Report of the International Committee on Listing of New Enterprises

Executive Summary

January 2001

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Executive Summary of the Report's Key Findings

1. Motivations for the Study

An International Committee on the Listing of New Enterprises (the 'Committee') was set up in the Spring of 2000 to study the key factors that draw or repel issuers from listing in certain markets. Primary attention was given to Hong Kong's second board market, the Growth Enterprise Market (GEM), and the types of growth stocks drawn into this nexus. The Committee's overriding objective has been one of '... *helping to maintain Hong Kong's status as an international financial centre friendly to issuers and attractive to investors*'. The brief of the Committee's study was to go beyond the staple of rule changes proposed for GEM, in the Stock Exchange of Hong Kong's Consultation Paper of May 2000, and to consider the range of issues (including listing rules) that make a venue attractive to issuers, analysts and investors. The study is therefore complementary to the Exchange's consultations and it is anticipated that the findings from this study will feature as input in the overall deliberations concerning listing rule changes.

The advent of the New Economy makes the study a timely one, with markets around the globe seemingly in 'competition' to attract quality growth companies, many of which share a high-tech business orientation with little or no earnings' record. To allow meaningful assessment of the GEM board, comparison with some of the major markets for New Economy, growth stocks is an essential prerequisite. Such comparison forms an integral part of the analysis, with some of the world's most prominent markets (Germany's Neuer Markt, the UK's AIM board and techMARK segment and the Nasdaq National Market) providing benchmarks.

In considering the broader motivations for listing, listing rules are inevitably one factor, but not the only one. Other factors, which make-up the overall listing 'environment', must be taken into account. The cost of going public, the accounting standards and on-going obligations imposed, perceived market liquidity, fund-raising prospects and costs post-IPO and, significantly, the types of corporate behaviour brought on by the overall regulatory and legal environment in which the market operates are likely to be important.

To help in delineating and weighting the various factors influencing an issuer's decision to list on GEM (or on any other competing market), an 'on-market' survey of issuers and other key players in the Hong Kong market place has been undertaken. This survey forms a central part of the study and profiles findings from a series of in-depth interviews with key decision-makers in issuers (and their sponsors) and investor-based groups, including venture capitalists and analysts. As the overall equation of success for a market reflects the contribution of both issuer- and investor-based groups, an analysis of issuers alone has the potential to mislead. In terms of the equation of success, issuer-based groups and investors must be cognisant of the others' preferences.

2. The Performance of GEM since its Launch

Certain qualifications must be made before assessing the results in this study. Above all, the study was not triggered by any perceived weakness in the GEM board. In terms of key criteria, such as numbers of issuers and funds raised, the market has performed well and, perhaps, beyond expectations. In terms of its primary market for instance, funds raised on GEM during 2000 are comparable with funds raised on the longer-established KOSDAQ and ROSE second boards (in S. Korea and Taiwan, respectively). Relative to all the second board markets in Asia, GEM is the third largest, in terms of market capitalisation. This is quite an achievement for a market that has only been in existence for approximately one year. Liquidity and volatility levels on the board also compare reasonably with other regional second boards.

Concern in the media has, however, been aroused by the performance of the GEM index. Again, this requires careful qualification. Comparison with other boards with a strong tech flavour, and recognition that the Index was constructed when ‘tech fervour’ was at its zenith, indicates that GEM stock prices have broadly followed the international tech trend. To reiterate, then, this Report is not written as a ‘health-check’ on GEM, but rather with a view to consolidating and enhancing the strength of the market, especially in the light of perceived competition for issuers.

3. Stages of Analysis Employed

The ‘On-Market Survey’ provides the principal area of analysis in this Report. This is complemented by two stages of preliminary analysis: an examination of Hong Kong-headquartered companies that have listed overseas in recent years (Stage 1); and (ii) a comparison of the regulatory regimes, governance and legal frameworks that pertain to GEM and other major markets, using Nasdaq’s National Market, the Neuer Markt and London’s AIM and techMARK boards for benchmark comparison (Stage 2). Findings from the On-Market Survey follow as Stage 3.

4. Stage 1: An Analysis of Hong Kong-Headquartered Companies Venturing Overseas for IPO

Based upon the Committee's study of IPOs of Hong Kong issuers on overseas markets, the flow of companies leaving Hong Kong's shores for fund-raising listings overseas has, to date, been rather limited. Even within this flow, only a few market organisers - essentially Nasdaq’s National Market and the Singapore Exchange - have been able to draw anything more than a trickle of issuers. Secondary market activity, for counters listed in 'foreign' jurisdictions, has, more often than not, also failed to impress.

