

For Information

**The Legislative Council
Panel on Financial Affairs**

Report on the Growth Enterprise Market

PURPOSE

This paper informs Members of the observations made by the International Committee on Listing of New Enterprises (“The Committee”) and the results of the recent review of the Listing Rules of the Growth Enterprise Market (GEM).

BACKGROUND

Overview

2. GEM was set up in November 1999 to offer growth enterprises an avenue to raise capital. 117 companies are now listed in GEM with a total market capitalization of HK\$66 billion. From its inception to December 2001, a total of HK\$24.5 billion capital was raised through GEM.

3. As GEM is a new market for Hong Kong, it was recognized at the outset that its operation and Listing Rules may need to be adjusted in the light of market needs at some stage after its establishment. Two major reviews were launched subsequently and their results are set out below.

Study by SFC’s International Committee on Listing of New Enterprises

4. The Committee, comprising international market experts and prominent individuals from the Hong Kong market, was formed by the Securities and Futures Commission (SFC) in April 2000 to conduct an independent study into the key factors that make a listing venue attractive to issuers, analysts and investors, including the role of the applicable regulatory rules. The membership of the Committee is at **Annex A**. The Committee conducted the study by -

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- (a) comparing the regulatory regimes, governance and legal frameworks that pertain to GEM and other major markets,

- using Nasdaq's National Market, Frankfurt's Neuer Markt and London's AIM and techMARK boards as a benchmark;
- (b) interviewing key decision-makers in 30 organisations characterised as either 'issuer-based' or 'investor-based'; and
- (c) examining Hong Kong-headquartered companies that were listed overseas in recent years.

5. On the basis of its study, the Committee made a number of observations in relation to GEM and offered the following recommendations -

- (a) In view of the tendency for local (and Mainland) issuers to list on 'home soil', moves geared to maintaining and enhancing the quality of GEM would not necessarily deter issuers; on the contrary, enhancing and maintaining quality would help "internationalize" the market by attracting issuers from overseas.
- (b) Retaining a unified GEM that caters both to companies with an established track-record and issuers with recognised growth potential was preferable to segmenting GEM's platform into two sections: one for companies with 'active business pursuits' or track-record and another for 'start-ups'.
- (c) The level at which listing rules is set, particularly in relation to provisions like 'lock-up' and 'track record' is a relevant factor but this must be evaluated against the wider statutory and regulatory framework. In relation to track record, the Hong Kong Exchanges and Clearing Limited (HKEx) should review whether GEM should remain with the existing criteria (of 'active business pursuits'), which provides for some flexibility on the issue, or build in one or more specific profit, revenue or other qualitative requirements. As a further variation, a hybrid of both approaches could be considered. In any event, track record criteria should be measured against the material business(es) listed.
- (d) Considering the success and experience of dealer-based trading systems elsewhere, changes might be made to the GEM market microstructure that could facilitate liquidity gains for small cap stocks, where market-makers may quote firm prices and investors may trade-off transaction costs for immediate execution.
- (e) The HKEx should re-appraise the size of the 'free-float' for GEM companies and the concentration of shares amongst

places. Evidence elsewhere indicates that liquidity improves with the size of the free-float. While there are difficulties in broadening the base of places, so that the largest places take up a smaller proportion of the issue, measures to do this would probably promote liquidity (even in the absence of a market-making system). Further study could be given to this issue.

6. The Committee stressed that the central message, applicable to all markets, is the importance of ensuring quality in market structure and administration.

7. The findings of the study were published in July 2001. A copy of the Executive Summary is at **Annex B**. The findings were referred to HKEx for consideration.

Listing Rule Review conducted by HKEx and Changes Made

8. HKEx issued a consultation paper in May 2000 proposing changes to the GEM Listing Rules. The key areas for consultation include the moratorium period for the initial management shareholders; shares issued within six months of listing; active business pursuits; accountants' report; share option schemes; revenue/profit requirement and offering mechanism.

9. The consultation ended in June 2000 with 165 responses. The comments received showed a divergence of views between issuer-related respondents and investor respondents. Numerous discussions were held between the SFC and HKEx to assess the responses and the shape of the proposed rule revisions. In July 2001, the SFC and HKEx issued a joint announcement setting out the main provisions of rule changes and the related transitional arrangements. The final detailed rule changes became effective on 1 October 2001.

