowed to dispose of shares which would result in their ceasing to have control over 35% voting rights in the listed company.

9. To give GEM more flexibility without compromising investor protection, the Exchange is in favour of adopting the combined approach of the Main Board and the graduated approach similar to that used by Singapore. *The Exchange's proposal is to reduce the lock-up period for controlling shareholders and / or initial management shareholders from two years to six months but a further limit would apply to disposals in the second six months after listing: controlling shareholders would only be allowed to dispose of shares during the second six months provided no disposal would result in their ceasing to have control over 35% of the voting rights in the listed company; and initial management shareholders who are not controlling shareholders would only be allowed to dispose of up to 50% of their interest.*
10. The Exchange does not favour reducing the Moratorium Period to six months only. It is believed that it is more appropriate to have an overall 12-month lock-up requirement, albeit on a gradually reducing basis. This is because a half-yearly financial report would at least be issued by a listed company during the 12-month period pursuant to the GEM Listing Rules so that public investors have a basis upon which to judge whether or not to continue investing in the company prior to the expiry of the lock-up, i.e. they should be given an opportunity to exit earlier than the management. From the perspective of the controlling shareholders and the initial management shareholders, the proposed approach mentioned above will provide them with the flexibility to sell their shares up to a certain limit in the second six-month period. This approach is also more akin to the requirements of the other international markets.
11. The Exchange invites comments on the above proposals. Comments are also invited generally on whether there should be a “*graduated*” approach to the lock-up requirement and, if so, whether this should take the form as adopted in the Joint Announcement or whether an approach similar to that of SESDAQ (permitting the relevant shareholders to reduce their interest by a fixed percentage) should be adopted.
12. Apart from the duration of the moratorium, the Exchange also wishes to seek public views on who should be subject to the moratorium. Currently, the Moratorium Period only applies to “*initial management shareholders*”. As mentioned above, this

term is defined as “any management shareholder of the issuer immediately prior to the date of the issuer’s initial listing document”. “Management shareholder” is defined as “any person who is (or group of persons who together are) entitled to exercise or control the exercise of 5 per cent or more of the voting power at general meetings of the issuer and who is (or are) able, as a practical matter, to direct or influence the management of the issuer”. The note to this definition provides that the Exchange will not ordinarily consider any professionally managed fund as a management shareholder if it can be shown that it does not actively participate in the management of the issuer’s business.

13. With a view to adopting a more objective measure to decide whether a person is an “initial management shareholder”, the Exchange has in practice deemed the following persons, who have interests in the voting rights of the GEM issuer immediately prior to the date of the listing, as “initial management shareholders” for the purpose of the lock-up:
 - i. all members of senior management such as those persons named in the “senior management” section of the listing document of a GEM issuer;
 - ii. all directors on the board of a GEM issuer, including non-executive directors; and
 - iii. all investors, including but not limited to investment funds, with board representation.
14. In practice, the Exchange deems all the above persons to be subject to the Moratorium Period regardless of whether or not the person concerned has or controls 5% or more voting rights in a GEM issuer.
15. In the case of the Neuer Markt, the 6 months lock-up applies to all “existing shareholders” of the listing applicant regardless of the number of shares or the extent of interest they control. SESDAQ, on the other hand, only applies the lock-up requirements to controlling shareholders, their associates and executive directors.
16. *The Exchange proposes to include a note in the GEM Listing Rules to provide that all persons listed in paragraph 13 above would be deemed as initial management shareholders for the purpose of the lock-up, regardless of whether or not the person concerned has or controls 5% or more voting rights in a GEM issuer. However, it is proposed that amendments would be made to the GEM Listing Rules so that the investors referred to in paragraph 13iii would only be deemed as “initial management shareholders” for the purpose of the moratorium provisions only and not for the purpose of deeming them as “connected persons” under Rule 20.10 of the GEM Listing Rules.*

17. The Exchange invites comments on the above proposals.
18. The Exchange also proposes that the following types of disposals by initial management shareholders be permitted by expressly exempting them from the meaning of “*disposal*” under the moratorium provisions:
 - i. stock lending by initial management shareholders to underwriters during the 30-day period after the issue of shares by the issuer solely for the purpose of covering any short position prior to the exercise of the over-allotment option; and
 - ii. a sale of shares above the limit mentioned in paragraph 9 above by initial management shareholders during the second six-month period after listing only for the purpose of effecting a placing and top-up transaction and provided (a) that there is no change in the number of shares held by such shareholder upon completion of the top-up transaction compared with its holding immediately before the transaction; and (b) that in the case of controlling shareholders, there is no change in the control of the company concerned.
19. *The Exchange takes the view that the two kinds of disposal described above do not in substance constitute a reduction of interest in GEM companies by initial management shareholders. Therefore, they should not be subject to the moratorium provisions. Views are sought from the public on these proposals.*

II. Share Issues Within Six Months of Listing

1. Pursuant to Rule 17.29 of the GEM Listing Rules, no further shares or securities convertible into equity securities of a listed issuer may be issued, or form the subject of any agreement to issue, within the first six months of the date on which securities of the issuer first commence dealing on GEM. The note to Rule 17.29 provides that the Exchange may be prepared to waive such requirement in “*exceptional circumstances*”. An example of an “*exceptional circumstance*” is where the listed issuer raised less than the maximum amount stated in its listing document at the time of the IPO. Under such circumstance, the Exchange may give a waiver to allow it to issue new shares so as to enable the issuer to raise the shortfall of the maximum amount indicated.⁷
2. A number of newly listed companies have indicated that they would wish to issue shares within the first six months of listing, subject to obtaining a waiver from strict compliance with the GEM Listing Rules from the Exchange.

⁷ *This follows from the special feature of GEM where new issues do not have to be fully underwritten. Issuers are only required to specify a minimum amount which their offers must raise in the listing application, failing which the offer will not proceed.*

3. The requirements of overseas exchanges are:

Market	Country	Limit
NASDAQ National Market	USA	None
NASDAQ Small Cap Market	USA	None
Neuer Markt	Germany	An issuer is required to refrain from “ <i>offering or selling shares directly or indirectly, or announcing such action, or taking other measures economically equivalent to a sale</i> ” within a period of six months from the date of admission to the Neuer Markt. The DBAG may exempt the issuer from such requirement upon a “ <i>substantiated request</i> ”. ⁸
SESDAQ	Singapore	None

4. Most of the above exchanges do not have an express prohibition on the issue of new shares by an issuer within six months of listing.
5. The prohibition in Rule 17.29 on issuing new shares within six months of listing has developed from Rule 10.07 of the Main Board Listing Rules which has been consistently applied.⁹ The purpose of Rule 17.29 is to protect public investors by preventing dilution of their interests and changes in the shareholding structure of the listed company within a period of six months after listing. The Rule assumes that an issuer would have satisfied its funding needs for the first six months after listing by raising sufficient capital through its IPO to meet major business developments. This is not an unreasonable assumption in the context of GEM given that specific requirements to disclose detailed business objectives during the two years after listing and the use of proceeds are deemed necessary. An effect of the Rule is that existing shareholders will neither be called upon to contribute additional funding for the company, nor see their interest in the company diluted by fund raising in the first six months after listing.