Nonetheless, some markets, like Nasdaq's National Market already have 24 Hong Kong-based issuers on their market, with evidence of increased migration in the last year or so. While several of these counters have also dual-listed in Hong Kong, Nasdaq's overall structure, the institutions drawn to it and the agglomeration of tech companies and analysts it provides, suggest that it has greater 'pulling-power' for quality growth stocks than any other international market. For Mainland H share issuers, the NYSE clearly provides an attractive listing outlet, but again such counters are typically dual-listed in Hong Kong. In short, competition does exist and there is always a fear that the brightest and best of companies might migrate. The issue, then, is one of ensuring that local and Mainland companies continue to view Hong Kong as their 'home base' for listing and that the highest quality counters perceive the local market to be the most appropriate outlet in relation to fund raising and liquidity.

On the surface at least, recent evidence of companies pursuing overseas IPOs indicates that most local issuers are still strongly predisposed to a 'home' listing where investor familiarity with the issuer's assets, brand name, business operations and management is greatest.

5. Stage 2: Regulatory Comparisons between GEM and certain other Stock Boards

Particulars of listing rules and the wider regulatory and legal framework, governing the behaviour of issuers on GEM, Nasdaq's National Market, Germany's Neuer Markt and London's AIM/techMARK markets are set out.

Comparison of the four market settings is strewn with difficulties. However, corporate governance practices, in jurisdictions like the US, appear to benefit from the legal/statutory framework and the presence of large-scale institutional stock investment. Where institutional investors are key shareowners (as they are in the US, Germany and UK), they necessarily demand sound disclosure practices. The obligations imposed upon underwriters, through the US legal system, and the presence of class action suits (with attendant contingency fees) which make it easier for minority shareholders to seek redress, have a role to play in protecting minority investors. The environment in Hong Kong, which lacks the statutory framework of the US, and is not buttressed by institutional share-ownership, in the way that for instance the UK or Germany is, necessitates a different approach. The obvious long-term solution is to attract more institutional investment. This is a 'chicken-and egg' problem, however, as the corporate governance practices that institutions help mould must be mature to some extent before such institutions are prepared to enter significantly as share owners. Experience has also shown that institutional investors (with the exception of a small number of specifically focussed funds) tend to shy away from growth board stocks. Drawing in such players is therefore an invidious task for any growth board organiser.

In light of the seeming reluctance of institutional investors to invest in growth boards, and the generally reduced involvement of institutional investors in the Hong Kong market as a whole, a greater case can be made for consolidating and bolstering corporate governance through the imposition of more stringent qualitative and quantitative listing rules. This is not to say that rules with such an aim are not present elsewhere; simply that they are buttressed in other markets by other external factors which may lessen the need for the imposition of stringent listing and on-going requirements in certain areas.

Comparisons may be made between Hong Kong’s GEM and the proposed second board in Shenzhen, Mainland China. As yet, this market is only at the consultation stage and its listing rules and structure are not yet finalised. However, certain of the entry requirements appear likely to be more stringent than GEM’s. If this is in fact the case, some may view the Shenzhen second board as a higher quality board than GEM. However, as noted above, one should view the entry requirements in the context of the overall regulatory and legal framework and the maturity of the securities market as a whole. In short, GEM’s more mature status, the Exchange’s surveillance and enforcement record and the SAR’s general statutory and regulatory framework, provide some justification for less onerous listing requirements, in certain areas, relative to those proposed for Shenzhen’s new board.

6. Stage 3: An Interview Survey of GEM Issuers, GEM Sponsors, Local Issuers Migrating Overseas for IPO, Venture Capitalists and Analysts

Interviews were conducted with key decision-makers in 30 organisations characterised as either 'issuer-based' or 'investor-based'. The former comprised GEM issuers, sponsors and issuers migrating overseas for IPO and, in total, accounted for 20 of the 30 in-depth interviews. The remaining 10 interviewees, representing investor-based concerns, comprised analysts and venture capitalists. The summary of key findings, which capture the principal results of this Report, are set out below:

(i) Something of a consensus on listing rules appears to exist. These appear not to be the key issue of concern for 'issuer-' and 'investor-based' users of GEM. Amongst other things, (i) perceived liquidity of the issuer’s stock, (ii) prospects for issuing additional stock in subsequent years, (iii) profile of investors, and (iv) overall market sentiment in run up to the stock issue were generally signalled as key issues in judging a listing venue.

It was also noted that listing rule comparisons between GEM and Nasdaq have limited value since, in practice, US underwriters and issuers respond to the larger US legal framework. The due diligence expected of, and undertaken by underwriters and other professionals, may mean that certain 'requirements', not specified in listing rules, filter into the listing process in the form of unwritten protocols. Ultimately, these protocols may dictate the type of issuer coming to market.

