Charltons - Hong Kong Law Newsletter - 22 May 2008

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# New Growth Enterprise Market Rules To Come Into Effect On 1 July 2008

## Introduction

Hong Kong Exchanges and Clearing Limited (**HKEx**) published its Consultation Conclusions on the Growth Enterprise Market (**GEM**) on 2 May 2008 which set out the amendments to the GEM Listing Rules which will be made to reposition GEM as a second board and as a stepping stone to the Main Board. The Listing Rule amendments will come into effect on 1 July 2008 and adopt, with minor amendments, the proposals set out in HKEx's July 2007 Consultation Paper.

The GEM Consultation Conclusions and copies of the submissions made can be downloaded from the "Market Consultation -- Consultation Conclusions" section of the HKEx website at [www.hkex.com.hk](http://www.hkex.com.hk/).

The amendments to the GEM Listing Rules can be downloaded from the "Regulatory Framework and Rules -- Rules and Guidelines on Listing Matters-- Listing Rule Update/Interpretation for GEM Listing rules" section of HKEx's website. Amendments to the Main Board Listing Rules are available from the "Regulatory Framework and Rules -- Rules and Guidelines on Listing Matters -- Supplementary materials on Listing rules and rule changes" section of HKEx's website.

A set of frequently asked questions is also available on the HKEx website under "Regulatory Framework and Rules -- Rules and Guidelines on Listing Matters -- Supplementary materials on Listing rules and rule changes".

## I. The Principal Changes

The amendments are aimed at raising the quality of companies listing on GEM in order to strengthen market confidence and reduce the cost and duration of the listing process. They will also facilitate the process of transfer of GEM companies to the Main Board. The principal changes are set out below.

### 1. Enhanced Admission Requirements

#### A. Cash Flow Requirement

GEM applicants will be required to have an adjusted cash flow from operating profits before changes in working capital and taxes paid of HK$20 million in aggregate for the preceding two financial years. This will replace the current requirements for a "focused line of business"[[1]](#footnote-28) and "a business of both substance and potential"[[2]](#footnote-29).

According to HKEx, interpretation of the requirement for a business of substance and potential has become one of the major points for discussion between the Listing Division and applicants. HKEx hopes that the introduction of a specific requirement for cash flow which will remove the need for discussion on this point, will help to reduce the cost and duration of the listing process.

HKEx considers cash flow to be a better indicator of business viability than profit since profit can be affected by significant valuation measurement adjustments and increased by one-off items, whereas operating activities that are generating a reasonable level of cash flow are more likely to be sustainable.

The proposed operating cash flow requirement will mean that GEM will no longer provide a listing venue for start-ups.

##### Calculation of Positive Operating Cash Flow

An applicant's cash flow from operating activities is required to be calculated using the indirect method as described under International Accounting Standard 7 (**IAS7**) or Hong Kong Accounting Standard 7 (**HKAS7**) for the 2 immediate preceding financial years.

Under the indirect method described in HKAS7, positive cash flow from operating activities is determined by adjusting profit or loss for the effects of:

1. non-cash items including depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, undistributed profits of associates and minority interests; and
2. all other items for which the cash effects are investing or financing cash flows.

#### B. Operating History

The current requirement for 24 months of active business pursuits will be replaced by requirements for:

1. management continuity for at least 2 completed financial years; and
2. ownership continuity and control for at least 1 completed financial year,

immediately before the issue of the listing document. In both cases, continuity must continue until the date of listing.

#### C. Market Capitalisation Requirement

The minimum market capitalisation requirement will also be raised from an effective HK$46 million[[3]](#footnote-33) to HK$100 million.

#### D. Minimum Public Float

The minimum public float requirement will follow the Main Board requirement: it will be set at 25%, or 15% to 25% for companies with a market capitalisation of more than HK$10 billion. The market capitalisation of the public float will however be set at HK$30 million (compared to HK$50 million for the Main Board).

#### E. Spread of Shareholders

The requirements will be for:

1. A minimum of 100 public shareholders. Employee shareholders will be allowed to be included as "public shareholders". Connected persons will be precluded from counting towards the public float, as on the Main Board;
2. The 3 largest public shareholders to own less than 50% of the publicly held shares.

