

By Email (consultationsupport@hkex.com.hk)

4 November 2023

8/F, Two Exchange Square,
8 Connaught Place, Central,
Hong Kong

Dear Sir/Madam,

[RE: CONSULTATION PAPER – GEM LISTING REFORMS](#)

CFA Society Hong Kong (the “Society” or “we”) appreciates the opportunity to respond to the Hong Kong Exchanges and Clearing Limited (the “Exchange”)’s consultation paper on GEM listing reforms. We are providing comments in line with our missions of promoting fair and transparent capital markets and safeguarding investors’ interests.

Overall, we are supportive of the GEM listing reforms proposal, which aims to establish an alternative eligibility test, introduce amendments to continuing obligations, and implement a new streamlined transfer mechanism to facilitate capital raising opportunities for high-growth Small & Medium Enterprises (“SMEs”) while maintaining investor protection. We have reviewed the consultation paper and provided in this letter our responses based on our in-depth analysis and research. Our key suggestions are summarized below:

Initial Listing Requirements

- Replacing the R&D test to a test based on operating cash flows before R&D expenditures (**Response 2**)
- Adding a stock marker following the stock short name of GEM issuers listing through the alternative eligibility test (**Response 1**)

Continuing Obligations

- Retaining the requirement for quarterly results announcements and removing the requirement for publication of quarterly reports (**Response 9**)

Streamlined Transfer Mechanism

- Shortening the minimum track record requirement for a streamlined transfer applicant to two full financial years as a GEM listed issuer prior to its transfer (**Response 14**)
- Changing the monetary threshold in the Daily Turnover Test to a test that refers to the average historical daily volume of small-cap Main Board issuers (**Responses 15 & 16**)

Other

- Optimizing the extreme transaction rule under GEM Rule 19.06(c)(1) to allow GEM issuers to revive their business through legitimate mergers and acquisitions transactions (**Response 5**)

Separately, we have taken note of the Exchange's consideration of a measured approach for GEM issuers in implementing ESG-related requirements that are proportionate to their circumstances. This approach is in line with the suggestions made in our response letter¹ to the Consultation Paper on Enhancement of Climate-related Disclosures Under the Environmental, Social, and Governance Framework, in which we suggested the Exchange to adjust the disclosure requirements according to the size of the issuer's operations to mitigate proportionality challenges. For instance, allowing GEM issuers to adopt a "comply or explain" approach for complex disclosures, such as scenario analysis, GHG emissions, and metrics. We appreciate the Exchange's stance in this regard as a differentiated approach for GEM issuers would ensure that the proposed disclosure framework is commensurate with issuers' skills, capabilities, and resources, promoting a fair reporting standard while maintaining the comparability and reliability of ESG Reports.

Thank you for your consideration of our views and perspectives. We welcome and appreciate the opportunity to meet and provide you with more details on our letter. If you have any questions or seek further elaboration on our responses, please contact Mr. Matthew Chan, the Managing Director of the Society at matthew.chan@cfahk.org.

Sincerely,
For and on behalf of
CFA Society Hong Kong

Matthew Chan
Managing Director

¹ https://cfasocietyhongkong.org/wp-content/uploads/2023/07/CFAHK-CFAI-Joint-Response-%E2%80%93-HKEX-Climate-related-Disclosure_website.pdf

Responses to specific questions

Question 1

Do you agree that an alternative eligibility test should be introduced to enable the listing of high growth enterprises substantively engaged in R&D activities on GEM?

We welcome the Exchange's proposal for an alternative revenue test, which we believe to be a key criterion in identifying high-growth companies. However, apart from those incurring substantial R&D expenses, we would like to suggest the alternative test to accommodate a wider range of high-growth SMEs with less reliance on R&D for its growth strategies.

It is important to recognize that SMEs, in addition to product innovation, employ various growth strategies that can be reflected in their innovative business models, capital investment, operational efficiency, and expansion of customer bases. In many cases, particularly for SMEs, growth may not be driven by significant R&D expenses (Zhu, Zhang, Huang & Mao, 2021²).

To ensure a more inclusive approach that caters to a wider range of high-growth SMEs, we suggest an alternative eligibility test without a rigid threshold for R&D expenses (see our response to **Question 2**).