(ii) There may be a case for enhancing the quality of new entrants to GEM. For several respondents, comprising both issuers and analysts, a view that a minority of issuers may have listed a little too prematurely was relayed. Several respondents suggested that measures to enhance issuer quality would be beneficial to the market's overall prospects. Others, while fewer in number, remarked that markets oriented towards a disclosure-based model of regulation (with a minimum of listing rules) require investors to make the call on stock quality, and as such, potentially allow regulators to 'let the market decide' on the types of issuers that list.

(iii) Despite the proliferation of stock trading globally, participants believe that the majority of local issuers are inherently drawn to the market where their assets and business focus can be found. GEM staying with the 'status quo' is unlikely, therefore, to precipitate a flow of local companies listing overseas. Instead, companies with greater quality might gain reassurance from a sufficiently comprehensive regulatory platform (whether grounded as at present in terms of a mix of merit- and disclosure-based regulations or on a US style disclosure-based regime). Moreover, many respondents argued that listing rules should be expressed clearly and applied consistently.

(iv) While the GEM initiative is generally welcomed by participants, some concerns about its development were signalled. As a balance to such concerns, a number of respondents opined that certain ('teething') problems might ameliorate with time. Secondary market inactivity and the downward trend in prices, especially between early April and late July of 2000, were pinpointed as key concerns. Some of this can be traced to a lull in sentiment for high-tech counters globally - and to the April/May retreat in Nasdaq in particular. This appears to be only part of the story, however. A number of established issuers and analysts argued, in varying degrees, that issuer quality was also a factor. Concern over the illiquidity of GEM was stressed throughout. Some issuer-based respondents (particularly sponsors) noted that market-making systems might help. Others suggested that greater effort should be geared towards investor education and promotion of the market.

(v) In the absence of a sudden upturn in high-tech sentiment or a drive to quality - as recommended in several interviews - the outlook for GEM is currently, perhaps, a little uncertain. A real, or merely perceived, trade-off of stock quality for listing numbers could have a debilitating effect on the market over the longer-term, especially if sentiment were to turn against small, high-tech stocks. To stem fears in this direction, a number of respondents argued that the GEM listing authorities should campaign a little more vigorously in the media to allay such fears. Some respondents suggested that a campaign to further educate investors, as to the inherent risks of small, emerging market stocks would help in stemming a possible confidence crisis on GEM (if and when one or two of its counters go to the wall). In keeping with this, several respondents remarked that investors and issuers should be educated towards a disclosure-based view of markets. Others concluded that a more direct approach, namely a drive to quality, would have more meaningful positive effects.

(vi) As mentioned, the views relayed from respondents suggest that the current crop of proposals to relax GEM's listing rules may be subordinate to the key issue of concern: liquidity. Nevertheless, of the listing requirements raised in interviews, issuer track-record appeared significant. A number of respondents suggested that track-record (or a substantial period of 'active business pursuits', to use the GEM terminology) was helpful in judging stock quality.

(vii) Several participants expressed a view that reverse takeovers (sometimes known as back-door listings (BDLs)), involving the injection of private assets into shells of companies listed on the Main Board of the Stock Exchange of Hong Kong could, under certain circumstances, provide an alternative to GEM listing. Various problems pertaining to the BDL route were also signalled, however, rendering the approach, in the minds of most respondents, somewhat less credible than the IPO.

(viii) Virtually all respondents expressed a desire for GEM to succeed. In interpreting interviewee responses, the relative balance of issuer- and investor-based groups and the actual timing of interviews may have had a bearing on respondents' sentiment. Concerns over issues like liquidity were, in general, conveyed a little more strongly by analysts and venture capitalists. Had the issuer: investor interviewee ratio of 2:1 been configured more favourably towards investors, outcomes might well have differed slightly. Nonetheless, the general findings from issuer- and investor-based groups bore many similarities. More significant, perhaps, is the timing issue. All interviews were conducted between late June and early August of 2000 and, accordingly, reflect some of the pessimism in the markets deriving from the April/May slide in high-tech sentiment. Had the interviews been conducted in March, a rather more positive tale might have unfolded. Despite this observation, interviews cannot be timed with market sentiment in mind. If anything, broadly similar market conditions prevailed during the interview period.

7. <u>Recommendations</u>

Both Stages 1 and 3 of the study uncovered a predilection for local (and Mainland, Red-Chip) issuers to list on 'home soil'. In view of this, moves geared to *maintaining* GEM as a 'quality' board would not necessarily deter issuers. On the contrary, maintaining and enhancing quality might help to 'internationalise' the market by drawing in issuers from Asia in general, especially companies with an interest in Mainland investment and retail markets. Listing rules may also be an issue as certain exchanges, in relation to provisions like 'lock-up', appear to take a more 'liberal' approach than GEM. This must, however, be evaluated against the overall statutory and regulatory framework that feeds into a market. In the US, in particular, underwriters may impose protocols – in view of their absolute liability – that go well beyond listing provisions. Nonetheless, there is an argument that issuers may pay greater attention to the written protocols (i.e., listing rules) than the unwritten ones. Members of the Committee recognised such a possibility, but accepted that the underwriters and other agents involved in the listing process would typically ensure that the full extent of unwritten protocols be made known to issuers in initial discussions. Moreover, underwriters in the US would need, in light of the due-diligence requirements and their reputational capital, to ensure that issuers meet all of their own requirements.