#### F. Requirement for Independence from Controlling Shareholder

The Main Board listing requirement that the applicant must demonstrate and disclose its ability to carry on its business independently of its controlling shareholder and its associates will be incorporated into the GEM Rules (paragraph 27A of Part A of Appendix 1). The change reflects the fact that applicants under the revised GEM regime are expected to be more mature and HKEx's desire to improve corporate governance standards and reduce conflicts of interest.

### 2. New GEM Continuing Obligations

#### A. Lock-up Period

As the new admission requirements will preclude start-ups, existing GEM requirements which relate to new companies will be removed. Accordingly HKEx will:

1. Drop existing GEM requirements imposing lockups on management shareholders and significant (5%) shareholders; and
2. Drop the requirement for the initial management and significant shareholders to hold in aggregate 35% of the issued share capital at the time of listing.

GEM issuers will instead be subject to the same restrictions as Main Board issuers, namely:

1. Controlling shareholders will be prohibited from disposing of their shares for 6 months following listing (and must disclose all pledges or charges of their shares for 12 months following listing); and
2. For the next 6 months, controlling shareholders can sell their shares but must retain control.

#### B. Annual Reports

As proposed in the consultation, issuers will be required to report on the achievement of their business objectives (as stated in their listing document) in their first 2 annual reports after listing. In addition, issuers will have to report on the achievement of business objectives in each half-year report published during the first 2 full financial years after listing (new Rule 18.08A).

The principal disclosure requirements are for:

1. a balanced and concise analysis of the level of achievement of the business objectives;
2. a quantitative as well as qualitative analysis based on financial and non-financial information; and
3. a description of the principal risks and uncertainties and a commentary on the directors' approach to them.

The Notes to new Rule 18.08A give guidance (which do not amount to mandatory requirements) on the information which is expected. This includes information on:

1. significant developments by key business segments;
2. trends, internal and external environmental and industry factors affecting performance or achievement of business objectives;
3. the principal risks and uncertainties (including strategic, operating and financial risks); and
4. key performance indicators.

Note 2 to Rule 18.08A gives the following examples of key performance indicators: (a) customer retention and satisfaction; (b) capital adequacy and expenditure; (c) store portfolio changes; (d) reserve replacement costs; (e) equipment utilisation and capacity; (f) loan loss; (g) asset quality; (h) expected return on sales; and (i) sales volume per square foot of store space. The note states that issuers should determine and state their own key performance indicators which should be quantitative in nature so that the level of achievement of objectives can be quantified. Issuers are also encouraged to use a comparative table for disclosure of achievement of business objectives with a recitation of the business objectives as stated in the listing document on one side and the directors' comments as to the level of achievement on the other.

#### C. Public float

As discussed above, GEM companies will have to comply with more stringent public float requirements. Existing GEM companies will be given three years to comply with the new regime. New GEM Rule 17.38A requires listed issuers to include a statement of sufficiency of public float in their annual reports.

#### D. Prohibition on Fundamental Change in Business Activity

The period during which the GEM rules prohibit a fundamental change in business activity (unless approved by the independent shareholders) will be reduced from 2 years to one year after dealings in the relevant issuer's securities have commenced on GEM, to match the Main Board provision (GEM Rule 17.25).

#### E. Spin-Off

The Main Board spin-off requirement of separate listing of assets/businesses of the existing group will be incorporated into the GEM Rules by the creation of a GEM Practice Note 3 that is based on Practice Note 15 of the Main Board Listing rules. As a consequential change, requirements have been added for independent financial advisers and an independent board committee in a GEM spin-off (GEM Rule 17.47(6) and (7)).

For companies that have transferred from GEM to the Main Board, the three-year waiting period (currently in paragraph 3(b) of Practice note 15) will start on the date of listing on GEM, rather than on the date of Main Board listing.

#### F. Sufficiency of Operations/Tangible/Intangible Assets

The GEM Rules sufficiency of operations requirement in GEM Rule 17.26 is to be aligned with Main Board Rule 13.24 which will effectively relax the existing provision. A requirement for "tangible assets of sufficient value and/or intangible assets for which a sufficient potential value can be demonstrated" will be added as an alternative to the existing requirement that an issuer must carry out a sufficient level of operations to warrant the continued listing of its securities.