Separately, we propose the GEM issuers listing through the alternative eligibility test be prominently identified through a stock marker at the end of their stock short names to remind the investing public of the underlying risks associated with such companies with little positive operating cash flow (i.e., less than HK\$30 million in aggregate for the two financial years prior to listing). This approach would be consistent with that adopted by the Exchange with respect to Biotech Companies (under Main Board Rule 18A.11), Pre-Commercial Companies (under GL115-23 paragraph 74) and issuers with a WVR structure (under Main Board Rule 8A.42).

Question 2

If your answer to Question 1 is "Yes", do you have any comments on the proposed thresholds for the alternative eligibility test as set out in paragraphs 63 to 75 of the Consultation Paper?

We propose an operating cash flow test to effectively identify a wide range of high-growth SMEs. Rather than relying on a rigid threshold for R&D expenses, we suggest that GEM IPO candidates should demonstrate positive operating cash flow after adding back R&D-related cash outflow for live projects (**Pre-R&D Cash Flow Test**). Here are the rationales supporting our proposal:

- a) Different industries exhibit varying patterns of R&D expenditures and intensity. A one-size-fits-all approach based on a specific threshold of R&D expenses may not adequately capture the diversity of high-growth SMEs. Therefore, setting the threshold appears arbitrary.
- b) R&D expenses may not be a consistent indicator of high-growth SMEs. Empirical research shows a positive relationship between R&D intensity and the growth of large companies with superior

² Zhu H., Zhang Z., Huang Y. and Mao W. (2021) *Quantile heterogeneous impact of R&D on firm growth in Chinese manufacture: how ownership, firm size and sectors matter?* Applied Economics 53:28, pages 3267-3287

financial resources, competitiveness, and absorptive capacity (Choi & Lee, 2017³). However, as Zhu, Zhang, Huang & Mao found, the relevant relationship on SMEs is mixed due to their limited resources and market shares.

- c) R&D expenses have been a subject of controversy from an accounting perspective. Accounting standards generally require the expensing of the research phase of R&D, as future economic benefits are challenging to demonstrate during this phase. Therefore, R&D expenses are subject to accounting manipulation and may not reflect the genuine economic value.
- d) By replacing the R&D test to the Pre-R&D Cash Flow Test, the alternative test considers a company's ability to realize its R&D investments into cash inflow. It provides a more holistic assessment of the viability and sustainability of the GEM IPO candidate and reduces the potential for accounting manipulation.

In consideration of the above, Pre-R&D Cash Flow Test would better accommodate the diverse R&D intensity across industries and ensure a more accurate assessment of a company's financial sustainability.

Question 3

Do you agree with the proposal to reduce the post-IPO 24 months lock-up period imposed on controlling shareholders of GEM issuers to 12 months as set out in paragraph 76 of the Consultation Paper?

We agree to reduce the lock-up period to 12 months due to the following:

- a) Concerns regarding controlling shareholders' commitment should be better addressed through proper Board composition and an appropriate incentive scheme. These factors play a crucial role in ensuring the alignment of interests between controlling shareholders and other stakeholders;
- b) Reducing the lock-up period allows a larger portion of shares to become available for trading in the market. This increased free float enhances liquidity, as more shares are readily accessible to investors. It can contribute to a more active and efficient market for a company's shares; and
- c) The trading activities of controlling shareholders can offer valuable barometer to the market participants regarding the controlling shareholders' confidence in the company's prospects.

³ Choi, J. and J. Lee. (2017) *Firm Size and Compositions of R&D Expenditures: Evidence from a Panel of R&D Performing Manufacturing Firms*. *Industry and Innovation* 25(5), pages 459-481

Question 4**Should any other existing eligibility requirement for a listing on GEM be amended?**

We do not have any specific comments regarding the amendment of existing eligibility requirements for a listing on GEM. We believe that the current eligibility requirements have been established to maintain market integrity and protect investor interests.

Question 5**Do you agree with the proposed consequential and housekeeping amendments to the reverse takeover and extreme transaction Rules as set out in paragraphs 81 and 82 of the Consultation Paper?**

We agree. The proposed amendments primarily focus on housekeeping matters, seeking to enhance the existing rules and improve their coherence.

