Part B Consultation Questions

Please indicate your preference by checking the appropriate boxes. Please reply to the questions below on the proposed change discussed in the Consultation Paper downloadable from the HKEX website at:
https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Consultation-Paper/cp202011.pdf

Where there is insufficient space provided for your comments, please attach additional pages.

Capitalised terms have the same meaning as defined in the Consultation Paper unless otherwise stated.

1. Do you agree that the Profit Requirement should be increased by either Option 1 (150%) or Option 2 (200%)? Please give reasons for your views.

☐ Yes

☑ No

The Consultation Paper in the executive summary mentions the "reasons" why the profit requirement is being reviewed and includes the following:-

- No intention to raise funds for the underlying business.
- Valuations were reverse-engineered to meet the Market Capitalization Requirement.
- Investors not independent
- Listing made to manufacture shell companies for sale after listing.
- Listing not genuinely supported by the market after the listing, resulting in share price drop after listing thus hurting investors.
- Thin trading after listing, and company more susceptible to speculative trading.
- IPO prices do not generally reflect expected market clearing prices.
- Failure to meet profit forecasts post listing.
- Price discovery process being undermined by the offering of rebates to entice investors to take up shares.
- Manufacturing of artificial shareholder base.
- Market manipulation or insider dealing.

We believe such "reasons" have nothing to do with a Profit Requirement or the size of a profit achieved which relate to a listing applicant's performance based on its <u>historical past history</u>.

We believe such "reasons" cannot reasonably justify the argument that an IPO applicant should have higher historical profits to be eligible for listing. The "reasons" or concerns can only be addressed by specific rules (either new or tightening existing rules) that directly focus on the concern or perceived market mischief.

We disagree with the proposals of increasing the Profit Requirement due to the following:

A. The proposed change will reduce the number of listing applications

Paragraph 9 of the Consultation Paper points out that the proposed Profit Requirement would have eliminated on average 62% (462) of the Profit Requirement IPO applications submitted between 2016 and 2019. We believe that there will be at least a similar impact on future listing applications.

B. The proposed changes will make the Hong Kong Stock Exchange the hardest place to list

The Exchange has ranked top in global IPOs because of its ability to attract listing applicants. If the proposed revision is implemented, the Main Board's profit requirement will become the highest of the Selected Overseas Main Markets included in the Exchange's analysis, and it is likely it will lose its competitiveness especially where the Exchange also has, in addition, a minimum expected market capitalization requirement which the other overseas exchanges do not have. Moreover, as explained in paragraph 42 of the Consultation Paper, the profit requirement in the overseas exchanges is based on "pre-tax" whereas the Exchange looks at "post-tax" profits.

C. Issues concerning Small Cap applicants

The Consultation Paper mentions that some Small Cap Issuers inflate valuations in order to be eligible to meet the Market Capitalization requirement. If this is the case, it is also possible that large and new economy applicants may also do so for various purposes so it may not be unique to Small Caps. As mentioned above, this concern is not a profit requirement issue and there are other ways to directly address this regulatory concern, such as issuance of detailed guidelines on requirements.

The Consultation Paper also points to misconduct by Issuers that inflate profit forecasts at the time of IPO and failing to meet the forecast afterwards, and other misconduct, such as offering rebates to investors who subscribe to the IPO shares. Similarly, such misconducts have nothing to do with historical profits. The Exchange can always invoke appropriate disciplinary actions on a case-by-case basis to address the relevant concern.

With respect to the post-listing performance, we note from paragraphs 34 and 35 of the Consultation Paper that numerous Issuers have missed their profit forecasts. We believe the number of cases is significant and cannot be ignored and corrective action is needed to ensure information provided to investors is supportable and reasonable and that any significant deviations from forecasts are explained.

The Exchange mischaracterizes Small Cap listing applicants and presumes some listings are made to create shell companies. We believe that there are already existing mechanisms in place for stopping them from coming to the market. The Exchange has laid down criteria for suitability of listing in HKEx Guidance Letter 68-13A. Moreover, the Exchange has implemented stringent rules to discourage back-door listings via shell companies. The Securities and Futures Commission has also introduced measures to regulate sponsors, licensed corporations, listed companies and listing applicants to minimize the risk of market misconduct at an early stage. These actions directly address these types of misconduct whereas raising the Profit Requirement does not.