⁸ Rule 7.2.9 of the Rules and Regulations of the Neuer Markt.

⁹ Waivers on the Main Board Rule are rarely given. A recent case in which waiver was refused involves Paramount Publishing’s proposed acquisition of an Internet-related business from a connected person by issuing new shares.

6. Further, since new issues on GEM can proceed as long as the minimum amount of funds required is raised, if an issuer expects that it would need more funds shortly after listing for particular acquisitions or business development, it has the flexibility to indicate in its initial listing document the maximum amount of funds needed. In such circumstances, the listing document would have to disclose the anticipated use of proceeds and the issuer's intention and plans to enter into acquisitions and other business development. This is consistent with the emphasis of GEM being a disclosure-based market. If the maximum amount of funds is not raised at the IPO stage, the issuer can take advantage of the note to Rule 17.29 in obtaining a waiver to issue new shares for raising the full maximum amount indicated in the listing document within the six-month period after listing.
7. Given the flexibility provided by other provisions in the GEM Listing Rules as mentioned above, the prohibition referred to in Rule 17.29 only has limited impact on a company's ability to raise funds by issuing new shares within the six-month period after listing. The real limitation imposed by Rule 17.29 is on a company's ability to issue new shares as consideration for direct acquisitions. A number of listing applicants and listed issuers have argued that such limitation is not reasonable; particularly in circumstances where the opportunity to acquire particular assets only arises after the issue of the initial listing document.¹⁰
8. The Exchange acknowledges that there may be circumstances where shareholders would be prepared to see their interests diluted (or be prepared to subscribe for additional shares) to allow the company to take advantage of a business opportunity. Such flexibility might be considered to be of particular importance to the growth-oriented companies that GEM is targeted at.
9. The Exchange considers that with the appropriate safeguards to protect existing shareholders' interests it is appropriate to ease restrictions on the issue of shares in the six months after listing.
10. *The Exchange therefore proposes to permit companies to issue new shares in the first six months after listing provided that the following conditions are satisfied:*
 - i. *The shares are issued for the purpose of an acquisition of a business or assets which would complement the focused line of business of the issuer;*

¹⁰ *Timeless Software Limited applied to the Exchange for a waiver of Rule 17.29 to issue certain convertible bonds for the acquisition of office premises shortly after listing. The application was rejected by the Exchange. Hongkong.com Corporation also applied to the Exchange for a waiver of the same rule to issue new shares as consideration for the acquisition of certain interest in an e-commerce company. The application was approved by the Exchange subject to certain conditions and to the SFC's consent under Rule 2.07 of the Rules. The SFC did not grant any consent as the waiver, if given, would have general effect and would be tantamount to a rule change. The SFC considered it more appropriate to include the issues raised by Rule 17.29 in this consultation exercise prior to approving any rule change.*

- ii. *The share issue should not have the effect of changing the control of the issuer within the meaning of the Hong Kong Code on Takeovers and Mergers;*
- iii. *The prior approval of independent shareholders (i.e. shareholders other than controlling shareholders, substantial shareholders and initial management shareholders or otherwise associated with the controlling shareholders or management of the issuer) would be required for such an issue;*
- iv. *The issuer would be required to appoint an independent financial adviser to advise on whether the acquisition is fair and reasonable to independent shareholders including its value and the pricing;*
- v. *The circular to be issued to shareholders must state whether the company and its directors had any plan or intention to acquire the business or assets concerned before or at the time of the issue of the initial listing document; the circumstances under which the opportunity to acquire has arisen; the number of new shares to be issued and the dilution effect on shareholders; material information on the business or assets concerned, its value and how the price for the issue of shares is being fixed or agreed; reasons for the acquisition; how the acquisition would complement the issuer's business within the six-month period after listing and thereafter; the reasons why it is important for the issuer to acquire the business and assets during such six-month period and the effect that the acquisition would have on the issuer's business and prospects; reasonable details on the persons who would be entitled to receive the new shares assuming that the transaction is approved; whether such persons are connected or associated with the company's controlling shareholders, substantial shareholders or directors; and any other relevant information necessary for independent shareholders to make an informed decision.*
- vi. *The persons who would receive the new shares would be subject to a lock-up arrangement similar to that applicable to initial management shareholders and significant shareholders depending on the percentage holding so received by them as a result of the transaction or (if already a shareholder or associated with a shareholder) held by them following the transaction. This means, for example, that if a person receiving the new shares would come to hold an interest of 5% or more in the listed issuer and would be involved in the management of the issuer post-transaction, such person would be subject to the same moratorium requirements as if he were an initial management shareholder when the issuer's shares were first listed on GEM. Hence, the duration of the lock-up period for such persons is dependent on the timing of the transaction vis-a-vis the relevant date of listing.*

11. The Exchange believes that the above proposals would provide listed issuers with sufficient flexibility to take advantage of business opportunities which may arise during the six-month period after listing without prejudicing the interest of public shareholders. The Exchange invites comments on the above proposals. Views are also invited on:
 - i. whether the shares issued should be subject to a lock-up as mentioned above;
 - ii. whether such share issues should be limited to those for the acquisition of businesses only (i.e. excluding acquisition of assets); and
 - iii. whether a maximum limit on the total number of shares to be issued by an issuer within the six-month period should be imposed for the purpose of acquisitions, and if so, the appropriate limit to be set.
12. The proposals in paragraph 10 are made on the basis that the issue of new shares by a company within six months after listing would not be regarded as a “*disposal*” by initial management shareholders or significant shareholders who are subject to the moratorium provisions. Further, the proposals are not intended to have any impact on the moratorium itself – i.e. notwithstanding the issue of new shares during the six-month period, the shares held by initial management shareholders and significant shareholders when the company was first listed would still be subject to the lock-up for the same duration as if no new issue had taken place.

III. Active Business Pursuits

1. Pursuant to Rule 11.12 of the GEM Listing Rules, a new applicant must demonstrate that, throughout the period of 24 months immediately preceding the date of the listing document (the “**Track Record Period**”), it has, either by itself or through one or more of its subsidiaries, actively pursued one focused line of business under substantially the same management and ownership. This is a special feature of GEM. It was an Exchange proposal in its May 1998 Consultation Paper¹¹ and was introduced in light of the absence of a profitability record of issuers and the higher risk involved in investing in emerging growth companies:

“The principal purpose underlying the requirement to demonstrate Active Business Pursuits is first to give potential investors information on which to reach a judgement as to whether the applicant’s business is likely to succeed, and secondly to make it more difficult for over-aggressive issuers and promoters to obtain a listing in the Second Market.”¹²

¹¹ Page 10 of the Exchange May 1998 Consultation Paper.