In addition to the above, we suggest the Exchange to optimize the existing extreme transaction rule. Specifically, we suggest amending GEM Rule 19.06(c)(1) and GEM Rule 19.53A(2) in extreme transactions to allow GEM issuers conducting significant business acquisition with a change in control, removing the related sponsor due diligence requirement, while increasing the voting threshold in the relevant general meeting and deeming the acquisition as a connected transaction. Here are the reasons:

- a) We observed that in some cases, issuers were delisted due to failing to meet the operational sufficiency requirement under GEM Rule 17.26. Interestingly, some of these issuers possess substantial assets and the proposed acquisitions may revitalize or diversify their businesses to meet the operational sufficiency requirement. However, these potential acquisitions have been restrained by the reverse takeover rule. Consequently, the public investors face two possible outcomes:
 - Prolonged Suspension: The shares of issuers are suspended from trading due to their non-compliance with GEM Rule 17.26. These shares remain suspended until the issuers become compliant of the Rule through organic growth before delisting deadline. This prolonged suspension deprives the investors' opportunity to exit their positions in these issuers.
 - Cancellation of Listing: If the issuers are unable to re-comply with GEM Rule 17.26 before the deadline, their listing status will be canceled, and they become private companies. In this scenario, controlling shareholders retain control over the company, leaving other investors with illiquid investments due to the lack of secondary market.
- b) SMEs inherently exhibit higher risk characteristics, which often limits their abilities to conduct equity financing to raise cash for business expansion. As such, it is common for GEM issuers to fund the acquisitions by issuing new shares to the sellers. By relaxing the requirements in extreme transactions, issuers would have the opportunity to revitalize their struggling businesses through inorganic growth at an appropriate time. Investors may benefit from the growth potential of the issuer's new business, potentially improving the returns on their investments.

Although there have been instances of price manipulation issues associated with shell companies in the past, we believe that these issues should be effectively addressed through a combination of measures such as the recently imposed investor identification regime, strong enforcement actions, and robust pre-vetting processes which can safeguard the integrity and transparency of the market without compromising the interests of public shareholders.

Question 6

Do you agree with the Exchange's proposal to remove GEM's compliance officer requirement as set out in paragraph 85(a) of the Consultation Paper?

We agree. It is essential to recognize that compliance is a shared responsibility of the entire Board, rather than a specific person only.

To maintain a strong culture of compliance, it is crucial to foster a sense of collective responsibility among board members. The compliance culture should be established by the Board throughout the organization and that all directors should actively contribute to the oversight on the compliance with the rules and regulations.

Question 7

Do you agree with the Exchange's proposal to shorten the period of engagement of GEM issuers' compliance advisers and to remove the additional obligations currently imposed on a GEM issuer's compliance adviser as set out in paragraphs 85(b) and 86 of the Consultation Paper?

We agree. Under the current regime, company secretary plays a key role in advising the Board on compliance matters. As Hong Kong has evolved into a matured financial market over the past decades, there is now a robust pool of experienced and qualified company secretaries available to offer necessary guidance to the Board regarding compliance with listing rules and regulations. Therefore, we believe that it would be appropriate to shorten the duration of the GEM issuers' compliance advisor's appointment and remove the additional obligations currently imposed on a GEM issuer's compliance adviser to align with the requirements of the Main Board.

Question 8

Should any other continuing obligation currently applicable to a GEM listed issuer also be removed?

Apart from our proposal in relation to the optimization of the extreme transaction rule as mentioned in our response to Question 5 above, we agree that the remaining continuing obligations currently applicable to GEM issuers should be retained. These obligations are essential in ensuring fair treatment of shareholders and maintaining investor confidence.

Question 9

Do you agree with the Exchange's proposal to remove quarterly financial reporting as a mandatory requirement for GEM issuers and instead introduce it as a recommended best practice in GEM's Corporate Governance Code?

We partially agree. The appropriate reporting interval, whether quarterly or otherwise, has been a subject of ongoing debate. The fundamental objective of reporting requirements is to provide regular and transparent information to shareholders and the market. Some argue that less frequent reporting intervals could lower the associated costs for listed companies. On the other hand, proponents of the quarterly reporting believe that quarterly reporting offers crucial information to investors and helps mitigate market volatility.