10. The principal changes are as follow -

- (a) *Minimum active business period* for listing applicants is fixed at 24 months. However, a new category of entry requirement has been introduced to facilitate listing of companies with substantial size and significant public following, but which cannot satisfy the 24-month period requirement. The minimum period for these GEM applicants is 12 months, provided that they satisfy the prescribed criteria regarding total revenue (no less than \$500

million, or total assets of at least \$500 million, or market capitalisation of at least \$500 million determined at the time of listing); minimum market capitalisation (\$150 million held by at least 300 public shareholders); and initial public offer price (at least \$1).

- (b) *A GEM listed issuer may not issue new securities within first six months of listing, except in order to acquire assets which complement its focused line of business and that certain conditions regarding the size of acquisition, shareholders' approval are met.*
- (c) *The moratorium period for initial management shareholders is 12 months in general, and 6 months for initial management shareholders with no more than 1% shareholding in the GEM listed issuer.*
- (d) *The definition of initial management shareholders is extended to include all members of senior management, directors and investors with board representation.*
- (e) *Certain requirements for share option schemes are amended to allow greater flexibility in their operation. At the same time, further requirements are placed in other areas, such as the grant of options to connected persons, disclosure of the identities of scheme participants, and setting the maximum entitlement of each participant, to safeguard against abuse of the scheme and to protect minority shareholders.*
- (f) *The prescribed public float for issuers with initial market capitalisation of not more than \$4 billion is increased to 25%. For issuers which have initial market capitalisation of over \$4 billion, the public float is required to be the \$1 billion or 20%, whichever is higher. In addition, employees and their associates will not be counted as members of the "public" in determining minimum public float at the time of listing.*

11. A copy of the Joint Announcement by the SFC and HKEx is at **Annex C**.

Related Initiative – The Corporate Finance Adviser Code of Conduct

12. An Initial Public Offering (IPO) is a key step in the fund raising chain for listings both in the Main Board and GEM. The early

experience of listings in GEM clearly demonstrates that an IPO subscription process requires the close co-operation as well as good communication amongst all parties involved. In particular, the sponsor is responsible as an overall manager and has the responsibility to assess the likely interest in the offer by the public and put in place sufficient arrangements and resources to ensure that the process is conducted in a fair, timely and orderly manner.

13. To make clear this responsibility and the consequent obligations, the SFC has included detailed requirements for sponsors in a new Corporate Finance Adviser Code of Conduct. The draft Code was issued in May 2000 for public consultation, which ended on 30 June 2000 with 23 responses. A further round of consultation was done in February 2001 and the final Code was published in November 2001 and came into effect on 1 December 2001.

14. Apart from IPO-related matters, the Code covers many other aspects of corporate finance advisory work. The SFC will take into account the ability of an advisor to discharge all of the stated duties satisfactorily in assessing its fitness and properness for continued registration. A summary of the requirements with special emphasis on the IPO aspect is at **Annex D**.

WAY FORWARD

15. GEM provides a fund raising avenue for growth enterprises outside the Main Board and enriches the services and choices offered by Hong Kong as a capital formation centre. It also promotes the development of venture capital investments. Experience over the past two years has laid a useful foundation for the further development of GEM. Efforts will continue to be made to enhance the quality of this Market to increase its attractiveness and protection offered to investors.

Securities and Futures Commission
Financial Services Bureau
February 2002

International Committee on
Listing of New Enterprises

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Member
Growth Enterprise Market Listing Committee

Report of the
International Committee on Listing
of New Enterprises

Executive Summary

January 2001

Report of the International Committee on Listing of New Enterprises

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 avenue 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. Recommendations

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.

Annex C

TO THE BUSINESS EDITOR
FOR IMMEDIATE RELEASE

27 July 2001

JOINT PRESS RELEASE

*Joint Announcement on the
Market Consultation and Changes to the Rules governing the Listing of Securities on the
Growth Enterprise Market ("GEM")*

The Securities and Futures Commission (the "SFC") and the Stock Exchange of Hong Kong Limited (the "Exchange") have agreed in principle the proposed amendments to the GEM Listing Rules which are highlighted as follows:

1. Minimum active business pursuit period for listing applicants will be 24 months. However, a new category of entry requirement will be introduced to facilitate listing of companies with substantial size and significant public following. Provided that certain criteria are met, the minimum period for these GEM applicants will be 12 months.
2. A GEM listed issuer may not issue new securities within the first six months of listing, except in order to acquire assets which complement its focused line of business, provided that certain criteria are met.
3. The moratorium period for initial management shareholders will be 12 months in general, and 6 months for initial management shareholders with no more than 1% shareholding in the GEM listed issuer.
4. The definition of initial management shareholders will include all members of senior management, directors and investors with board representation.
5. The interpretation of "disposal" by initial management shareholders will exclude stock lending arrangements with underwriters at the time of the GEM applicant's initial offering for the purpose of satisfying any over-allotment, and the sale of shares pursuant to a placing and top-up transaction during the second six months after listing.
6. Certain requirements for share option schemes will be amended, such as the identity of the participants of the scheme and the overall scheme limit, to allow greater flexibility in operations. Further restrictions will be placed in other areas, such as the grant of options to connected persons and the maximum entitlement of each participant under the scheme, to safeguard against abuse of the scheme and to protect minority shareholders.
7. Employees and their associates will not be counted as members of the "public" in determining minimum public float at the time of listing.

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8. The prescribed minimum percentage of securities in public hands will be 25% and 20% for GEM listed issuers with market capitalization not exceeding HK\$4 billion and over HK\$4 billion respectively. At the time of listing, the minimum market capitalization in public hands must be the higher of HK\$30 million and 25% for GEM applicants with market capitalization not exceeding HK\$4 billion, and the higher of HK\$1 billion and 20% for GEM applicants with market capitalization over HK\$4 billion.

Amendments are currently being made to the GEM Listing Rules to reflect these new requirements. To ensure effective and fair implementation of these new proposals, the various provisions will commence application in stages, starting on or after the date of this announcement. In addition, the Joint Announcement issued by the SFC and the Exchange on March 11, 2000 will cease to have effect, except for transitional purposes in certain respects.

Details on the proposed amendments to the GEM Listing Rules and the transitional arrangements are set out below.

The SFC and the Exchange have conducted an overall review of the Rules governing the Listing of Securities on the Growth Enterprise Market (the "GEM Listing Rules"), after gaining experience from the administration and operation of the GEM Listing Rules upon the establishment of GEM in November 1999.

On 11 March 2000, the SFC and the Exchange jointly announced the temporary relaxation of certain GEM Listing Rules (the "First Joint Announcement"). The First Joint Announcement was intended to be an interim measure to ensure a level playing field and transparency in the application of the GEM Listing Rules, pending a full review of the rules after market consultation. The Exchange released a consultation paper in May 2000 (the "Consultation Paper"), and the consultation period closed on 30 June 2000.

Submissions from different interest groups were received. The respondents represented a wide spectrum of the market including sponsors, professional firms, financial institutions, professional associations, companies including GEM listed issuer, Main Board listed issuers and new listing candidates, and individuals. A summary of the consultation results is available on the Hong Kong Exchanges and Clearing Limited and the GEM websites at <http://www.hkex.com.hk> and <http://www.hkgem.com.hk>.

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At around the time of the market consultation, the SFC appointed a committee known as International Committee on Listing of New Enterprises (the "International Committee") to study the key factors that draw or repel issuers from listing in certain markets. The Executive Summary of the report prepared following this study is available on the SFC website at <http://www.hksfc.org.hk>.

The SFC and the Exchange have taken into account the responses to the market consultation, the findings and recommendations of the International Committee, and the experience gained from the operation of GEM in considering amendments to the GEM Listing Rules. The SFC and the Exchange are of the view that such amendments are beneficial to the long-term development of GEM, and would strike a balance between ensuring market competitiveness and maintaining the quality of the market.

The proposed amendments to the GEM Listing Rules have been approved in principle. Amendments are currently being made to the GEM Listing Rules, and it is estimated that this process will take two to three months before the amended GEM Listing Rules will become effective (the "Effective Date"). To ensure effective and fair implementation of these new proposals, the various provisions of the new proposals will commence application in stages, starting on or after the date of this announcement.

Set out below are the principles of the proposed amendments to the GEM Listing Rules, and details of the transitional arrangements applicable from the date of this announcement.