¹² Page 13 of the Exchange May 1998 Consultation Paper.

2. Since GEM was launched, however, the Exchange has received a number of requests from listing applicants to shorten the Track Record Period. The principal arguments advanced by applicants in support of these requests are:
 - i. Although the applicant has a Track Record Period of less than 24 months, it has already established a substantial business demonstrated by other means for example, by having generated a particular level of gross revenue or customer base.
 - ii. Other stock exchanges do not require a track record period of 24 months.
3. The Track Record Period requirements for various international markets are summarised below:

Market	Country	Minimum track record period
NASDAQ National Market	USA	<p>None if: Market capitalisation is above US\$75 million; or Total assets and total revenue are both above US\$75 million</p> <p>Otherwise, the issuer must show: 2 years operating history and net tangible assets of at least US\$18 million; or Pre-tax income of over US\$1 million in the latest fiscal year or two of the last three fiscal year (indicating that the issuer must have operating history of at least one fiscal year)</p>
NASDAQ Small Cap Market	USA	<p>None if market capitalisation exceeds US\$50 million</p> <p>1 year if market capitalisation is below US\$50 million</p>
Neuer Markt	Germany	3 years (see note)
SESDAQ	Singapore	None

Note: Based on the informal discussion with the official of Neuer Markt, it is understood that if an issuer has been in operation for at least 1 financial year and has generated revenue, the rule can be waived on a case-by-case basis. If an issuer has not been in operation for 1 financial year, it will be regarded as having satisfied that rule by showing that it has been in operation for some time and that it has a detailed plan for the rest of its first year. It is also understood that a lot of Internet companies have been granted an exemption from this rule.

4. The track record sets a period over which information about the operations of the applicant (i.e. *“both the qualitative and quantitative information about the progress and achievements of the company in the two calendar years prior to listing”*¹³) must be provided to investors on which to make a judgement as to the prospects of the listing applicant. It also provides a period over which the management of a listing applicant can demonstrate that they have operated together cohesively as a team. A longer track record requirement has also been thought of as reducing the risks associated with investing in the business of a listing applicant in that it will have provided more time for that business to become established.
5. It is also recognised that there are sectors of the economy which have experienced rapid development, for example, the so-called e-businesses and i-businesses. Such businesses may need to seek several rounds of financing before they have been in operation for 24 months. A two-year Track Record may deprive such companies of access to funding for business development. It may also deprive investors of the opportunity to invest in such companies. By providing a fund raising arena to less-established emerging companies, GEM can complement the SAR Government’s initiatives to promote the development of high technology industries in Hong Kong.
6. Whilst recognising the concern that a shorter track record period will make it easier for over-aggressive companies to obtain listing on GEM, the Exchange is also aware of the need for “growth” companies to seek financing in their early stage. The Exchange also considers that the market should be given a choice as to whether to invest in “young” companies.
7. The Joint Announcement indicates that pending the completion of this consultation, exercise, the Exchange has the discretion to grant waivers to reduce the 24 months active business pursuits in Rule 11.12 to at least 12 months, active business pursuits. Where an applicant has a longer period of active business pursuits, the disclosures in the listing document should cover that period up to the maximum of 24 months.
8. By reducing the track record requirement to at least 12 months, the Joint Announcement strikes a balance, at what might be thought of as the mid-point, between the existing 24-month requirement and suggestions that the period be abandoned completely. It also brings the Exchange more into line with the requirements of other markets as discussed above.

¹³ Page 13 of the Exchange May 1998 Consultation Paper.

9. *The Exchange now proposes that the minimum Track Record Period should be reduced from the current 24 months to at least 12 months.*
10. The Exchange invites comments on this proposal. The Exchange would particularly welcome comments on whether a Track Record Period requirement should apply and, if so, whether it should be longer or shorter than that proposed by the Exchange in this Consultation Paper.

IV. Accountants' report

1. Rule 7.03 of the GEM Listing Rules currently requires the accountants' report in the listing document of a new applicant (the "**Accountants' Report**") to include the consolidated results of the applicant covering at least the 2 financial years immediately preceding the issue of the listing document.
2. Following the proposed reduction in the minimum track record period as discussed above, the minimum period to be covered by the Accountants' Report would have to be reduced accordingly.
3. *The Exchange proposes that if the minimum track record period is reduced to at least 12 months, the period to be covered by the Accountant's Report should also be reduced to at least 12 months which correspond with the track record period. If the applicant concerned has carried on business for more than such 12-month period, the Accountants' Report should be made up for and cover the full period of its operations up to the maximum of 2 financial years.*
4. The Exchange invites comments on this proposal.

V. Share option schemes

1. Chapter 23 of the GEM Listing Rules sets out the rules regarding the share schemes of GEM issuers and their subsidiaries. The Exchange proposes to amend the share scheme provisions along the same line as that proposed for the Main Board in the Consultation Paper on Share Options issued on 8 May 2000¹⁴. The principal proposed amendments are discussed below. The market is referred to the Main Board Consultation Paper on Share Options for more detailed commentaries of the proposals made.

¹⁴ *The Main Board Share Options Consultation Paper is available on the Exchange's web site at <http://www.sehk.com.hk>.*

Application of Chapter 23

2. Similar to Chapter 17 of the Main Board Listing Rules, the provisions of Chapter 23 of the GEM Listing Rules apply to all schemes involving the grant of options over securities of the listed issuer or of any subsidiary of a listed issuer. Various views have been expressed that these provisions should not cover share schemes involving the securities of unlisted subsidiaries of a listed issuer.
3. *The Exchange proposes that share schemes of unlisted subsidiaries of a listed issuer will no longer be governed by Chapter 23. However, in view of the effect on deemed disposal of the subsidiary resulting from the grant of options, the Exchange proposes that these plans be approved by shareholders of the listed issuer. Furthermore, if the participant of the subsidiary's share scheme is a substantial shareholder of a listed issuer, or any of his/its associates, the grant of options to such participant must be approved by independent shareholders of the listed issuer. If the grant of options over shares in a listed issuer to its substantial shareholders requires independent shareholders' approval (as discussed in paragraph 24 below), options over shares of an unlisted subsidiary granted to such persons should be subject to the same requirements.*
4. The Exchange invites comments on the proposed rule, in particular,
 - i. the approval of share schemes of unlisted subsidiaries by the shareholders of the listed issuer; and
 - ii. the requirement for independent shareholders' approval for the grant of options under the unlisted subsidiary's plan to substantial shareholders of the listed issuer.

