

Response to the HKEX New Board Concept Paper and Consultation Paper on Review of the Growth Enterprise Market (GEM) and Changes to the GEM and Main Board Listing Rules

The Financial Services Development Council (“FSDC”) deliberated at its July 4, 2017 Council meeting the content of the captioned papers (“Papers”) issued by the Stock Exchange of Hong Kong (“SEHK”) in June 2017. Unless otherwise indicated, the terms used in this response shall have the same meanings as in the Papers.

1. General – a holistic approach

On the whole, the FSDC is in strong support of the general direction envisioned by the SEHK in the Papers.

In our paper No. 09 “Positioning Hong Kong as an International IPO Centre of Choice” of June 2014 (“FSDC IPO Paper”) we made a number of suggestions to bring the Hong Kong market to the next level, amongst which was market segmentation with a view to diversifying the market and removing some of the ills of a “one-size-fits-all” listing regime. We are encouraged to see that the SEHK has taken concrete steps to turn this into reality.

As the FSDC IPO Paper also mentioned, a review of financial and legal infrastructure of our market on a holistic basis is correct. We agree with the SEHK that both Papers need to be considered holistically, and have prepared this response on that basis.

2. Capturing New Economy issuers

We agree with the SEHK and strongly support the general direction it proposes. We believe that the SEHK has built a compelling case substantiated by solid data that we need to attract a more diverse range of companies to list in Hong Kong. We also agree strongly with the SEHK that New Economy industries should be the key focus. In fact for any IPO market that aspires to a leading position in the world, we consider it nothing less than a practical necessity that the market be amenable and attractive to quality New Economy enterprises, which inevitably would make up a substantial portion of the IPO pipeline in the future.

3. Gateway to China and to the world

In the FSDC IPO Paper, we stressed Hong Kong’s unique position as China’s gateway to the world as well as the world’s gateway to China. Our sight is on global players, many of which may well have originated in China but for which the label “China player” is rapidly losing its meaning, especially with New Economy businesses that are breaking out of traditional physical and geographical boundaries.

The SEHK mentioned in the Papers that in the past 10 years over 6,000 Mainland companies that did not meet our Main Board profitability test or GEM cash flow test have listed on NEEQ, NYSE and NASDAQ, and that the number of those with

HK\$200m or above in market capitalisation amounted to 1,502. We see in this a potent sign of the scale of opportunities that, with some new flexibilities worked into our system, we can and should capture in future.

4. Tightening up and repositioning GEM

We are also in support of the proposal to tighten up regulation of the GEM board. Obviously, for the kind of success that our market has always aspired to, quality and quantity must go hand in hand. The misuse of the “GEM to Main Board” migration process and the problems of listed “shells” are causing an undue amount of harm to the reputation and order of our market. We echo the SEHK’s view that it is very important to step up regulation of the GEM listing requirements.

We agree with the SEHK that eligibility to the GEM board should be raised, that steps must be taken to address the problems of shell creation, and that the long-term positioning of GEM must be fundamentally re-considered and articulated clearly to the public. We agree with the proposals to remove the streamlined transfer process from GEM to the Main Board, which will revamp the “stepping-stone” positioning of GEM and help clear up some of the related malpractice.

5. Our views on the proposals

We understand that the Concept Paper is intended only to describe the contours of the proposed New Board, and that the granular details will be worked out in the future based on the feedback received from the public. In this connection, we would like to suggest to the SEHK some areas for which more caution should be exercised in respect of the proposed creation of the New Board.

a. New Board PREMIUM

We agree generally with the concepts behind New Board PREMIUM. We believe that opening up a new segment with full accessibility to all classes of investors and catering for the New Economy and other groups of good potential issuers is crucial for market development.

However, we do not necessarily see this segment as a stand-alone new board as opposed to a new segment of the Main Board. In particular, given that we believe New Board PRO segment is probably not a project we need to pursue with utmost priority (please see our comments in section 5b below), this begs the question whether we must create a New Board as a distinct board separated from the Main Board in order to have the new segment desired. The SEHK’s stated goals appear to us achievable by putting features into the Main Board and giving it additional tiering and flexibility. We expect the SEHK to have considered carefully the advantages and disadvantages of each approach. We have equally noted the costs and benefits in each, and will continue to keep them in view.