#### G. Removal of Requirement for Announcements/Notices to be sent to Gazetted Newspapers

GEM Rule 16.06 has been revised to remove the requirement for GEM issuers to send announcements and notices to all English and Chinese language gazetted newspapers at the same time as the announcement or notice is submitted for publication on the GEM website.

It is no longer considered necessary for a GEM issuer to provide gazetted newspapers with copies of its announcements or notices since under the Electronic Disclosure Project the websites of the issuer and HKEx (hkgem.com in the case of GEM issuer) are the principal source of regulatory information for investors.

### 3. The Listing Process

In order to streamline the GEM admission procedure, and so reduce the cost of listing, the power to approve new listings will be delegated from the Listing Committee to the Listing Division. GEM applicants will have a right of appeal to the Listing Committee against the Listing Division's initial decision on an IPO.

### 4. Existing GEM Issuers Continue To Be Listed On GEM

Issuers listed on GEM when the proposed revised GEM rules come into effect will be required to comply with the new rules with immediate effect, except that a grace period of 3 years will be given in the case of the public float requirement (see point 2C above).

### 5. Streamlining Of Process Of Transfer Of Listing From GEM To The Main Board

#### A. Requirements for Transfer to the Main Board

Under the new Chapter 9A to the Main Board Listing Rules, a GEM company may apply to the Main Board if it:

* Meets the Main Board quantitative requirements;
* Has been listed on GEM for at least 1 year and has published its first full year audited financial results subsequent to its date of listing on GEM; and
* Has a "good behaviour" record, i.e. no disciplinary investigation by the Exchange in relation to a serious breach or potential serious breach of any Listing Rule for the 12 months preceding the transfer application and until commencement of dealings in its securities on the Main Board.

#### B. No Sponsor Requirement

GEM companies transferring to the Main Board will not require a sponsor and HKEx's review will be based as far as possible upon the issuer's existing recent public disclosures.

#### C. Simplified Transfer Process

At present, GEM companies that wish to transfer to the Main Board have to go through the full normal application process, in the same way as other Main Board applicants. They are additionally required to go through a formal process of delisting from GEM. Under the amended Rules, the procedure will take the form of announcements of the transfer backed by the submission of supporting documentation.

The Listing Division will process and administer applications for transfer from GEM to the Main Board, while the Listing Committee will give final approval.

In order to apply for a transfer of listing to the Main Board, a GEM listed issuer is required to submit the following documents to the Listing Division (new Main Board Listing Rule 9A.06):

1. a formal application for listing in the form set out in Form J in Appendix 5, signed by a duly authorised director;
2. a new Main Board standard form declaration (Form K in Appendix 5) confirming compliance with all applicable listing requirements and signed by every director and supervisor (if applicable);
3. a prescribed checklist signed by each director and supervisor (if any):
4. an advanced draft public announcement of the transfer (as required under Rule 9A.08);
5. the initial listing fee (at a 50% discount to the normal Main Board listing fee);
6. directors' Form B (or Form H in the case of PRC issuers) and supervisors' Form I declarations required under Rule 9.11(7);
7. copies of any relevant corporate resolutions or regulatory approvals; and
8. a working capital sufficiency statement for the next 12 months.

On the same day, the applicant will have to publish a short announcement informing the public of the application. HKEx does not expect this to contain substantial details and its content will not be specified in the rules.

#### D. Reduced HKEx Scrutiny

HKEx scrutiny will be reduced. As far as possible, HKEx will consider an application on the basis of the issuer's existing recent public disclosures and its compliance record throughout the time of its listing on GEM. Where relevant information is not available, or the circumstances otherwise demand, HKEx may request additional information to be provided by the issuer and/or its management (Main Board Rule 9A.05).