Adoption of a New Scheme

5. Chapter 23 intends to address issues relating to the on-going dilution effect on the interest of existing shareholders as well as the abuse of share option schemes by management to remunerate themselves.
6. *In respect of the dilution effect which relates to all shareholders, the Exchange is of the view that all shareholders should be allowed to vote to approve a new scheme as long as all the terms are clearly set out in the scheme document and the circular to shareholders. In particular, the Exchanges proposes that for the adoption of a new share option scheme:*
 - i. *approval by the shareholders of the listed issuer (and also by shareholders of any holding company which is listed on the Exchange) must be obtained. All shareholders can vote at the general meeting;*

- ii. *the listed issuer has to issue a circular to shareholders (containing terms of the scheme, and the purpose of the scheme and how the terms will serve the said purpose); and*
- iii. *the listed issuer has to publish an announcement on the outcome of the shareholders' meeting for the adoption of the scheme immediately after such meeting.*

7. The Exchange invites comments on the above proposal.

Eligible Participants

- 8. Pursuant to Rule 23.03(1) of the GEM Listing Rules, share options can only be granted to full-time employees of the issuer or its subsidiaries. This limitation is imposed on the basis that the primary purpose of share option schemes is to provide incentives for the employees of listed issuers and their subsidiaries. However, the Rule limits the ability of companies to award options to employees and directors who do not work full-time.
- 9. The Exchange notes that internationally, it is becoming more common for companies, particularly start-up companies that have limited cash resources, to use share options in payment for services and, in some cases, for goods. *The Exchange therefore proposes not to impose restriction on the eligibility of participants of share option schemes but the issuer must define the participants in its share option schemes before such plans are approved by shareholders.*
- 10. The Exchange invites comments on the proposed rule, in particular,
 - i. whether there should be some restriction as to who can participate in a listed issuer's share schemes; and
 - ii. if yes, what would the criteria be for a person to be eligible to participate in a share scheme of the listed issuer.

Procedures for Shareholders' Approval for Mandate for Granting Options

- 11. Pursuant to Rule 23.03(2) of the GEM Listing Rules, the total number of the securities subject to the scheme must be stated and it must not, in aggregate, exceed 10% of the relevant class of securities of the listed issuer (or the subsidiary) in issue from time to time.

12. Views have been expressed to the effect that companies should be free to determine the size of mandate of their schemes as long as they can justify the size and obtain shareholders' approval.
13. Whilst recognising the need to allow flexibility for the listed issuers to grant share options, the Exchange is of the view that it may not be appropriate to totally relax the requirements for companies listed on GEM and certain safeguards have to be built in the Rules to prevent the management from abusing the share option schemes to remunerate themselves.
14. The Joint Announcement includes certain safeguards which apply if the share options limit is to exceed 10%. In particular the granting of options over the 10% limit requires specific shareholder approval in general meeting.
15. *The Exchange therefore proposes:*
 - i. *Shareholders of a company may authorise directors to grant options under outstanding share option schemes entitling grantees to exercise up to an aggregate 10% of the issued shares of the company, based on the issued share capital at the date of shareholders' approval (the "General Mandate Limit"). When the listed issuer has granted options under an existing mandate, it can refresh the 10% mandate by way of shareholders' approval.*
 - ii. *Subject to the Scheme Limit (as defined in paragraph 17 below) not being exceeded, the company may issue share options to specified participants over and above the General Mandate Limit if such grant is specifically approved by shareholders in general meetings.*
16. The Exchange invites comments on the proposed rule, in particular,
 - i. the proposed size of the general mandate for directors to grant options under share option schemes and whether such mandate should continuously be renewable subject to shareholders' approval; and
 - ii. whether a listed issuer should be allowed to obtain the proposed specific mandate for granting options to specified participants.

Limit on Options Granted under Share Option Schemes

17. Under the existing GEM Listing Rules, the total number of securities subject to the scheme must not, in aggregate, exceed 10% of the relevant class of securities of the listed issuer (or the subsidiary) in issue from time to time (the “Scheme Limit”). The Exchange has received a number of requests from listing applicants to increase the Scheme Limit. In making these requests, listing applicants have submitted that:
 - i. Share options are a powerful tool for companies to recruit, retain and motivate employees, particularly those in the Internet and information technology industries.
 - ii. Share options may be particularly attractive to companies which are not making a profit and/or which have very high level of capital and operating expenditure. These companies may conserve resources by granting share options in place of higher salaries to recruit and retain their employees.
18. Views have also been expressed to the effect that there should not be restrictions on share options schemes and that it should be for the shareholders of the listed issuer to determine the number of options to be issued.
19. The NASDAQ National Market, the NASDAQ Small Cap Market, the Neuer Markt and the SESDAQ Market do not have any specific restrictions on the maximum number of share options that can be granted by an issuer.
20. Whilst recognising the potential of options to reward and remunerate staff, it must also be recognised that they may dilute the interests of shareholders. *The Exchange is therefore of the view that a limit should be retained to avoid unreasonable and on-going dilution of shareholders’ interests.* The Joint Announcement indicates that pending completion of this consultation exercise, the Exchange will grant a waiver to listing applicants in relation to the Scheme Limit. The Joint Announcement indicates that the total number of shares, which may be exercised under all outstanding share option schemes of an issuer, must not exceed 30% of an issuer’s total issued shares from time to time. *The Exchange proposes to adopt this as a requirement, i.e. to increase the Scheme Limit from 10% to 30%.*
21. The Exchange invites comments on the above proposals, in particular,
 - i. whether there should be a limit on the number of shares subject to options based on the total number of shares issued; and
 - ii. if yes, what percentage of the relevant class of securities would be acceptable.

Limit on Options Granted to an Individual Participant

22. Under the existing rules, the maximum entitlement of each participant is 25% of the securities subject to the share scheme. This equates to a limit of 2.5% of issued shares over a ten-year period. *The Exchange is of the view that an annual limit to each participant should be retained to safeguard the interest of shareholders. The limit is proposed to be 0.5% of the securities subject to the share scheme for a 12-month period. Under the proposal, a listed issuer will not be prohibited from granting options to any particular participant in excess of the individual limit provided that it is separately approved by the shareholders of the listed issuer, with such participant and his associates abstaining from voting.*
23. The Exchange invites comments on the above proposal, in particular,
- i. whether there should be a limit on options granted to each individual participant; and
 - ii. if yes, what size of limit and the period covered would be appropriate.