We understand that part of the SEHK’s concern in this regard is to “ring-fence” companies that are not strictly eligible for Main Board listings from the Hang Seng Index and thereby to safeguard the integrity of that index and any

investment products that track it or are otherwise linked to it. We believe, however, the SEHK needs not be excessively concerned in this regard. What to or not to include in an index is primarily a matter for the index companies and the regulators are unlikely to have an active role to play. As markets evolve, the index compilers may change their own strategies and interested groups may even lobby them for a change. This is not a sufficient reason by itself for introducing a distinct New Board.

The SEHK may also think about further widening the new segment so that it does not simply accommodate companies that, except for their non-traditional corporate governance structures, would otherwise meet the Main Board requirements. For example, the financial eligibility standards could be further modified to cater for a broader spectrum of pre-profit companies. It may be a good idea to add a new chapter to the Listing Rules to embody such modifications, as this may also encourage the SEHK and the public to think about the issues holistically during the drafting and consultation process for the new Listing Rules. To help investors differentiate these new target issuers from the traditional ones, the SEHK may use a prefix / suffix to the stock code or other marking device on the trading system.

In short, we invite the SEHK to put more thoughts into alternatives to opening a new trading board, and to consider whether the stated objectives in the Papers could be achieved more effectively by augmenting the existing structure. In any event, however, this question must not be allowed to hamper or delay the overall reform process.

b. New Board PRO

i. Professional-only listings

With regard to New Board PRO catering for professionals-only listings, we have considerable reservations whether it is appropriate to introduce such a new market segment at this point in time.

In this regard, our market is not without experience to draw from. On the Main Board we have Chapter 21 for equity listings of investment companies as well as Chapter 37 for debt listings. As is common knowledge, Hong Kong has never managed to build up a critical mass for Chapter 21 investment company listings, as Chapter 21 listings conducted through restricted marketing to professional investors are subject to fairly stringent constraints, often resulting in difficulties in building up adequate liquidity. In our view, therefore, the creation of New Board PRO as a professionals-only trading board should not be handled as an innovative experiment – the experience is already there and we should think about what lessons can be learned from it. In particular, with the proposed light-touch regulation for New Board PRO, the market may be justifiably concerned about the quality of companies listed on this segment. The SEHK should consider carefully whether the lowering of regulatory standards (or even just the public perception of such) is a worthy trade-off for an experiment which Hong Kong may not need at this juncture.

ii. Full access to all classes of investors

We consider that, in order for the proposed New Board to attract quality issuers, it must be designed to allow those issuers to access the full spectrum of professional and retail investors including those investing in the Hong Kong market through the Stock Connect programme. We suggest that the SEHK should bear that in mind when designing the optimal way to “house” these New Economy issuers. It is acknowledged that some of these New Economy issuers (especially those adopting alternative corporate governance structures) may be perceived to have a more risky profile. We believe, however, that the more appropriate risk mitigants in this regard may be more robust investors’ education, heightened disclosure requirements (e.g. more frequent periodical reporting) and other measures which promote accountability of the directors of these issuers.

If indeed the SEHK wants to explore further the opening up of an additional segment catering for issuers with higher risk profiles and reserve that for only a subset of investors, we suggest that such a project be left to a later stage and more thorough consideration be given to the positioning of such a market, which seems to us to be more akin to a quotation system instead of a trading board. It is a matter of higher urgency and priority to proceed with the proposals behind New Board PREMIUM.

c. “Centre of gravity”

In the FSDC IPO Paper, we had looked forward to the 2013 JPS (at the time only a year old) bringing more companies from different countries to secondary-list in Hong Kong. Sadly, this has not materialised due to a number of factors. At the time of preparing this response, only seven companies remain secondary-listed in Hong Kong compared to 10 at the time of the FSDC IPO Paper. Over the past three years as we have seen, Hong Kong’s attractiveness to potential candidates for secondary listings has at best stagnated and at worst deteriorated.

