

**CONSULTATION PAPER
ON A PROPOSED NEW MARKET FOR
EMERGING COMPANIES**

MAY 1998

THE STOCK EXCHANGE OF HONG KONG LIMITED

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DEFINITIONS USED

In this consultation paper, the following terms save where the context otherwise requires, have the following meanings:

"CCASS"	the Central Clearing and Settlement System established and operated by Hong Kong Securities Clearing Company Limited
"Companies Ordinance"	the Companies Ordinance (Chapter 32 of the Laws of Hong Kong) as amended from time to time
"director"	includes any person who occupies the position of a director, by whatever name called
"Exchange"	The Stock Exchange of Hong Kong Limited
"Financial Shareholders"	Financial investors holding 5% or more of the issued share capital of the Company immediately prior to listing and who are not Management Shareholders
"HK\$"	Hong Kong dollars, the lawful currency in Hong Kong
"Hong Kong"	the Hong Kong Special Administrative Region of the People's Republic of China
"Listing"	the grant of a listing of and permission to deal in securities on the Exchange and "listed" shall be construed accordingly
"Listing Agreement"	an agreement between an issuer and the Exchange setting out the continuing obligations which the issuer undertakes to comply with as a condition of listing
"Listing Documents"	a prospectus accompanying application forms and any other documents issued or proposed to be issued in connection with an application for listing
"Exchange Listing Rules"	the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited as amended from time to time, the appendices thereto, any listing agreement or other contractual arrangement entered into with any party pursuant thereto, and rulings of the Exchange made in pursuance thereof
"Main Board"	the present securities market operated by the Exchange
"Main Board Listing Rules"	Exchange Listing Rules applicable to the Main Board
"Management Shareholders"	the shareholders, including directors, who are directly or indirectly involved in the management of the Company or who are able, as a practical matter, to direct or influence management

"Principal Shareholders"	the Financial Shareholders and the Management Shareholders
"SDI Ordinance"	the Securities (Disclosure of Interests) Ordinance (Chapter 396 of the Laws of Hong Kong) as amended from time to time
"Second Market"	reference to the proposed new market to be operated by the Exchange
"Second Market Listing Rules"	Exchange Listing Rules applicable to the Second Market
"Sponsor"	an applicant which applies to the Exchange to act as sponsor of companies seeking to list on the Second Market, and which is accepted by the Exchange

EXECUTIVE SUMMARY

The following summarises the main proposals contained in this document.

1. Main Objectives (sections 1 & 2)

This consultation document invites written comments from all interested parties on two major issues :

Is there a need for a Second Market which would enable smaller companies to raise capital to finance their business development and/or expansion?

If there is a need for a Second Market, are the market theme, target investor group, listing requirements, regulatory features and trading aspects proposed in this document appropriate and practicable?

2. Theme of the Second Market (section 3)

The Second Market will be an alternative market to the Main Board. Its main objective is to provide capital formation for emerging companies to facilitate their business development and/or expansion.

3. Risks to Investors (section 4)

The greater uncertainty of future business performance of emerging companies and the lower entry requirements of the Second Market which render it accessible to over-aggressive issuers and promoters will significantly increase the risks to investors.

4. Target Investor Group (section 5)

In light of the significant risks to investors, the Second Market should not be a mass market open to all investor groups but a specialised market targeting only sophisticated investors (i.e. professional and knowledgeable retail investors). It is proposed to set a high minimum transaction size to deter the participation of other retail investors and to raise investors' awareness of the need to conduct a thorough appraisal prior to investing in these companies.

5. Entry Requirements (section 8)

The main entry requirements will be:

- Two years of active business history under substantially the same ownership and management;
- Minimum public float of HK\$30 million or 35% of market capitalisation, whichever is higher;
- Management Shareholders and Financial Shareholders to hold collectively at least 35% of market capitalisation at the time of listing;

- Management Shareholders will be subject to a moratorium of two years and during this period, their shares will need to be deposited with an agreed depository. Financial Shareholders will not be allowed to dispose of their shareholdings in the first year after listing; and
- There will be no minimum profit requirement.

6. Regulatory Philosophy and Emphasis (sections 9 to 14)

The Second Market will adopt a "let the buyer beware" philosophy with prominent risk warnings. Unlike the Main Board which adopts a combination of merit and disclosure based regulatory approach, the Second Market will implement an enhanced disclosure based regime. The major emphasis will be on greater disclosure and increased corporate governance, and Sponsors will be required to meet detailed eligibility criteria.