Granting of Options to Connected Persons

24. The Joint Announcement also includes a requirement that before options can be granted to a connected person, the independent non-executive directors must approve them. *The Exchange proposes to adopt this as a requirement. The Exchange further proposes that if options are granted to a participant who is also a substantial shareholder or an independent non-executive director of the listed issuer or any of his/its associates, and the securities underlying all options granted to him within a 12-month period up to and including the latest proposed grant (i) represents over a certain percentage, say 0.1%, of the securities in issue; and (ii) has a value in excess of certain amount, say HK\$5 million, the latest proposed grant of options is also subject to independent shareholders' approval with all connected persons abstaining from voting. The above requirements for connected persons do not apply to the granting of options to a person who is only a proposed director/ chief executive of the listed issuer.*
25. The Exchange invites comment on this proposed rule, in particular,
- i. whether independent non-executive directors should approve the issue of options to connected persons;
 - ii. whether independent shareholders should approve issues of options above a de minimis limit only to connected persons who are substantial shareholders or independent non-executive directors;

- iii. whether independent shareholders should approve issues of options to all connected persons above a de minimis limit, in particular, where a listed issuer does not have any substantial shareholder and therefore the directors may have full discretion over the operation of the plans;
- iv. if the requirement for shareholders' approval for options in excess of the individual limit suggested in paragraph 24 above is dropped, does this affect your answer to ii and iii above;
- v. whether the de minimis limit should apply to options granted within a 12-month period and relate to:
 - (a) a percentage of the securities in issue; and/or
 - (b) the value of the underlying securities; and/or
 - (c) the fair value of the options; and
- vi. what should the de minimis limit be in v(a), (b) and (c)?

Disclosure of Options Granted

- 26. The Joint Announcement also indicates that details of options granted to each director and all other participants in option schemes must be disclosed in the interim and annual reports of issuers. A summary of the major terms of each share option scheme approved by shareholders is also to be disclosed in the interim and annual reports.
- 27. The Exchange considers that the disclosure obligations promote transparency in relation to options. The disclosure of directors' share options is consistent with the Exchange's initiatives in relation to corporate governance.
- 28. *The Exchange therefore proposes that the listed issuers should disclose in their annual and interim reports the details of options (including the fair value) granted to (1) each connected person; (2) each participant with options granted in excess of the individual limit; (3) aggregate figures for employees working under employment contracts that require over 18 hours of service each week; and other participants in aggregate.*

29. *Disclosure of the fair value of options granted during the financial year/period must include:*
- i. the method used to calculate such fair value, for example, the Black-Scholes option pricing model or other method that the listed issuer considers appropriate; and*
 - ii. the effect on the listed issuer's profit or loss and earnings per share if the fair value of options granted were treated as remuneration expense.*
- The auditors must also confirm to the listed issuer that the method used to calculate the fair value of options is correctly disclosed.*
30. The Exchange invites comments on the proposed rule, in particular,
- i. whether it is appropriate to introduce the requirement to disclose fair values of options granted by listed issuers;
 - ii. whether any additional disclosure should be made;
 - iii. whether the Exchange should dictate in the Rules which model to use or leave it to the listed issuers to decide as long as the model used is fully disclosed; and
 - iv. whether it would be practical and appropriate to require auditors to confirm the matters relating to the calculation of fair value of options as required under the proposed rule.

VI. Revenue or profit requirement

1. The GEM Listing Rules do not have a specific requirement in relation to the revenue or profit record of the listing applicant. However, there have been suggestions that applicants should have achieved a certain level of revenues or profits before being listed on GEM. It is argued that a listing applicant would be more objectively able to demonstrate that it had already established a business of substance during the track record period if a profit or revenue requirement is introduced.

2. The requirement relating to the revenue or profit achieved by listing applicants of various internationally recognised markets is summarised below:

Market	Country	Minimum revenue / profit
NASDAQ National Market	USA	<p><i>No revenue or profit requirement if:</i> Market capitalisation is at least US\$75 million</p> <p>OR</p> <p>Revenue of minimum US\$75 million and Total Assets of minimum US\$75 million</p> <p><i>No revenue or profit requirement if:</i> There is an operating history of 2 years and Net Tangible Assets of at least US\$18 million</p> <p><i>No revenue or profit requirement if:</i> Net Tangible Assets of at least US\$6 million and Pretax Income of at least US\$1 million in the latest fiscal year or 2 of the last 3 fiscal years)</p>
NASDAQ Small Cap Market	USA	<p>No revenue requirement but must satisfy one of the following:</p> <ul style="list-style-type: none"> i. Market Capitalisation > US\$50 million ii. Net Tangible Assets > US\$4 million iii. Net Income > US\$750,000
Neuer Markt	Germany	No revenue or profit requirement but Equity > US\$1.4 million and Market Capitalisation > US\$4.8 million
SESDAQ	Singapore	No revenue or profit requirement

3. *Taking account of the existing rules of the other internationally recognised stock exchanges and the fact that many of the technology companies may not be able to generate any turnover or profit before they have to raise funds from the public, the Exchange is of the view that there should be no changes to the existing GEM Listing Rules. Listing applicants will not be required to achieve a specific level of revenues or profits to qualify for a listing on GEM.*
4. The Exchange now invites comments on this proposal.

VII. Offering Mechanism

1. Chapter 10 of the GEM Listing Rules deals with the methods by which securities may be brought to listing on GEM. These methods include offers for subscription, offers for sale and placing. These follow from requirements in the Listing Rules applicable to the Main Board (set out in Chapter 7 of the applicable Listing Rules). The GEM Rules have no equivalent of Main Board Rule 7.10 which provides that *“the Exchange may not permit a new applicant to be listed by way of a placing if there is likely to be significant public demand for the securities.”* Such requirements and Practice Note 18 of the Main Board Listing Rules were considered but were rejected by the Second Market Committee to provide more flexibility to growth companies.
2. There have been suggestions that a similar provision to Main Board Rule 7.10 should be included in the GEM Listing Rules. At the time the GEM Listing Rules were developed, it was considered that companies seeking a listing on GEM might not have sufficient appeal to general investors to require provisions that allow the Exchange to restrict the use of placing. Recently, there have been a number of initial public offerings where there has been considerable public interest. Thus, the original reasons for not including Rule 7.10 in the GEM Rules are now open to question.
3. *In light of this, the Exchange now considers that it is appropriate that provisions similar to Rule 7.10 of the Main Board Listing Rules be introduced into the GEM Listing Rules. This proposal, if adopted, would allow the Exchange more flexibility and discretion in determining the method of listing of a company in cases where the Exchange believes there is considerable public interest.*
4. There have been suggestions that new listings on GEM should, like the Main Board, include a public offer tranche. It has also been suggested that the public offer tranche should be increased by a clawback mechanism from the placing tranche where the initial public offer tranche is oversubscribed.