PRINCIPLES OF THE PROPOSED AMENDMENTS TO THE GEM LISTING RULES

1. Active Business Pursuit Period and Accountants' Report

GEM Listing Rule 11.12 requires a GEM applicant to demonstrate that it has actively pursued one focused line of business for a minimum period of 24 months before listing. Under the First Joint Announcement, the 24-month period is reduced to at least 12 months. Under the proposed amendments, the requirement of GEM Listing Rule 11.12 is maintained.

A new category of entry requirements will be introduced, however, for companies of substantial size and with significant public following, but which cannot satisfy the 24-month period requirement to list on GEM. The rule will be amended to allow such a GEM applicant to list subject to satisfying the following criteria:

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- i. has pursued its focused line of business for at least 12 months;
- ii. has total revenue of no less than HK\$500 million in the last 12 month period as shown in the accountants' report in the initial listing document, total assets of at least HK\$500 million as shown in the balance sheet in the accountants' report, or market capitalization of at least HK\$500 million determined at the time of listing;
- iii. at the time of listing, has a minimum market capitalization of HK\$150 million in public hands which is held by at least 300 public shareholders, with the largest 5 and largest 25 of such shareholders holding in aggregate no more than 35% and 50% respectively of the securities in public hands. In determining the “300 public shareholders”, only a maximum of 100 shareholders who have obtained their securities through a distribution in specie may be counted as public shareholders; and
- iv. the initial public offer price of the securities must be at least HK\$1.

GEM Listing Rules 11.10 and 7.03 require a GEM applicant to have an accountants' report covering at least two financial years immediately preceding the issue of the initial listing document. The two financial years under the First Joint Announcement is reduced to at least 12 months, corresponding to the minimum 12-month period of active business pursuit. Under the proposed amendments, the requirement under GEM Listing Rules 11.10 and 7.03 is maintained, however, for GEM applicants meeting the above criteria for a reduced active business pursuit period, the requirement for accountants' report will correspondingly be reduced to a minimum of 12 months.

The maintenance of the minimum 24-month period of active business pursuit for GEM applicants in general will provide more time for those companies to establish their businesses, and to allow their management to demonstrate that they have operated together cohesively as a team. At the same time, the introduction of a new category of entry requirements will facilitate quality companies with potential and public following to be listed on GEM.

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2. Share Issue within Six Months of Listing

GEM Listing Rule 17.29 prohibits further issuance of securities by a GEM listed issuer during the first six months after its listing under general circumstances. This rule will be amended to allow a GEM listed issuer to issue new securities in the first six months after listing, provided that the following conditions are satisfied:

- i. the securities are issued to acquire assets which will complement the GEM listed issuer's focused line of business;
- ii. the size of the acquisition must not constitute a major (and larger) transaction (in general, this means the size of the acquisition cannot be 50% or greater compared to the profit or net assets of the GEM listed issuer);
- iii. the issue of securities must not result in any controlling shareholders of the GEM listed issuer ceasing to have control over 35% of the voting rights in the GEM listed issuer after the issue of securities, and in any event, must not result in a change in control of the GEM listed issuer within the meaning of the Takeovers Code;
- iv. shareholders' approval by way of a poll is required, and any connected persons, initial management shareholders and their associates, and shareholders interested in the issue or the related transaction must abstain;
- v. any person who subscribes for the securities will be subject to lock-up arrangement similar to that applicable to an initial management shareholder or significant shareholder, as applicable, for the remaining duration of the moratorium period; and
- vi. the GEM listed issuer is required to issue a circular which must include an opinion from an independent financial adviser together with information on the transaction and securities issue, including the circumstances surrounding and reasons for the acquisition, why the GEM listed issuer must acquire the assets within six months of its listing, and whether the GEM listed issuer had any intention to acquire the asset at the time of listing.

A GEM listed issuer will generally be expected to have raised sufficient funds during its initial public offering to satisfy its funding needs for at least the first six months. The rule amendment is in line with this expectation, while allowing GEM listed issuers the flexibility to issue securities as consideration for acquisitions, particularly in circumstances where the opportunity to acquire those particular assets only arises after its listing. Meanwhile, the conditions imposed will ensure that shareholders will have a right to be heard in the acquisition, and that their interests will not be unreasonably diluted in the near term.