#### E. Announcement of Transfer

An applicant must publish a long-form announcement (a draft of which must have been pre-vetted by HKEx) as soon as reasonably practicable and in any event no later than 1 business day after the issuer receives HKEx's formal in-principle approval for transfer of its listing to the Main Board and at least 5 clear business days before the intended date of commencement of dealings in the issuer's shares on the Main Board. This long-form announcement must contain at least the following information (Main Board Rule 9A.09):

1. a prescribed form HKEx disclaimer;
2. a directors' responsibility statement;
3. a statement confirming that that all pre-conditions for a transfer of listing have been fulfilled;
4. the reasons for the transfer of listing;
5. a statement that the following documents are available for inspection on HKEx's website and the issuer's own website: (i) the directors' report and annual accounts for the latest financial year; (ii) the issuer's latest half-year report or summary half-year report(if any) and (if more recent) the latest quarterly report; (iii) the issuer's constitutional documents; (iv) any prospectuses and circulars issued in the preceding financial year; and (v) announcements and other corporate communications as required under the Main Board Listing Rules;
6. a statement that approval has been granted for the issuer's securities to be listed on the Main Board and de-listed from GEM, together with the date on which dealings will commence on the Main Board and terminate on GEM;
7. the issuer's stock codes on GEM and the Main Board;
8. a statement on CCASS eligibility;
9. a statement of any listing of options, warrants or similar rights or convertible equity securities that will be transferred with the underlying securites;
10. information on any competing or potentially competing business of a controlling shareholder or director of the applicant (the same level of disclosure will be required as for a normal Main Board IPO applicant);
11. the names of the directors; and
12. any other information required by the Exchange.

#### F. Transfers of Infrastructure, Mineral and Investment Companies

Infrastructure, mineral and investment companies transferring to the Main Board will be required to meet the relevant requirements of Main Board Chapter 8.05B(2) or Chapter 18 or 21. These companies will have to comply with all the listing qualifications and disclosure requirements applicable to these types of companies. In terms of disclosure, applicants will have to issue a circular containing all relevant information (including any report or statement which is normally required to be made by professional adviser(s) in a listing document), with such modifications as HKEx may determine. The circular must be available online and in hard copy form and be distributed to the issuer's shareholders in the same way as other corporate disclosure documents.

#### G. Exemptions

Applicants that transfer from GEM to the Main Board will be exempt from the following restrictions that apply to new Main Board applicants:

1. The ban on new share issues within 6 months of listing;
2. The ban on fundamental changes in principal business activities within 1 year of listing;
3. The ban on the controlling shareholder selling its shares within 6 months of listing (and the requirement to disclose any pledges or charges within 12 months of listing); and
4. The ban on changes in control during the subsequent 6 months.

#### H. Financial Assistance provided by Connected Persons

The Main Board requirement for financial independence is normally applied strictly as it is to Main Board IPO applicants. HKEx realises however that releasing a transfer applicant from all financial assistance provided by its connected persons prior to transferring to the Main Board may be disruptive to the GEM company's normal business and may not be in the interests of its shareholders as a whole.

HKEx refers in the FAQ to Listing Decision 42-1, which states that (a) all listing applicants seeking to list on the Main Board are ordinarily required (in the absence of exceptional circumstances) to repay all outstanding loans due to, and release guarantees provided by, their controlling/substantial shareholders; and (b) this standard practice applies to cases moving from GEM to the Main Board. GEM transfer applicants who have exceptional circumstances are advised to consult HKEx at an early stage.

#### I. Satisfaction of Good Behaviour Requirement

Before making a transfer application, a GEM issuer can contact the Listing Division to obtain their written confirmation as to whether the issuer has been the subject of any disciplinary investigation by HKEx in relation to a serious breach or potential serious breach of any Listing Rules in the 12 months preceding the date of the confirmation letter. HKEx may of course change its opinion if additional information subsequently comes to light, in which case it will normally notify the issuer of the change in circumstances if the information comes to light within 2 months of the date of the letter.

## II. Continued Differences In GEM And Main Board Requirements

While the GEM and Main Board continuing obligations will be brought further into line in a number of areas, it is proposed that the requirements of the two boards will continue to diverge for the time being in the areas set out below.

### 1. Periodic financial reporting

Quarterly reporting is mandatory under the GEM Listing Rules, whereas for Main Board issuers, it is a recommended best practice under the Code on Corporate Governance Practices. In relation to annual and half-year reporting, GEM also imposes tighter deadlines than the Main Board.