We agree strongly with the proposal to remove the requirement for “centre of gravity outside China” in respect of companies seeking a secondary listing in Hong Kong. As we mentioned in section 3 above, an increasing number of New Economy enterprises have a global footprint, and the geographical centre of gravity concept is fast getting out of date. It is a constraint Hong Kong does not need and we welcome the widening of the SEHK’s vision in this respect.

d. Weighted voting rights

The FSDC is generally in support of opening up the market to companies with non-traditional corporate governance structures, such as weighted voting rights. The SEHK needs to work out the details with market consultation.

In our view, however, reform in this area should not be exploited by already-listed companies attempting to take rights away from investors that have invested on the basis that these companies are “one share one vote” companies. We therefore suggest giving the concession to new listing applicants only. Safeguards should be put in place to prevent already-listed companies from delisting from the Main Board and then re-listing on the new market segment.

e. Making the Listing Rules more New Economy friendly

The Concept Paper discusses primarily eligibility requirements applicable to the various boards, and does not contain any proposals to make the Listing Rules themselves more friendly to New Economy companies. This is something we strongly believe the SEHK should pay more attention to.

A good part of the Listing Rules and the published guidance are created with traditional companies in mind and quite a number of their underlying concepts do not sit well with the way New Economy companies conduct business and stay competitive. For example, more flexibility could quite easily and safely be introduced into the current approach to delineation of business, reliance on parents, competition, employee incentivisation, and other issues that often hamper New Economy company listings. In these areas, even some small fine-tuning, in particular more willingness to adopt a disclosure-based approach, could make a big difference. We strongly encourage the SEHK to engage the market, gather views, and make suitable innovations.

In this connection, we would stress that in our view, the above adjustments should not be a pre-requisite for adopting the new eligibility listing criteria for either the Main Board or GEM. We believe the SEHK should go forward with reforms that, once implemented, will improve the market, rather than to wait for the “perfect solution” with all the components in place.

f. Branding

We note that the names New Board PRO and New Board PREMIUM are used for “strawman” purposes only and are not the final decision on branding. In this regard, we have the following ideas to share with the SEHK:

- a. We should bear in mind that any names chosen should be for the long term – the word “new” should be used with care as it will unavoidably become obsolete over time.
- b. A term like “premium” may also be reconsidered, as it may give an incorrect message given that the Main Board is supposed to remain the highest level of our markets.

6. Conclusion: It’s time to push forward

Although we have in this response raised some issues that we believe the SEHK should investigate further, this does not detract from our general support for the SEHK’s effort to bring about development in the Hong Kong market.

Given the outstanding issues that require further study in relation to the New Board PRO proposals, we would encourage the SEHK to press ahead first with the other reforms that are more urgent, namely creating the new market segment currently envisaged under the New Board PREMIUM concept, and the repositioning and tightening up of GEM. We consider the need to augment our market a pressing one. We therefore suggest that the SEHK adopt a nimble approach to effecting the proposals, with a goal to publishing a regulatory framework before the end of the year, to be supplemented by guidance letters in the future as the SEHK gains more experience handling applications by new economy issuers.

Some commentators have raised concerns about the New Board doing a disservice to the market by taking away liquidity from the Main Board. We are not inordinately concerned with the effect of the New Board on liquidity. In our view, the current problems of liquidity are attributable more to existing practices such as the prevalent use of cornerstone investors and the distortions in the price discovery process. To properly address issues of liquidity, we should focus on revamping the regulation of cornerstone investments and correcting other distortions in price discovery, as was highlighted in the FSDC IPO Paper.

Change always gives rise to risks as well as opportunities, and there will always be pros and cons in each reform. That must not make us lose sight of the overriding need to maintain Hong Kong's reputation and position as one of the world's leading IPO markets. This is our first priority and we cannot afford to let the market stagnate for fear of potential abuse. In fact, we believe the appropriate way to address market abuse is to step up enforcement, and in this regard, we observe that the SFC has made impressive progress in the past few years with a number of important enforcement actions which have helped consolidate Hong Kong's reputation as a well-regulated market. With this in mind, we do not think it would be productive to allow potentialities for abuse to hamper market development. We trust that the SFC and the SEHK will work together and strike a good balance between market development and regulation.

It is time to inject new energies to our market, and we are encouraged to note that the SEHK is taking a step in the right direction.

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