D. Market circumstances since last Consultation Paper in 2017

The consultation conclusions to "The Review of the Growth Enterprise Market and Changes to the GEM and Main Board Listing Rules" published in December 2017 stated that there was market-wide consensus that the profit requirement for Main Board listings at the time should be retained.

Except for the COVID-19 pandemic and the social and political unrest which arose in 2019, we see no other significant change in market circumstances since December 2017. The impact of these two matters have significantly damaged the Hong Kong economy. Other economies in the world have also been significantly affected by the COVID-19 pandemic resulting in significant drops in revenue and profits of many companies and businesses. Most economies are in a recession. We do not see a reason to increase the profit requirement in this difficult time as recovery in both the Hong Kong and overseas economies will take some time.

E. The Stock Exchange's role to provide a fund-raising platform for all that seek capital

The Exchange has exclusive rights as the sole fund-raising platform in Hong Kong. The Exchange has a duty to facilitate access to capital for all companies that wish to raise funds for expansion, enhancing liquidity and other legitimate business purposes.

The proposed Profit Requirement, which will lift the profit benchmark, will deny many companies listing opportunities. The Exchange is incumbent to provide a fair fund-raising platform to all given its monopoly status as to do otherwise would dampen economic growth prospects in Hong Kong and its capital market. The Exchange must not forget that one of its key fundamental purposes is to provide a fund-raising platform for local businesses in Hong Kong.

The Exchange has an obligation to serve all types of companies, not just big businesses, new economy companies, but also local SMEs and traditional industries as well.

F. Driving up unemployment in financial services and the Hong Kong economy

As of December 2020, there were 127 sponsor entities.[1] Reducing 62% of new listing applications will decimate the financial services sector, including sponsors, lawyers, accountants, valuers, investor and public relations professionals. Industry practitioners expect the proposed change will drive out a significant amount of their businesses, causing significant unemployment which in turn will have a ripple effect on other sectors in Hong Kong. The financial services sector will be severely disrupted and this will lead to other sectors being downsized. If the proposed changes are implemented, it will result in a severe blow to the Hong Kong economy when Hong Kong and also other economies are trying to recover from the adverse effects of the COVID-19 pandemic.

The Exchange has social responsibilities as a public organization. With reference to the Census and Statistics Department's report, the unemployment rate in Hong Kong was 6.6% (seasonally adjusted), representing approximately 246,000 persons unemployed in the latest period in 2020[2]. The Trade and Industry Department's statistics show that there were over 340,000 SMEs in Hong Kong employing more than 1.2 million people as of September 2020, which accounts for approximately 44.5% of total employment (excluding civil service)[3]. SMEs in Hong Kong play a pivotal role in Hong Kong's economy and the Exchange should not create barriers to companies (including SMEs and other innovative companies) on their ability to raise funds. Rather, the Exchange should find ways to expand their opportunities to raise funds. Only by creating a healthy funding platform will companies in Hong Kong be in better position to propel business development and enhance employment opportunities in Hong Kong.

G. Responsibilities to shareholders of the Exchange

Paragraph 9 of the Consultation Paper shows that introduction of the Profit Requirement will likely have a significant impact on new listings going forward.

By adoption either option 1 or option 2, the Exchange would be hurting itself and its shareholders. It would have less future income as it would not receive the related one-off and recurring fees that new listings bring.

H. Spin-off of listed companies will be affected

The proposed Profit Requirement will not only affect IPO applicants but also existing listed companies. A holding company may wish to maximize its group value buy a spin-off of a subsidiary's business. This will be harder to achieve under the proposed changes. Moreover, existing listed issuers will have greater difficulty in identifying businesses profitable enough under the proposed requirements. The Exchange must realise that many companies potentially may not be able to comply with listing rule 13.24 given the business downturn. It would be unfair to their shareholders if the substantial increase in Profit Requirement will also be applied to companies once listed as it will mean that their listing status may be forfeited.

I. Is the Profit Requirement linked to the Market Capitalization Requirement?

Market Capitalization should be factual and based on real data as it just computation of a mathematical formula, namely, "Quoted Price x Number of Shares"

Main Board Listing Rules (MBLR) 8.09 (2) currently states:-

"The expected market capitalisation of a new applicant at the time of listing must be at least HK$500,000,000 which shall be calculated on the basis of all issued shares (including the class of securities for which listing is sought and such other class(es) of securities, if any, that are either unlisted or listed on other regulated market(s)) of the new applicant at the time of listing."