HKEx has however published proposals to introduce mandatory quarterly reporting and shorten annual and half-year reporting deadlines for Main Board issuers[[4]](#footnote-59).

### 2. Compliance Officer

HKEx proposes to retain the GEM requirement for one executive director to be a compliance officer for the reason that GEM companies are typically at an earlier stage of development. There is no comparable requirement for Main Board issuers.

### 3. Compliance adviser

HKEx will retain the current requirement for a compliance adviser to be retained until dispatch of the annual report for the second full financial year after listing. The requirement for the Main Board is that a compliance adviser must be retained only until after dispatch of the annual report for the first full financial year. Again, the rationale is that early-stage companies benefit from the compliance adviser's input.

## III. Implementation Of New Rules

The revised GEM and Main Board Listing Rules will come into effect on 1 July 2008.

New listing applications received by HKEx on or **before 2 May 2008** will be processed according to the GEM Listing Rules in force when the application was accepted for vetting.

Any new listing application and any refreshed application received **after 2 May 2008** will be subject to the GEM Listing Rules that are in force on the date of listing.

These transitional arrangements will not however affect continuing obligations and other aspects of the GEM Listing Rules, which will become effective immediately on 1 July 2008, save for the grace period of 3 years from that date to secure compliance with the new public float requirements.

The purpose of this note is to provide a summary only of the principal amendments to the GEM Rules which will come into effect on 1 July 2008. Specific advice should be sought in relation to any particular situation.

## Annex A

### Amended GEM Admission Requirements

**Existing GEM**

**Revised GEM (from 1.07.08)**

**Financial requirements**

No requirements

Positive operating cash flow > HK$20m in aggregate for the latest 2 financial years

**Operating history**

24 months active business pursuits (may be reduced to 12 months)

Latest 2 financial years under same management

**Market Capitalisation (MC)**

MC effectively > HK$46m; or

MC > HK$500m for companies with only 12 months business pursuits

MC > HK$100m

**Minimum public float**

Minimum HK$30m

MC < HK$4b: 25%

MC > HK$4b: higher of HK$1b and 20%

At least HK$30m

25%, or 15%-25% if MC > HK$10b (i.e. as for Main Board)

**Holding by management and major shareholders**

> 35% in aggregate

Ownership continuity and control for most recent financial year

**Lock-up period**

12 months for initial management shareholders, 6 months if > 1%

6 months for 5% shareholders

Controlling shareholders can't sell shares for 6 months (for 12 months must disclose pledge/charge)

For next 6 months, controlling shareholders can sell shares but should retain control

**Spread of shareholders**

Minimum 100 non-employee shareholders (300 if 12 months business pursuits, with the largest 5 and 25 holding < 35% and 50% respectively of securities in public hands)

Minimum 100 public shareholders

< 50% owned by 3 largest public holders

**Underwriting and offering mechanism**

Underwriting not compulsory

Free to decide the offering mechanism provided full disclosure

Offer price > HK$1 for companies with only 12 months business pursuits

Free to decide the offering mechanism provided full disclosure

100% placing allowed, underwriting not compulsory

**Sponsor**

Must appoint a sponsor

Must appoint a sponsor

**Focused line of business**

Must pursue a focused line of business

No requirement

**Business plan**

Must state business objectives and how to achieve after listing

Must state business objectives and how to achieve after listing

Must report on achievement of objectives in first 2 annual reports and in half-year reports for first 2 financial years after listing

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1. Rule 11.12(1) [↑](#footnote-ref-28)
2. Listing Rule 11.23(d)(Note 3) [↑](#footnote-ref-29)
3. Listing Rule 11.23(2)(a) requires a minimum public float of HK$30 million at the time of listing. Rule 11.22 requires initial management shareholders and significant shareholders to hold at least 35% of the issued share capital at listing. Initial management and significant shareholders are excluded from the public float at the time of listing under Rule 11.23(5) Note 2. The maximum public holding allowed is therefore 65%. Dividing HK$30 million by 65% gives HK$46 million. [↑](#footnote-ref-33)
4. HKEx Consultation Paper on Periodic Financial Reporting published August 2007. [↑](#footnote-ref-59)