It is recognised that numerous companies – often without track-record, and therefore of unknown quality - require an equity platform for growth. The reluctance of other parties to finance such companies is well understood. For GEM to cater to such companies, and to simultaneously provide a platform for quality stocks, with some track-record, one possible solution would be for GEM to segment its platform into two sections: one for companies with 'active business pursuits' or track-record and another for 'start-ups'. The Committee considered this but concluded that there are dangers in pursuing such a course of action. First, by carving up a market that is developing, there is a risk that GEM's overall focus might be weakened. Such a step might also prove to be a little premature and threaten one of the Market's assumed objectives: attracting a critical mass of counters as a prelude to enticing analysts, institutions and other key players. There is also the potential risk that an additional tier, designated for stocks with no or limited track-record, would fail to act as a substitute for or complement to the venture capital funding route, thus leading to a highly illiquid board. Third boards elsewhere have been plagued by such problems.

Staying with the status quo, that is retaining a unified GEM that caters to companies with an established track-record and also attracts issuers with recognised growth potential, appears to be the safest option. Several members of the Committee were concerned, however, with the precise interpretation of track-record or ‘active business pursuits’, in the absence of quantitative criteria on the issue for GEM. In view of the goals prescribed by GEM – as captured in the first part of this paragraph – the flexibility offered by the existing interpretation of ‘active business pursuits’ has some merit. To support this interpretation, most respondents in the Survey highlighting the importance of track-record or ‘active business pursuits’ appeared to be a little more concerned with the prescribed period rather than the quantitative criteria used to measure it. However, the absence of more defined criteria for establishing a track record may be a negative factor as potential issuers and investors may find that it provides too little certainty for them to judge qualitatively the stocks and the market itself. The Committee concluded that the Exchange should review whether to retain the existing definition, which ostensibly provides for some flexibility on the issue, or build-in one or more specific profit, revenue or other quantitative requirement. As a further variation, a hybrid of both approaches could be considered. Whatever the outcome on this issue, the Committee considers that the track-record criteria should be measured against the material business(es) listed.

The Committee believes that changes to market microstructure should also be considered, given the success of dealer-based trading systems elsewhere. By inviting market-makers to quote firm prices, and allowing investors to trade-off trading costs for immediacy, some liquidity gains may emerge for even the smallest cap stocks. While market-making is not particularly common in Asia, it has met with notable success in various markets in North America - particularly Nasdaq - and Europe. Such systems are not limited to large caps either; Nasdaq's Small Cap Market and London's AIM demonstrate that market-makers can be drawn to quote prices for the kinds of stock that GEM is ostensibly designed to serve. Documented evidence elsewhere, including IOSCO's Emerging Markets Committee Report (1999) on '*The Influence of Market Makers in the Creation of Liquidity*', strongly points to the desirability of market-making systems in emerging markets.

One of the recommendations of this Report is that further study and consideration be given to the possible adoption of market-making on GEM. The concerns surrounding such an initiative are inevitably the same: the perceived difficulty in attracting highly-capitalised dealers in small cap stocks. Nonetheless, there is a case for arguing that, potentially, small cap stocks benefit the most from specialist pricing. Superficially, this issue might be complicated by technology concerns, although the advent of AMS3 appears to make a possible move to quote-driven trading more feasible than hitherto.

One final issue, noted in some analysis in the final section to the Report, is that shares are sometimes highly concentrated within the top-ten placees in GEM IPOs (where a placing occurs concurrent with or instead of a public offering of shares). This issue bears directly upon liquidity, as a greater concentration of shareholdings at IPO may result in a lower effective 'free float', notwithstanding the 'public' float requirement set by the Exchange. Given the importance of liquidity, a further recommendation – though subordinate to the market-making issue – is that further consideration be given to ways of lessening placee concentration. At the same time, enticing a broad base of placees, especially for stocks with little or no qualitative earnings history, poses certain difficulties. As such, one might have to accept the slightly higher placee concentration figures currently evident as an inevitable constraint facing a board for emerging companies.

In sum, the Committee's view is that the suggestions in the foregoing be further explored by the Exchange as it strives to build on the initial development of its GEM board initiative. The central message, applicable to all markets, is the importance of ensuring quality in market structure and administration.