MBLR 8.05 (2) requires that a new listing applicant made under the market capitalization test "must have a market capitalization of at least HK$2,000,000,000 at the time of listing."

The word "expected" appears in MBLR 8.09 (2) but not in MBLR 8.05 (2). The former is essentially a "guess" or a "projection" determined by use of subjective judgements based on estimated data whereas the latter should be real computed based on real factual data.

We believe that there is no direct correlation between (1) the quoted price of a company's shares used in the computation of market capitalization and (2) its reported historical profits. A company's share price at which shares are traded on the Exchange is not based solely on the movement or size of a company's profits. Other factors (e.g. valuable untapped underutilized assets, dividend history, quality management, wider economic conditions and future expectations) are also considered and these may have a more significant influence in determining the price of a company's shares than a company's historical profits. We also believe there can be found many examples where despite a reported increase in profits of an Issuer the company's share price, for some reason, moves in another direction.

If the Exchange is concerned with how "expected" market capitalization requirements are being met, the more direct and proper course of action to take is for it to require the sponsor to examine the "expected" valuation more closely to determine whether the valuation exercise was performed properly. The role of the underwriter is to ensure all shares are taken up at the designated IPO offer price and that price is solely determined by the listing applicant and its advisors prior to actual listing.

The Exchange may also wish to consider whether to remove the requirement in MBLR 8.09 (2) as the real actual (and not the "expected") market capitalization, in any event, will be determined by the market on listing. In other words, MBLR 8.09 (2) is effectively a temporary indication of market capitalization that is superseded within a very short period of time between the publication of a prospectus and the company's actual listing.

The above solutions can be achieved without the need to increase the profit requirement. The presumption that appears to be taken by the Exchange is that the larger the profit of a listing applicant, the larger its share price and the larger its market capitalization. This presumption is not necessarily true.

J. Quality market

Paragraph 11 of the Consultation Paper appears to equate the size of profit as a measure of the overall quality of a listing applicant and the quality of the Hong Kong market. This is not true and we would stress that the quality and integrity of management is perhaps more important and a better measurement of quality both from the short-term and long-term point of view. The USA Enron collapse and the more recent UK Carillion collapse have shown that a company can appear to be profitable, but this does not necessarily give any comfort on the quality of a company and whether investors will be protected.

The unfortunate reality is that profits can be deliberately inflated or manipulated. Setting a higher minimum profit requirements may encourage dishonest ways and means to show results that are not real, or results that cannot be sustained, and this will in fact lead to a greater loss of confidence in the market.

We are aware of many existing listed Main Board companies that would not meet the proposed profit requirement and a fundamental question the Exchange needs to consider is whether all listed companies (and not just new listing applicants) should also have minimum profits to protect investors. We believe introduction of such a requirement however would be impractical and would be unrealistic as running a business is always a risk and many factors will determine whether it will be a success or a failure. Such a requirement for post listing profits may likewise encourage profit manipulation which would not be in the interest of investors.

As the Exchange will be acutely aware, whether profits can be made and when they are made depends on circumstances that cannot be accurately predicted. The COVID-19 epidemic is an extreme example where not just a few enterprises are affected but also whole industries and businesses. The winding up of Dragon Air by Cathay Pacific is a case example where not only profit was significantly reduced from past achievable levels but was eliminated entirely because continuation of a business unit was not viable.

2. Besides the proposed increase in the Profit Requirement, is there any other alternative requirement that should be considered? Please give reasons for your views.

☑ Yes

☐ No

You may provide reasons for your views.

As mentioned in our response to Question 1, the Profit Requirement does not address the Exchange's "reasons" for increasing the required profit before an applicant is eligible for listing. The "reasons" can be more effectively and directly addressed by amending existing rules or introducing new rules to directly address the misconduct. The Exchange may also wish to explore or consider the following:-

<u>A. Consider other listing eligibility criteria</u>

Adopting additional listing eligibility criteria such as those allowed in other exchanges as set out in Appendix II to the Consultation Paper.

<u>B. On-going listing criteria</u>

To improve the quality of listed issuers, the Exchange may consider including ongoing listing requirements, such as minimum market capitalization, minimum numbers of shareholders, minimum net assets or liquid assets and minimum shareholders equity.