3. Moratorium Period for Initial Management Shareholders

GEM Listing Rule 13.16 requires the moratorium period for initial management shareholders to be 24 months. This 24-month period is reduced under the First Joint Announcement to 6 months, with a further restriction that no controlling shareholders may dispose of any relevant securities in the second 6-month period after listing, if such disposal would result in the controlling shareholders ceasing to have control over 35% of the voting rights in the GEM listed issuer. Under the proposed amendment, the moratorium period for initial management shareholders will be 12 months, and for initial management shareholders with no more than 1% shareholding in the GEM listed issuer, will be 6 months. The proposed amendment aims to provide flexibility to initial management shareholders, while at the same time allowing a sufficient period for management to demonstrate to investors its commitment to, and confidence in, the future of the GEM listed issuer.

4. Definition of Initial Management Shareholders for the purpose of Lock-up

Existing practice includes the following persons who have interests in the voting rights of the issuer immediately prior to the date of listing as “initial management shareholders” in addition to those defined in GEM Listing Rule 13.15(2):

- i. all members of senior management such as those persons named in the “senior management” section of the listing document of a GEM applicant;
- ii. all directors on the board of a GEM applicant, including non-executive directors;
and
- iii. all investors, including but not limited to investment funds, with board representation.

The GEM Listing Rules will be amended to include the above persons as initial management shareholders for the purpose of the moratorium period. This amendment codifies existing practice.

5. Interpretation of "disposal" by Initial Management Shareholders

Under existing practice, the Exchange grants waivers to exclude the following two types of disposal by initial management shareholders from the meaning of "disposal" under GEM Listing Rule 13.15(5):

- i. stock lending arrangements between shareholders and underwriters at the time of the initial public offering of the new applicant's securities, for the sole purpose of covering any short position prior to the exercise of the over-allotment option; and
- ii. sale of shares by the shareholder pursuant to a placing and top-up transaction during the second six-month period after listing where: a) there is no change in the number of relevant securities held by the shareholder before and after the transaction; and b) the transaction does not result in any controlling shareholders of the GEM listed issuer ceasing to have control over 35% of the voting rights in the GEM listed issuer.

The GEM Listing Rules will be amended to exclude the circumstances mentioned in (i) and (ii) above from the definition of disposal during the moratorium period. This amendment codifies existing practice, and is consistent with the Exchange's view that the above situations do not in substance constitute a disposal of shares in GEM listed issuers by initial management shareholders.

6. Share Option Schemes

Chapter 23 of the GEM Listing Rules sets out the current requirements governing share option schemes of a GEM listed issuer. This Chapter will be amended on certain requirements of the schemes to allow greater flexibility in operation, and at the same time, further restrictions will be placed in other areas to safeguard against abuse of the scheme and to protect minority shareholders. The major changes are summarized below:

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- i. the participants of the scheme – GEM Listing Rule 23.03(1) requires participants of the scheme to be full-time employees of the GEM listed issuer. This will be amended to remove all restrictions on the eligibility of participants of the scheme. However, the GEM listed issuer must define the participants, and the basis of determining the eligibility of the participants under the terms of its scheme, before such scheme is approved by shareholders;
- ii. overall limit on outstanding options – An overall limit will be imposed such that the number of shares to be issued upon the exercise of outstanding options under the scheme, and any other schemes, of the GEM listed issuer must not exceed 30% of its securities in issue from time to time;

In addition, the GEM listed issuer may only grant options of up to 10% of its issued shares at the date of approval of the limit (the "Scheme Mandate Limit"). The GEM listed issuer may renew this Scheme Mandate Limit at any time, subject to shareholders' approval and the issue of a circular. The GEM listed issuer may also seek separate shareholders' approval for granting options beyond the Scheme Mandate Limit to participants specifically identified by the GEM listed issuer, subject to shareholders' approval and the issue of a circular;

- iii. maximum entitlement of each participant – GEM Listing Rule limits maximum entitlement of each participant to 25% of securities subject to the scheme (i.e. a maximum of 2.5% of securities in issue). This rule will be amended to limit the total number of securities issued and to be issued upon exercise of the options granted and to be granted (including both exercised and outstanding options) in any 12-month period up to the date of grant to each participant not to exceed 1% of the securities in issue. Any further grant of options in excess of this limit must be subject to shareholders' approval, with that participant and his associates abstaining from voting, and the issue of a circular; and

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- iv. grant of options to connected persons –This provision will be amended to require any grant of options to a connected person or its associates to be approved by independent non-executive directors (excluding any independent non-executive director who is the grantee of the options). If a grant of options to a substantial shareholder or an independent non-executive director or their respective associates will result in the total number of securities issued and to be issued upon exercise of the options granted and to be granted (including both exercised and outstanding options) in any 12-month period up to the date of grant to such person exceeding the higher of 0.1% of the securities in issue and an aggregate value of HK\$5 million, then the proposed grant of options must be subject to shareholders' approval taken on a poll. All connected persons must abstain from voting, except that any connected person may vote against the resolution provided that his intention to do so has been stated in the circular.