It is worth noting that the U.S. Securities and Exchange Commission has been actively gathering public input on earnings releases and quarterly reports since 2018⁴ and there have been no policy changes thus far. The key consideration remains finding an equilibrium between providing timely and relevant information to investors while considering the costs and potential impact on market dynamics.

Nevertheless, facilitating timely and accurate information flow is indeed a crucial aspect of a matured market. Advancements in information technology have significantly reduced the costs associated with financial reporting. In light of this, we suggest keeping the GEM Rule 18.79 requirement for quarterly results but removing the quarterly reports requirement under GEM Rule 18.02 to strike a balance between costs and benefits.

Question 10

Do you agree with the Exchange's proposal to align the timeframes for GEM issuers to publish their annual reports, interim reports and preliminary announcements of results for the first half of each financial year with those for the Main Board, as set out in paragraphs 94 and 95 of the Consultation Paper?

We agree with the Exchange's proposal to align the timeframes for GEM issuers to publish their annual reports, interim reports and preliminary announcements of results for the first half of each financial year with Main Board issuers. As mentioned in our response to Question 9 above, we suggest retaining the requirement of publishing quarterly results announcements while removing quarterly financial reports requirement. While issuers are not required to publish quarterly reports, we suggest keeping the requirement to publish quarterly results announcements for first three months and nine months periods of each financial year not later than 45 days. This approach will ensure timely and accurate information for investors, while promoting transparency and accountability in the market.

In addition, upon the alignment of the timeframes for GEM issuers to publish their annual report with Main Board issuers, we suggest the Exchange to consider consequential and housekeeping amendments to the guidance letter (GL25-11) in relation to conditions for waivers with Main Board Rule 4.04(1) and GEM Rules 7.02(1) and 11.10 to align the conditions that the Exchange would ordinarily expect for the waivers for GEM listing applicants with that of the Main Board.

⁴ <https://www.sec.gov/files/rules/other/2018/33-10588.pdf>

Question 11

Do you agree that a streamlined mechanism should be introduced to enable qualified GEM issuers to transfer their listing to the Main Board?

We agree. The streamlined transfer mechanism offers an efficient method for GEM issuers to enhance their fundraising abilities by transferring to the Main Board. The proposed GEM Listing Rules Chapter 9B aims to alleviate the burden on eligible issuers by eliminating the need for an extra sponsor due diligence and prospectus, which saves significant time and costs.

Questions 12 and 13

If your answer to Question 11 is “Yes”, do you agree with the removal of the requirement for the appointment of a sponsor for the purpose of a streamlined transfer as set out in paragraph 108 of the Consultation Paper?

If your answer to Question 11 is “Yes”, do you agree with, for the purpose of a streamlined transfer, the removal of the requirements for a “prospectus standard” listing document and other requirements as set out in paragraphs 111 to 114 of the Consultation Paper?

We agree. We believe that the existing disclosure requirements for GEM listing applicants and listed companies adequately address the need for transparency and investor protection. When a company applies for listing on GEM, it is required to provide detailed information in its prospectus, which undergoes thorough due diligence by the sponsor during the listing process. This ensures that investors have access to comprehensive information about the company's operations, financials, and risks before making investment decisions. Furthermore, listed companies are already obligated to communicate their business updates and financial information periodically in accordance with the listing rules, which serve to provide regular updates on the company's performance and financial health to investors for making informed decisions.

Thanks to the existing disclosure and reporting mechanisms, we believe that additional requirements for the appointment of a sponsor and a “prospectus-standard” listing document for the purpose of a streamlined transfer may not be necessary. The current framework effectively balances the need to provide sufficient information to investors while minimizing the excessive administrative burden on listed companies.

Question 14

If your answer to Question 11 is “Yes”, do you agree with the track record requirements for a streamlined transfer applicant as set out in paragraphs 117 to 118 of the Consultation Paper?

We propose that a streamlined transfer applicant should demonstrate a minimum track record of two full financial years as a GEM issuer prior to its transfer, instead of the current proposal of three years.