<u>C. GEM is not an alternative</u>

The Exchange thinks companies unqualified for the Main Board under the new Profit Requirement can seek a listing on GEM. We, however, believe that GEM is not a viable option. Interest in GEM has dwindled. In 2017 and 2018, before the last Main Board reform, there were 80 and 75 companies listed on GEM respectively whereas in 2019, only 15 companies listed on GEM and it further shrank to only 8 companies in 2020. [4,5,6,7] As of December 2020, only 368 companies are listed on GEM in total with a daily average turnover value of HK$355 million[8] whilst 2,170 companies are listed on Main Board in total with a daily average turnover value of HK$140,494 million[9], which is approximately 67 times the daily average turnover per listed company more than that in GEM.

With the depreciation of GEM and its scanty performance, GEM has become less attractive to investors and potential issuers. GEM was initially aimed to accommodate early stage or pre-profit companies and thus no profit requirement was needed for listing on GEM. The positioning of GEM is now ambiguous and unclear.

The Exchange allows the listing of pre-revenue biotech companies through Chapter 18A and gives the market an impression that GEM is only for companies that are not profitable with no growth potential. If the proposed Profit Requirement is adopted, companies that have a three-year profit record between HK$50 million and HK$125 million would be caught in the middle and will not have a suitable path to list. Unless the Exchange can revitalize GEM with reform and rehabilitate companies' and investors' confidence, GEM is not viable alternative listing venue for many companies.

D. Board reform

If further reform of GEM is not possible, the Exchange could consider possible integration of the Main Board and GEM taking the best features of both (e.g. quarterly financial reporting etc.) in order cater for all potential listing applicants on one large diversified board comprised of companies of all sizes in different industries that use different business models to generate returns. There will be cross-fertilisation with the greater size of the board. Investors can and will choose which companies in the larger pool will be suitable to their investment capability and appetite. Investment analysts will also develop techniques and group classifications to effectively monitor and compare performance.

E. Enhance market diversification of Stock Exchange

The profit requirements of listing in two other major international initial public offering locations, NASDAQ and London Stock Exchange ("LSE") are comparatively lower than the proposed Profit Requirement in Hong Kong Stock Exchange and they offer issuers of every size an access to capital market.

The Exchange could also consider segmenting the Main Board to cater for different size/industries similar to that in LSE.

The Exchange could also enhance its competitiveness by accommodating potential listing applicants from more overseas jurisdictions instead of being heavily reliant on mainland Chinese companies. As the main promotor of Hong Kong financial market, the Exchange should strike a balance between listing supervision and convenience in order to develop and enhance the diversification and sustainability of Hong Kong's capital market.

3. Do you agree that the Exchange should consider granting temporary relief from the increased Profit Requirement due to the challenging economic environment? Please give reasons for your views.

☑ Yes

☐ No

You may provide reasons for your views.

As mentioned in our response to Question 1 above, we believe that an increased Profit Requirement (either Option 1 or Option 2) is not warranted as it does not address the "reasons" for the change. If the Exchange does increase the Profit Requirement for whatever reason we agree that a temporary relief should be granted. The temporary relief should be kept in place to allow the most directly affected sectors to implement measures to adopt and remain until there is solid recovery from the COVID-19 pandemic.

4. If your answer to Question 3 is yes, do you agree with the conditions to the temporary relief as set out in paragraph 55? Please give reasons for your views.

☐ Yes

☑ No

You may provide reasons for your views.

Given that it is uncertain when the worsening economic environment may end, we consider that the profit requirement should stay unchanged until the market and the Hong Kong economy is fully recovered. The relief provided in paragraph 55 is not very meaningful as under paragraph 55(a) the new minimum profit in aggregate must be achieved in any event. All the relief provides is the years in which the profit is "spread" over the three years. It is also unclear:- (a) Whether "all" the conditions must be met; (b) How the Exchange will be able to determine all cases in a consistent and fair basis, especially the conditions mentioned in paragraph 55(b), (c), (e) and (f) which are subjective. We would also comment that "cash flow" mentioned in paragraph 55(b) should be distinguished from "profit" as they are different concepts.

References

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3. Trade and Industry Department, HKSAR, (January 2021), Support and Consultation Centre for SMEs, *SMEs in HK*, [Online] Available at: https://www.success.tid.gov.hk/english/aboutus/sme/service_detail_6863.html

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9. HKEx, (January 2021), HKEx-Market Data-Statistics, Consolidated Reports, *Monthly Bulletin(Main Board),* [Online] Available at: https://www.hkex.com.hk/Market-Data/Statistics/Consolidated-Reports/Monthly-Bulletin?sc_lang=en#select1=0&select2=0

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