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# HKEx Publishes Discussion Paper on GEM

Hong Kong Exchanges and Clearing Limited ('HKEx') published its discussion paper on the Growth Enterprise Market (the 'Discussion Paper') on 20 January, 2006. The Discussion Paper does not contain a solution for GEM at this stage. Rather, it summarises the more prominent comments received from market practitioners in informal interviews and sets out HKEx's statistical analyses of GEM and research on overseas growth company markets. In order to facilitate public discussion, the Discussion Paper puts forward 3 structural options with different positioning and raises 12 key discussion questions. HKEx emphasises however, that it has an open mind about the 3 options and welcomes further comments on these or other options and any recommendations that could be pursued independent of the market's structure.

The consultation period for the Discussion Paper ends on 30 April, 2006. HKEx will then formulate specific proposals and initiatives for GEM based on the comments received. Such proposals will be subject to a further consultation. The Discussion Paper is available on [HKEx's website](http://www.hkex.com.hk). The purpose of this note is to summarise the Discussion Paper's principal proposals.

## 1. Background

The Discussion Paper notes that following a period of rapid growth in the number of companies listed in the years after its launch in 1999, the number of new listings on GEM has declined in recent years. In 2005, only 10 companies listed on GEM whereas 57 listed on the Main Board. In 2000 and 2001 more companies listed on GEM than on the Main Board.

Appendix 1 of the Discussion Paper contains a detailed review of GEM's development and profile. Before its launch, GEM was intended to be a professionals-only market with a transaction minimum of HK$250,000. However, by the time the market was launched, retail investors' participation was allowed. Initially, GEM was intended to be lightly regulated, operating on a disclosure basis. However, as some companies failed and others were implicated in corporate scandals, HKEx started to scrutinise listing applications and subsequent transactions more closely. GEM was also supposed to be an alternative board and in the early days had its own staff, rules and Listing Committee. With the exception of the listing qualifications and certain disclosure requirements, the GEM rules were however very similar to the Main Board rules and efforts were made to consolidate the set-up in order to improve consistency in rule interpretation and decision making. The staffing and Listing Committees of the GEM and Main Board are now largely unified and a common approach is adopted to the operation and development of policy for both boards, with consultations and rule changes being effected for both concurrently.

The key findings of the Discussion Paper's analysis of the concentration of placing shares allotment for GEM companies at listing (Appendix 2) are that:

* since launch up to the end of 2005, 77% of GEM new listings were by placing only;
* 50% or more of companies listed in 2004 and 2005 allotted 1-3 board lots of placing shares to less than 25% of placees; and
* all companies listing in 2004 and 2005 allocated an aggregate of 30% of placing shares to less than 10 placees and more than a quarter of them offered 50% of placing shares to 3 or less placees.

## 2. Overseas Growth Board Experience

Appendices IV and V of the Discussion Paper contain key information on 7 overseas second markets including London's AIM. In comparison with these overseas markets, as at June 2005 GEM ranked towards the lower end in terms of number of listed companies. With 203 companies, GEM had more listed companies than Japan's MOTHERS (130) or Singapore's Sesdaq (166), but far fewer than AIM (1,240) or Canada's TSX Venture Exchange (1,971).

## 3. London's AIM

London's AIM which was launched in June 1995 is by most measures the leading growth company market in the world. It is the world's largest growth market by market capitalisation with US$71.7 billion (compared to GEM's US$8.4 billion) and is by far the current leader in terms of new listings with 277 in the first half of 2005 (compared with just 2 for GEM in the same period). Today AIM lists 32 industrial sectors and 166 overseas companies.

AIM has an unusual, and perhaps unique, model in that regulatory emphasis is placed on the sponsor (the nominated adviser or nomad), rather than on the issuer. The issuer is required to maintain a nomad as long as it is listed on AIM. This apparently allows AIM to be operated with a light regulatory touch. Issues of securities amounting to less than 2.5 million euros (US$2.9 million) or to fewer than 100 people do not require a prospectus or vetting by the statutory authority (the UK Listing Authority within the FSA). The latter criterion is dominant, and brokers' private clients do not count towards the 100. Accordingly, many AIM listings, even for large amounts, do not require a prospectus. There are currently some 84 nomads including global investment banks and accounting firms as well as small firms.

## 4. Structural Options

HKEx hopes firstly to ascertain views on the most appropriate future positioning and structure for GEM. The 3 possible options outlined in the Discussion Paper are summarised below.

### i. GEM as a Second Board

Under this option, GEM would largely maintain its existing structure and GEM companies would be encouraged to grow and transfer to the Main Board. Accordingly, the process of transferring to the Main Board would be streamlined. The admission requirements would be scaled down versions of those for the Main Board and the regulatory approach and staffing and managerial supervision of the 2 boards would be primarily the same. Many overseas markets are second boards of this type (eg Singapore's Sesdaq, Malaysia's Second Board and Canada's TSX-V). Some growth company markets, although institutionally independent of their main boards, still perform a second board function (eg Taiwan's GTSM).