5. The Main Board Listing Rules include provisions dealing with IPOs which include both a placing tranche and a public subscription tranche. These rules were the result of consultation jointly conducted by the SFC and the Exchange in June 1997 (with conclusions drawn in 1998). These provisions are set out in Practice Note 18 to the Main Board Listing Rules. The provisions provide that the minimum allocation of shares to the subscription tranche shall be:
- An initial allocation of 10% of the shares offered in the IPO
 - A clawback mechanism that increases the number of shares to 30% when total demand for shares in the subscription tranche is more than 15 times but less than 50 times the initial allocation
 - A clawback mechanism that increases the number of shares to 40% when total demand for shares in the subscription tranche is more than 50 times but less than 100 times the initial allocation
 - A clawback mechanism that increases the number of shares to 50% when total demand for shares in the subscription tranche is 100 times or more the initial allocation
6. The clawback mechanism on the Main Board was developed as a means of allowing locally based retail investors to participate in international share offerings in the context of a market with significant retail involvement. This has resulted in a mechanism that provides for certain specified proportions of an offer by way of placing to be “clawed back” to the public offer tranche depending on the level of public demand in Hong Kong.
7. *In light of public demand for a fair opportunity to subscribe for GEM stocks during the initial public offering stage, the Exchange now proposes that a minimum of 10% of any initial public offering involving a listing on GEM be offered to the public by way of subscription.* The Exchange invites comments on this proposal.
8. *The Exchange also proposes that a clawback mechanism from the placing tranche to the public subscription tranche be adopted for GEM. The amount of shares to be clawed back should depend on the level of over-subscription for shares in the public subscription tranche.* The Exchange also seeks comments on whether the clawback formula for the Main Board as set out in paragraph 5 above should be adopted for GEM.

VIII. Additional matters for consultation

The Exchange would welcome comments on any aspect of the GEM Listing Rules which is not specifically addressed in this consultation paper.

JOINT PRESS RELEASE

Joint Press Announcement in relation to the review of the GEM Listing Rules and the grant of waivers in respect of matters under the GEM Listing Rules pending completion of such review

The Securities and Futures Commission (“SFC”) and The Stock Exchange of Hong Kong Limited (the “Exchange”) attach great importance to the Growth Enterprise Market (the “GEM”) as a market to raise funds for the business development of growth enterprises.

It was the original intention of the SFC and the Exchange that the GEM Rules be reviewed within six months from the launch of the market to take into account experience gained to date. With a view to ensure the competitiveness of the GEM, it has been agreed between the SFC and the Exchange that this review be conducted as soon as possible before the end of the six months period. In the meantime, the SFC and the Exchange have agreed the relaxation of certain requirements currently imposed on listing applicants/ issuers and their shareholders under the GEM Rules pending finalisation of the rule review.

The SFC notes that compliance with certain requirements of the GEM Rules has been waived by the Exchange in a number of individual cases. It is recognised that the Exchange has granted these waivers in order to develop the GEM and to compete with other markets. However, it is acknowledged that the lack of transparency associated with such waivers has given cause for public concerns.

Having regard to the Exchange’s intention to ensure the success and competitiveness of the GEM and the SFC’s regulatory concerns, and with a view to ensuring a level playing field and transparency in the application of the GEM Rules in the meantime, the SFC and the Exchange have agreed the following:

1. **Management shareholders moratorium:** The lock-up period referred to in Rule 13.16 of the GEM Rules applicable to initial management shareholders is reduced from two years to six months provided that no controlling shareholders (as such term is defined in the GEM Rules) are allowed to dispose of any relevant securities in the second six months period after listing if such disposal would result in the controlling shareholder or the group of persons constituting the controlling shareholder ceasing to have control over 35% of the voting powers at general meetings of the issuer.
2. **Active business pursuits:** The 24 months “active business pursuits” referred to in Rule 11.12 of the GEM Rules is reduced to at least 12 months of “active business pursuits”. If the issuer concerned has a longer period of business pursuits, disclosures in its listing document should cover the full period subject to a 24 months maximum.

3. **Accountants' report:** The two financial years accountants' report referred to in Rule 7.03 of the GEM Rules is reduced to at least 12 months accountants' report corresponding to the minimum 12 months "active business pursuits" mentioned in paragraph 2 above. If the issuer concerned has carried on business for more than such 12 months period, the accountants' report should be made up for and cover the full period of its operation up to the maximum of two financial years.
4. **Share options provisions:** Rule 23.03(2) of the GEM Rules which sets out the limit on the grant of share options is modified as follows:
- 4.1 Subject to 4.3 below, shareholders of a GEM issuer may authorise directors to grant options under outstanding share option schemes entitling grantees to exercise up to an aggregate of 10% of the issued shares of the company from time to time (the "General Mandate Limit"). Such general mandate may be renewed if approved by shareholders in general meetings.
- 4.2 Subject to 4.3 below, an issuer may issue share options to specified participants over and above the General Mandate Limit if such grant is specifically approved by shareholders in general meetings.
- 4.3 The total number of shares which may be exercised under all outstanding share option schemes of an issuer must not exceed 30% of its total issued shares from time to time.
- 4.4 The above modifications to Rule 23.03(2) are allowed subject to the additional requirements to Rules 23.03(3) and 23.08 as set out in paragraph 4.5 and 4.6 below.
- 4.5 Regarding Rule 23.03(3) - *Additional requirements on grant of options to connected persons:*
- (i) Any grant of options to a connected person (as such term is defined in the GEM Rules) must be approved by the independent non-executive directors of the issuer.
- (ii) Where options are proposed to be granted to a connected person who is also a substantial shareholder (as such term is defined in the GEM Rules) or an independent non-executive director of the issuer or any of their respective associates, and the proposed grant of options, when aggregated with the options already granted to that connected person in the past 12 months period, would entitle him to receive more than 0.1% of the total issued shares of the issuer for the time being and the value of which is in excess of HK\$5 million, then the proposed grant must be subject to the approval of shareholders in general meetings. Apart from

the connected person involved, all other connected persons of the issuer must abstain from voting in such general meeting (except where any connected person intends to vote against the proposed grant). A shareholders' circular must be prepared by the issuer explaining the proposed grant, disclosing the number and terms of the options to be granted and containing a recommendation from the independent directors on whether or not to vote in favour of the proposed grant.

4.6 Regarding Rule 23.08, the following additional disclosures must be made in the annual and interim reports of an issuer:

- (i) details of options granted to the following persons: each director; and all the other participants.
- (ii) a summary of the major terms of each share option scheme approved by shareholders.

The agreement between the SFC and the Exchange is against the following background.

- (a) The Exchange will prepare a consultation paper to conduct a full market consultation on the issues mentioned in paragraphs 1 to 4 above and any other issues which the Exchange or the SFC may consider appropriate, such consultation paper to be issued as soon as reasonably practicable and providing the public with a reasonable time within which to respond and to provide comments;
- (b) Within a reasonable time after completion of the consultation period, the Exchange will prepare and issue a consultation conclusions paper with sufficient details advising the market of the comments received and the conclusions drawn;
- (c) Within a reasonable time after the issue of the consultation conclusions, the Exchange will present the relevant amended rules to the Commission for consideration and approval pursuant to section 34 of the Stock Exchanges Unification Ordinance;
- (d) No waivers shall be given to further relax or modify the provisions of paragraphs 1 to 4 above until finalisation of the rule review process referred to in paragraphs (a) to (c) above; and
- (e) The SFC and the Exchange acknowledge that the rule review resulting from the public consultation may or may not be more restrictive than the existing provisions of the GEM Rules and those set out in paragraphs 1 to 4 above.