In addition, shareholders' approval as described above will also be required for any change in the terms of any options granted to a participant who is a substantial shareholder, an independent non-executive director or their respective associates to avoid circumvention of this provision.

The GEM Listing Rules will also be amended to further impose, or amend, minor requirements on the terms of the scheme, and impose additional disclosure requirements (including information regarding the valuation of options granted) in the circular to be issued to shareholders and in the interim and annual reports of the GEM listed issuer. Details of some of these amendments relating to the adoption of, and terms of the scheme, are available on the Hong Kong Exchanges and Clearing Limited and the GEM websites at <http://www.hkex.com.hk> and <http://www.hkgem.com.hk>.

Additional requirements, such as the requirements in relation to options granted to connected persons, and the maximum entitlement to a participant, will be imposed to safeguard against the abuse of the scheme and to protect minority shareholders. Furthermore, the new requirements for disclosure will increase transparency for shareholders in relation to the operation of the scheme.

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7. Offering Mechanism

The GEM Listing Rules will be amended to exclude employees of the GEM applicant and their associates from the definition of members of the "public" in determining the minimum public float at the time of listing. Another rule amendment will require further disclosure of the placing concentration and spread, including the level of interest and distribution of the placing shares, and an analysis of the concentration of the placing shares at the time of the public offering.

The rule amendments address the concern that a high concentration of shares in the hands of a few investors and/or a substantial number of employees may affect the liquidity of the securities. The proposed disclosure requirement will also promote greater transparency in the shareholdings of a GEM listed issuer at the time of listing.

8. Prescribed Minimum Percentage of Securities to be in Public Hands

The prescribed minimum percentage of securities to be in public hands under GEM Listing Rule 11.14(1)* will be amended to 25% and 20% for GEM listed issuers with market capitalization not exceeding HK\$4 billion and over HK\$4 billion respectively. At the time of listing, the minimum market capitalization in public hands must be the higher of HK\$30 million and 25% for GEM applicants with market capitalization not exceeding HK\$4 billion, and the higher of HK\$1 billion and 20% for GEM applicants with market capitalization over HK\$4 billion. This rule amendment is expected to improve market liquidity and reduce volatility, thereby enhancing the integrity and attractiveness of GEM.

* Clarified on 9 August 2001 that the correct reference is GEM Listing Rule 11.23(1).

DETAILED TRANSITIONAL ARRANGEMENTS

Since the publication of the First Joint Announcement, the Exchange has granted waivers to GEM listed issuers based on the requirements set out in the First Joint Announcement (the "Existing Waivers"). Existing Waivers already granted to GEM listed issuers would continue to apply, with an exception in the case of share option schemes. In these cases GEM listed issuers may grant further options from their existing schemes only if the options granted are in accordance with the new requirements. From the date of this announcement until the Effective Date, the Exchange will grant waivers based on the new proposals set out in this announcement ("New Waivers"). The Exchange will cease to grant Existing Waivers based on the First Joint Announcement from the date of this announcement, with two exceptions as stated below where Existing Waivers will continue to be granted for a limited period. Details of the application of the transitional arrangements to GEM applicants and listed issuers from the date of this announcement are set out below.

GEM Applicants

- 1. Active Business Pursuit Period and Accountants Report* - Existing Waivers may be granted to GEM applicants which submit new listing applications ("Form 5As") on or before September 30, 2001, provided that listings of the GEM applicants take place on or before December 31, 2001, or before the expiry of Form 5A if earlier. Where applicable, all other GEM applicants may apply for New Waivers.
- 2. Moratorium Period for Initial Management Shareholders* - Existing Waivers may be granted to GEM applicants who have submitted Form 5As before the date of this announcement, provided that listings of these GEM applicants take place within three months from the date of the announcement, or before the expiry of the Form 5A if earlier than three months. All other GEM applicants may apply for the New Waivers.
- 3. Definition of Initial Management Shareholders and Interpretation of "disposal" for Initial Management Shareholder* - The rule amendments reflect existing practices or waivers and their applications will continue.
- 4. Share Option Schemes* - New Waivers may be granted to GEM applicants from the date of this announcement.