### ii. GEM and the Main Board to Merge into a Single Board

Under this option, GEM would be merged into the Main Board to form a single board. This could be either (i) an undifferentiated market with a uniform set of ongoing obligations for all companies (with or without a concessionary channel for the admission of growth companies) or (ii) a two-tiered board of which the existing GEM would be the lower tier and the Main Board would form the upper tier. Under the tiered single board structure, there would be separate admission requirements for each tier. Companies would also be promoted or demoted between tiers depending on performance metrics such as market capitalisation, profitability, and/or a continuing period of under- or over-performance. Some overseas markets include additional tiers to further distinguish among companies, creating in effect a league table. Existing GEM companies would be grandfathered into the single board.

The Taiwan Stock Exchange is an example of a single undifferentiated board which provides a concessionary channel for technology-based companies. Technology-based companies are exempt from the track record requirement and benefit from reductions in other requirements.

The Tokyo Stock Exchange ('TSE') has a variant on the single board model. It has a second section, to which all but the largest issuers are allocated on initial listing, and a first section for larger and more seasoned issuers, with promotion or demotion between the two.

Canada's TSX-V market has 3 tiers: Tier One for larger venture companies, Tier Two for smaller ones, and NEX for cash shells. Each tier has its own admission requirements and rules and promotion and demotion between tiers depends on performance.

### iii. New Alternative Market

Under this option, a new alternative market for growth companies would be launched with a different and distinct positioning. The existing GEM would be merged into the Main Board and existing GEM companies would be grandfathered into the Main Board.

The new alternative market would be distinguished from the Main Board and would provide a listing venue where issuers are expected to stay for the long term. It would have a different approach from the Main Board in terms of regulation, branding and services offered. There would be no facilitation of transfer from the alternative market to the Main Board. The new market could have a more flexible vetting regime but stricter sponsor regulation, and might be restricted to professional investors only.

The UK's AIM has some of the characteristics of an alternative market, although the largest AIM issuers are generally expected to graduate to the main market eventually. According to the Discussion Paper, AIM's value proposition is to offer a platform for growth companies that is lightly regulated. While main market issuers are regulated directly by the UK Listing Authority ('UKLA'), in the case of AIM issuers the authorities rely largely upon the nominated investment adviser. The nomad maintains a permanent relationship with the issuer and is held responsible for the issuer's compliance with applicable rules and disclosures. There is no vetting of the admission document by the London Stock Exchange or the UKLA.

## 5. Key Discussion Questions

HKEx is requesting responses to 12 Key Discussion Questions set out in Chapter 5 of the Discussion Paper. These are reproduced below.

### Need for and Nature of a Growth Company Market

Q1. Is there a need for a growth company market in Hong Kong?

Q2. If so, should the market primarily serve local Hong Kong companies, or should it target Mainland-based companies or regional/international companies?

Q3. At what stage of development should companies be admitted to the growth market - at start-up stage or at a more mature stage?

Q4. What should be the core investor group for the growth company market - retail, professional and/or institutional? Should the growth company market be restricted to professional and institutional investors only?

Q5. Depending on your answers to the foregoing questions, what kind of regulatory regime would be appropriate for the growth company market? In particular, should growth companies have low-cost access to public capital, or should they, because of their higher risk, be required to comply with procedures that dictate relatively higher costs than those for Main Board companies?

### Possible Structural Options

Q6. Bearing in mind your responses to questions 1-5 above, please comment on the suitability of the following possible structural options for a growth company market in Hong Kong (see Chapter 4 of the Discussion Paper for details on these options):

1. GEM as a second board
2. GEM and the Main Board to merge into a single board:
	1. Universal single board - GEM and the Main Board to merge into a single board, with no distinction between them;
	2. Tiered single board- GEM and the Main Board to merge into a single board with the growth market forming the lower tier and the existing Main Board the upper tier. Further tiers might be introduced as well;
3. New alternative market - GEM to merge into the Main Board, and a new market with an enhanced regulatory regime to be launched for growth companies.
4. Others - do you have any other suggested structural options for GEM?

Q7. Based on your preferred structural option for GEM, do you have any specific views or recommendations concerning:

1. the targeted issuers (eg type of business, stage of development) and investors (eg retail, professional, institutional),
2. the regulatory approach,
3. the initial listing requirements and the listing process,
4. the process of ongoing regulatory supervision,
5. the disclosure and corporate governance requirements, and
6. the role of sponsors and other professionals?

Q8. If you consider that there is no need for a growth company board in Hong Kong, what should be done with GEM and its existing issuers?

Q9. What, if anything, should be done with delisted companies? Should there be a separate market for trading these companies?

### Other Issues

Q10. Do you have any suggestions on how to raise the profile of companies listed on the growth company board?

Q11. Should more information be provided on growth companies? If so, what information, and who should provide it?

Q12. Should market making be permitted on the growth company board? If so, what should be the obligations of and incentives provided to market makers?

## 6. Consultation

Responses to the Key Questions and any other comments should be sent to HKEx no later than **30 April, 2006**:

By mail to:

Corporate Communications Department Re. Discussion Paper on GEM Hong Kong Exchanges and Clearing Limited 12th Floor, One International Finance Centre 1 Harbour View Street, Central Hong Kong

By fax to: (852) 2524 0149

By online submission at: <http://www.sfc.hk>

By e-mail to: GEMdiscussionpaper@hkex.com.hk

*The purpose of this note is to provide a summary only of the principal issues raised in HKEx's Discussion Paper on the Growth Enterprise Market. The full text of the Discussion Paper is available on* [*HKEx's website*](http://www.hkex.com.hk)*.*

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