* * *

March 11, 2000

General

This questionnaire is designed to facilitate market response to the items of consultation set out in this Paper. Respondents are not required to use this questionnaire if they consider it more useful and constructive to provide comments to the Exchange by way of a letter or in other written form. It is acknowledged that the use of this questionnaire alone may not be adequate for respondents to fully communicate their comments on complex issues such as those set out in this Paper. Respondents who wish to use this questionnaire are therefore encouraged to supplement their comments and views by attaching additional sheets to this questionnaire.

Respondents are requested to provide their views and comments with reasoning. This would enable the Exchange to analyse the consultation result with more accuracy and would ensure a better understanding of public opinions for the formulation of listing policy relating to GEM.

The consultation period will close on 30 June 2000.

Consultation Items

1. Moratorium Provisions

(a) Moratorium Period For Controlling Shareholders (Please refer to pages 8 to 11 above)

Please indicate your preference on the duration of the moratorium period applicable to initial management shareholders who are controlling shareholders:

- ☐ Lock-up for 2 years after listing and no restrictions on disposal thereafter (i.e. no change to GEM Listing Rules)
- ☐ Lock-up for 1 year after listing and no restrictions on disposal thereafter
- ☐ Lock-up for 6 months after listing and no restrictions on disposal thereafter

- ☐ Lock-up for the first 12 months after listing and during the following 12-month period, a controlling shareholder cannot dispose of any interest in the GEM issuer if any disposal would result in his ceasing to have 35% control over the issuer (i.e. total restricted period is 2 years and limited disposal of shares is allowed during the second 12-month period)
- ☐ Lock-up for the first 6 months after listing and during the following six-month period, a controlling shareholder cannot dispose of any interest in the GEM issuer if any disposal would result in his ceasing to have 35% control over the issuer (i.e. total restricted period is 1 year and limited disposal of shares is allowed during the second six-month period)
- ☐ Lock-up for the first 6 months after listing and during the following 12-month period, a controlling shareholder cannot dispose of any interest in the GEM issuer if any disposal would result in his ceasing to have 35% control over the issuer (i.e. total restricted period is 18 months and limited disposal of shares is allowed during the last 12 months)
- ☐ Lock-up for the first 6 months after listing and during the following 18-month period, a controlling shareholder cannot dispose of any interest in the GEM issuer if any disposal would result in his ceasing to have 35% control over the issuer (i.e. total restricted period is 2 years and limited disposal of shares is allowed during the last 18 months)
- ☐ Other moratorium period (please specify) _____

Please support your view with reasons: _____

(b) Moratorium Period For Initial Management Shareholders (Please refer to pages 8 to 11 above)

Please indicate your preference on the duration of the moratorium period applicable to initial management shareholders who are not controlling shareholders:

- ☐ Lock-up for 2 years after listing and no restrictions on disposal thereafter (i.e. no change to the GEM Listing Rules)
- ☐ Lock-up for 1 year after listing and no restrictions on disposal thereafter
- ☐ Lock-up for 6 months after listing and no restrictions on disposal thereafter

- ☐ Lock-up for the first 12 months after listing and during the following 12-month period, an initial management shareholder can dispose of up to 50% of his interest in the GEM issuer (i.e. total restricted period is 2 years and limited disposal of shares is allowed during the second 12-month period)
- ☐ Lock-up for the first 6 months after listing and during the following 6-month period, an initial management shareholder can dispose of up to 50% of his interest in the GEM issuer (i.e. total restricted period is 1 year and limited disposal of shares is allowed during the second six-month period)
- ☐ Lock-up for the first 6 months after listing and during the following 12-month period, an initial management shareholder can dispose of up to 50% of his interest in the GEM issuer (i.e. total restricted period is 18 months and limited disposal of shares is allowed during the last 12 months)
- ☐ Lock-up for the first 6 months after listing and during the following 18 months period, an initial management shareholder can dispose of up to 50% of his interest in the GEM issuer (i.e. total restricted period is 2 years and limited disposal of shares is allowed during the last 18 months)
- ☐ Other moratorium period (please specify) _____

Please support your view with reasons: _____

(c) Interpretation of Initial Management Shareholders for the Purpose of the Lock-Up (Please refer to pages 11 to 13 above)

For the purpose of the lock-up, please indicate whether in your view, the following persons should be deemed as initial management shareholders, regardless of whether or not they have or control 5% or more of the voting rights in a GEM issuer:

- ☐ All members of the senior management
- ☐ All directors, including non-executive directors
- ☐ All investors, including but not limited to investment funds, with board representation
- ☐ Others – please specify _____ .

Please support your view with reasons: _____

(d) Interpretation of “Disposals” by Initial Management Shareholders (Please refer to page 13 above)

For the interpretation of “disposal” by initial management shareholders, please indicate whether you agree that the following types of disposals should be exempted from the meaning of disposal under the moratorium provisions:

- i) Stock lending by initial management shareholders to underwriter during the 30-day period after the issue of shares by the issuer solely for the purpose of covering any short position prior to the exercise of the over-allotment option.
- ii) Sale of shares by initial management shareholders during the second six-month period after listing only for the purpose of effecting a placing and top-up transaction and provided that there is no change in the number of shares held by such shareholder upon completion of the top-up transaction compared with its holding immediately before the transaction and in the case of controlling shareholders, there is no change in the control of the company concerned.

- ☐ Agree with the exemption as described in i) above only
- ☐ Agree with the exemption as described in ii) above only
- ☐ Agree with both of the above exemptions
- ☐ Disagree with both of the above exemptions

Please support your view with reasons: _____

2. Share Issues Within Six Months of Listing (Please refer to pages 13 to 17 above)

Please indicate your view on whether a GEM issuer should be allowed to issue new shares during the six-month period after listing:

- ☐ No change (i.e. issue of new shares not permitted in the first 6 months)
- ☐ Issue of new shares in the first six months be allowed without any restrictions

- ☐ Issue of new shares in the first 6 months be permitted but subject to all of the following conditions (please tick the conditions you agree with):
- ☐ the share issue is only restricted for the purpose of acquiring business or assets which are complementary to the issuer's focused line of business
 - ☐ the share issue should not have the effect of changing the control of the issuer within the meaning of the Hong Kong Code on Takeovers and Mergers
 - ☐ the issue be approved by independent shareholders
 - ☐ an independent financial adviser be appointed to advise on whether the acquisition and the issue price is fair and reasonable to independent shareholders
 - ☐ a circular with the details as proposed in page 16 above be issued to shareholders
 - ☐ the person who is issued the new shares would be subject to a lock-up arrangement similar to that applicable to initial management and significant shareholders (as the case may be)
 - ☐ a limit be imposed on the maximum number of shares which an issuer may issue within the six-month period – the maximum percentage of newly issued shares you consider appropriate is: _____.
 - ☐ Others – please specify _____.