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5. *Offering Mechanism and Public Float* – The rule amendments will come into effect on Effective Date.

GEM Listed Issuers

1. *Share Issue within the first six months of Listing, and interpretation of "disposal" for Initial Management Shareholder (top-up and placing transaction within the second six months)* - GEM listed issuers who did not apply for Existing Waivers (in the case of top up and placing transaction), and all GEM listed issuers (in the case of share issue) may apply for New Waivers from the date of this announcement.

2. *Moratorium Period for Initial Management Shareholders* - GEM listed issuers who did not apply for Existing Waivers may apply for New Waivers from the date of this announcement until the Effective Date. Nevertheless, such GEM listed issuer must issue an announcement upon being granted a New Waiver to inform shareholders of the new lock up arrangement. The new provisions will apply automatically on or after the Effective Date, however, the GEM listed issuer should issue an announcement on or before the disposal of shares by its initial management shareholder to inform its shareholders of the disposal or intended disposal. For GEM listed issuers who were granted Existing Waivers, such waivers will continue to apply after Effective Date.

3. *Share Option Scheme* – Options already granted as at the date of this announcement will not be affected by the new provisions. Furthermore, GEM listed issuers may continue to grant options under the existing schemes from the date of this announcement up to the day before the Effective Date. Where the GEM listed issuer has a contractual commitment before the date of this announcement to grant options, these options may continue to be granted under the existing terms. From Effective Date, GEM listed issuers may grant further options from their existing schemes only if the options granted are in accordance with the new requirements. Otherwise, they have to alter the terms of the scheme, or to adopt a new scheme before further options may be granted. Finally, the new disclosure requirements in the interim and annual reports will apply to financial periods commencing on or after October 1, 2001 for all GEM listed issuers.

4. *Minimum Public Float percentage* – The rule amendments will come into effect two years from the Effective Date.

The SFC and the Exchange emphasize that this joint announcement outlines the principles of the proposed amendments to the GEM Listing Rules only, and is intended to serve as a guideline for GEM applicants and listed issuers who intend to apply for New Waivers, and to provide market practitioners and the public with an overview of the general direction of the proposed rules. Amendments are currently being made to the GEM Listing Rules based on the above principles, and upon becoming effective, the new rules shall supercede the guideline above.

For further information, please contact the GEM Corporate Finance Department of the Exchange's Listing Division.

July 27, 2001

Corporate Finance Adviser Code of Conduct

The new Corporate Finance Adviser ("CFA") Code of Conduct would become effective on 1 December 2001. It sets out the requirements and guidelines in respect of the conduct of a CFA engaging in corporate finance advisory activities. Proper compliance of all the requirements and discharge of the duties and responsibilities set out in the Code would be taken into account to assess the fitness and properness for continued registration. The Code sets out standards and/or requirements covering the following areas:

1. Conduct of business
2. Competence
3. Conflicts of interest
4. Standard of work
5. Duties to the client
6. Communication with Regulators
7. Personal account dealings

Insofar the IPO subscription process is concerned, the "Standard of work" section of the Code contains provisions on duties and responsibilities as to what a CFA acting as sponsor to the IPO is expected to discharge during the public offering process. During the IPO public subscription process, the sponsor should be responsible as the overall manager. In this respect, the sponsor should assess the likely interest in the offer by the public and put in place sufficient arrangements and resources to ensure that the process is conducted in a fair, timely and orderly manner.

In fulfilling the above obligations, the CFA should, in particular, have regard to the following matters:

- Whether there are sufficient prospectuses and application forms;
- Whether specific responsibilities should be delegated to other professionals; and if so; whether such professionals are competent and have the capacity and resources to handle the responsibilities;
- Whether sufficient measures are put in place to ensure that (i) distribution of prospectuses and application forms to the public (ii) collection of completed application forms from the public; and (iii) despatch of unsuccessful applications, refund cheques and share certificates, can be made in a timely and orderly fashion;
- The need to avoid events of disorder during the public offer period and before trading of securities commence and to ensure appropriate contingency plans have been drawn up;
- Where balloting is required, whether appropriate arrangements have been put in place to ensure that it is done fairly and independently.