Compared to other exchanges, such as LSE AIM and Nasdaq Capital Market, which do not have specific track record requirements for their transfer mechanisms while SGX Catalyst and BSE only require track record period of two years and one year respectively in their transfer mechanisms, the proposed three-

year track record requirement for GEM issuers may be too stringent that will undermine the competitiveness of GEM against its peers.

Furthermore, it is worth noting that BSE also requires its listing applicants to be listed in the Innovation Tier of the National Equities Exchange and Quotations (NEEQ) for at least 12 months before transferring, effectively making the total listing period at least two years. However, a recent opinion⁵ by the China Securities Regulatory Commission (CSRC) in early September 2023 stated that the 12-month requirement for transferring from NEEQ's Innovation Tier to BSE would be relaxed. Instead, the new criteria would be listing for 12 months at the time of review by the BSE listing committee. The opinion also mentioned that qualified high-quality SMEs are allowed to conduct an IPO and be listed directly on BSE.

Considering that a streamlined transfer applicant could potentially list directly on the Main Board with a minimum track record of three full financial years and one full financial year of ownership continuity and control, and the fact that the GEM issuer has already demonstrated a track record of a minimum of two full financial year prior to its listing on GEM, we believe that the proposed requirement of a three-year track record with ownership continuity and control as a GEM listed issuer, as well as no fundamental change in the principal business, may be excessive.

Taking these factors into account, we propose shortening the track record requirement to two financial years. This adjustment would align GEM's track record requirement more closely with other exchanges and strike a balance between facilitating streamlined transfers and maintaining appropriate listing standards.

Questions 15 and 16

If your answer to Question 11 is “Yes”, do you agree with the daily turnover and volume weighted average market capitalisation requirements for a streamlined transfer applicant as set out in paragraphs 120 to 133 of the Consultation Paper?

If your answer to Question 15 is “Yes”, should the Minimum Daily Turnover Threshold for the Daily Turnover Test be set at: (a) HK\$100,000; (b) HK\$50,000; or (c) another figure (please specify)?

We agree with the daily turnover and volume weighted average market capitalisation requirements for a streamlined transfer applicant. However, we believe that the proposed monetary thresholds of HK\$100,000 and HK\$50,000 are inadequate, as the implied liquidity may not sufficiently justify the required market capitalisation of HK\$500 million for transfer to the Main Board. We note from Paragraph 121 of the Consultation Paper that the proposed thresholds were back tested using the statistics of a group of GEM issuers with low liquidity during 2023. It appears that the thresholds are set to accommodate for issuers with low liquidity. As such, we are concerned about the appropriateness of such basis for assessing transfer applicants, particularly considering the proposed significant changes in the GEM listing regime, including the streamlined transfer mechanism.

⁵ https://www.gov.cn/zhengce/zhengceku/202309/content_6901599.htm;
<http://www.csrc.gov.cn/csrc/c100028/c7429812/content.shtml>

We suggest the Exchange to consider making reference to the historical stock turnover of small-cap Main Board issuers as a basis for determining appropriate daily turnover test thresholds. For example, utilizing turnover velocity over a historical period, such as quarterly, would provide a better reflection of the liquidity and trading activity of transfer applicants. This approach would result in a more robust and relevant measure of liquidity for assessing GEM issuers' ability to meet the market capitalisation requirement.

Questions 17 and 18

If your answer to Question 11 is "Yes", do you agree with the proposed compliance record requirement for a streamlined transfer applicant as set out in paragraph 134 of the Consultation Paper?

Do you agree with the proposed modification to the existing compliance record requirement for a transfer from GEM to the Main Board as set out in paragraph 136 of the Consultation Paper?

We agree with the proposed compliance record requirement for both a streamlined transfer applicant and a transfer from GEM to the Main Board. The compliance record requirement serves as an important safeguard to protect the interests of investors and maintain market integrity. It helps to ensure that companies transferring to the Main Board have demonstrated a commitment to adhering to robust regulatory standards and have a history of fulfilling their obligations to shareholders. By setting clear and objective criteria for compliance, the proposed requirement enhances transparency and investor confidence in the transfer process.

Question 19

Do you agree that the Exchange should exempt GEM transferees to the Main Board from the Main Board initial listing fee?

We agree and have no further comments on the proposed initial listing fee exemption.