Please support your view with reasons: _____

3. Minimum Track Record Period (Please refer to pages 17 to 20 above)

Please indicate the minimum track record or operating history period which in your view should apply to a new applicant for listing on GEM:

- ☐ 24 months (i.e. no change to the GEM Listing Rules)
- ☐ 12 months but if the applicant has carried on business for more than 12 months, then disclosures in the initial listing document should cover the full period of the operation subject to a maximum of 24 months.
- ☐ No requirement

Please support your view with reasons: _____

4. Accountants’ Report (Please refer to page 20 above)

Please indicate the period which in your view the accountants’ report should cover in the initial listing document of a GEM issuer:

- ☐ 2 financial years (i.e. no change to the GEM Listing Rules)
- ☐ at least 12 months corresponding with the minimum track record period but if the applicant has carried on business for more than 12 months, then the accountants’ report should be made up for the full period of its operation up to a maximum of 2 financial years.
- ☐ No requirement

Please support your view with reasons: _____

5. Share Option provisions (Please refer to pages 20 to 27 above)

(a) Application of Chapter 23

Please indicate in your view whether Chapter 23 should apply to share schemes of the unlisted subsidiaries of the listed issuers

- ☐ Yes
- ☐ No

Please support your view with reasons: _____

Please indicate in your view whether independent shareholders’ approval is required for the grant of options under the unlisted subsidiary’s scheme to substantial shareholders of the listed issuer

- ☐ Yes
- ☐ No

Please support your view with reasons: _____

(b) Adoption of a New Scheme

Please indicate in your view whether the adoption of a new share option scheme by a listed issuer should be subject to the following conditions (please tick the conditions you agree with):

- ☐ Approval by the shareholders (and also by the shareholders of any holding company which is listed on the Exchange)
- ☐ Issue of a circular to the shareholders containing terms of the scheme, and the purpose of the scheme and how the terms will serve the said purpose
- ☐ Publication of an announcement on the outcome of the shareholders' meeting for the adoption of the scheme immediately after such meeting

Please support your view with reasons: _____

(c) Eligible Participants

- ☐ No restriction at all
- ☐ Restricted to full-time employees and executive directors
- ☐ Restricted to full-time employees, executive directors and non-executive directors

Please support your view with reasons: _____

(d) Procedures for Shareholders' Approval for Mandate for Granting Options

Please indicate in your view the appropriate size of the limit of the general mandate

- ☐ 10%
- ☐ Other limit (please specify) _____

Please support your view with reasons: _____

Please indicate in your view whether the general mandate should continuously be renewable subject to shareholders' approval

- ☐ Yes
- ☐ No

Please support your view with reasons: _____

Please indicate in your view whether a listed issuer be allowed to obtain the proposed specific mandate for granting options to specified participants

- ☐ Yes
- ☐ No

Please support your view with reasons: _____

(e) Limit on Options Granted under Share Option Schemes

- ☐ 30%
- ☐ 10%
- ☐ Other maximum share option scheme limit (please specify)_____

Please support your view with reasons: _____

(f) Limit on Options Granted to an Individual Participant

Please indicate whether you agree with setting a limit for options that can be granted to each participant in any 12 months (the “de minimus level”) unless separate shareholders’ approval is obtained

- ☐ Yes and the de minimus level should be set at
 - ☐ the higher of (i) 0.1% of the securities subject to the share scheme of a 12-month period; and (ii) HK\$5 million
 - ☐ other limit (please specify): _____
- ☐ No

Please support your view with reasons: _____

(g) Granting of Options to Connected Persons

- ☐ must obtain independent shareholders’ approval regardless of the size
- ☐ must obtain independent shareholders’ approval if it exceeds the “de-minimus level”
- ☐ to be approved by independent non-executive directors regardless of the size
- ☐ to be approved by independent non-executive directors if it exceeds the “de-minimis level”

Please support your view with reasons: _____

(h) Disclosure of Options Granted

Please indicate in your view whether you support the proposal that details of options granted should be fully disclosed in the interim and annual reports of issuers

- ☐ Support
- ☐ Do not support

Please support your view with reasons: _____

Please indicate in your view whether the following information relating to the granting of options under share schemes should be disclosed in the issuer's interim and annual reports (please tick the information that you think should be disclosed)

- ☐ Details of options (including the fair value) granted to
 - ☐ each connected person
 - ☐ each participant with options granted in excess of the individual limit
 - ☐ aggregate figures for employees working under employment contracts that require over 18 hours of service each week
 - ☐ other participants in aggregate
 - ☐ other suggestions – please specify _____
- ☐ Fair values of options granted and the method used to calculate such fair value
- ☐ The effect on the listed issuer's profit or loss and earnings per share if the fair value of the options granted were treated as remuneration expenses
- ☐ Confirmation from the auditors confirming that the method used to calculate the fair value of options is correctly disclosed
- ☐ Other information (please specify): _____

Please support your view with reasons: _____

6. Revenue or profit requirement (Please refer to pages 27 to 29 above)

Please indicate whether in your view, a revenue or profit requirement should be imposed on applicants seeking to list on GEM:

- ☐ No change (i.e. no specific requirement)
- ☐ Require a minimum turnover figure, please specify the minimum turnover amount: _____
- ☐ Require a minimum profit figure, please specify the minimum profit amount: _____
- ☐ Require a minimum turnover/profit figure but the requirement can be waived subject to conditions (such as a minimum market capitalisation level being met) – please specify the conditions you consider appropriate: _____

Please support your view with reasons: _____

7. Offering Mechanism (Please refer to pages 29 to 30)

Please indicate your view on whether the Exchange should be given the discretion not to permit a new applicant to be listed by way of placing only if there is likely to be significant public demand for its securities.

- ☐ Agree
- ☐ Disagree

Please support your view with reasons: _____

Please indicate whether in your view, there should be a compulsory public offer tranche for all share offerings involving a listing on GEM and if so, the appropriate size of the public offer tranche:

- ☐ No need for a compulsory public offer tranche (i.e. no change to existing rules)
- ☐ Public offer tranche be made compulsory with a minimum of 10% of the overall offer size be allocated for public subscription
- ☐ Public offer tranche should be made compulsory, please indicate the minimum size of the public offer tranche: _____

Please support your view with reasons: _____

Please indicate whether in your view, a clawback mechanism should be put in place for more shares to be clawed back to the public offer tranche depending on the level of public subscriptions and if so, the amount of shares to be clawed back:

- ☐ No need for clawback mechanism (i.e. no change to existing rules)
- ☐ Clawback mechanism be introduced and the level of clawback to be consistent with the Main Board.
- ☐ Clawback mechanism be introduced – please specify level of clawback considered appropriate: _____

Please support your view with reasons: _____

Other Comments

The Exchange welcomes comments on any aspect of the GEM Listing Rules which is not specifically addressed in this questionnaire.

Responded by : _____

Name of the signatory:
Title, if applicable:
Name of firm, if applicable:
Date:

Contact details:

Name and title, if applicable : _____

Firm : _____

Address : _____

Contact phone number : _____