7. Increased Disclosure Requirements (section 10)

The additional disclosure requirements will be:

- "A Statement of Active Business Pursuits" describing in detail the company's track record over the two years prior to listing;
- "A Statement of Business Objectives" describing in detail the company's development or expansion plans for the two financial years after listing;
- Publication of quarterly reports which need not be audited; and
- Comparison of business progress with Business Objectives in semi-annual and annual reporting.

8. Corporate Governance Requirements (section 13)

Second Market companies will be required to adopt the following corporate governance measures:

- A qualified person to supervise the accounting function and a member of senior management designated as compliance officer to ensure the observance of Second Market Listing Rules;
- Appointment of two independent directors with relevant experience;
- Establishment of an Audit and Compliance Committee; and
- Constitutional documents to incorporate special provisions which would allow shareholders to vote on a resolution to wind up a company in circumstances where there is a serious breach of Second Market Listing Rules or shareholders do not approve a material change in Business Objectives or a sustained failure to meet Business Objectives.

9. Requirements For Sponsors (section 11)

Sponsors of Second Market companies will be required to comply with the following requirements:

- Fulfil pre-qualification conditions by meeting detailed eligibility criteria;
- Provide guidance to Second Market companies and to act as the principal channel of communication with the Exchange for two full financial years after listing; and
- In their continuing responsibility, Sponsors to report on the extent to which Second Market companies have complied with their listing obligations and Business Objectives.

10. Role of the Exchange (sections 12 and 14)

The role of the Exchange in respect of the Second Market is as follows:

- Prior to listing, it will review the suitability for listing of applicants based on a preliminary notification of listing and examine Listing Documents to ensure that they comply with the provisions of the Companies Ordinance;
- Following listing and to check the compliance with Second Market Listing Rules, it will perform post-vetting of i) Listing Documents on a sample basis and ii) all announcements and circulars; and
- It will monitor the Second Market and enforce compliance of Second Market Listing Rules.

11. Other Major Features (sections 17 and 18)

The other major features will be:

- Adoption of a bulletin board as the trading platform;
- Companies wherever incorporated will be allowed to list on the Second Market provided that they meet the listing requirements;
- Public offerings need not be underwritten; and
- Equivalent of SDI disclosure threshold to be reduced from 10% to 5%.

1) Foreword

- 1.1) In recent years there have been comments from the Government, trade and industry bodies and other interested groups expressing concern about the lack of availability of capital for funding small and medium sized companies. Amongst the suggestions put forward is the formation of a Second Market to enable smaller and emerging companies to raise public capital to finance their business expansion and development.
- 1.2) In response to these public discussions, the Exchange embarked on a study to consider appropriate frameworks for a Second Market that could serve the needs of Hong Kong taking into account the different interests of issuers and investors. This consultation document sets out the principal features of a business and regulatory model for a Second Market which the Exchange believes may be appropriate for adoption in the Hong Kong context, with particular emphasis on market characteristics and regulatory philosophy. No attempt has been made to draft detailed regulations which, in the event that the proposal for the Second Market proceeds, will be introduced taking account the results of this consultation process.
- 1.3) This document invites written comments from all interested parties and the public on all aspects of the proposal and, in particular, on two major issues :
 - (i) Is there a need for a Second Market; and
 - (ii) If there is a need for a Second Market, are the proposed theme, target investor group, listing requirements, regulatory approach and trading aspects set out in this consultation paper appropriate and practicable from the perspective of issuers, investors, Sponsors and others who are likely to be involved in the Second Market, and do they strike the right balance between the interests of issuers and investors.

Comments should be sent to **The Stock Exchange of Hong Kong Ltd., Consultation on Second Market, Corporate Communications Department, 1/F, One & Two Exchange Square, Central, Hong Kong** and arrive at the Exchange not later than 31st July, 1998. When responding, please indicate the nature of your interest in the proposed market e.g. potential issuer, investor, etc.

2) Need For the Second Market

A Second Market which is accessible to smaller companies and which allows such companies to raise funds may facilitate the economic development of Hong Kong and create employment opportunities. Furthermore, many jurisdictions including those in Asia have established separate markets to cater to the needs of smaller companies. Those who are in favour of a Second Market will see this as a natural development to capitalise on, and thereby enhance, the established status of Hong Kong as an international financial centre.

Nevertheless, there are also those who believe that a Second Market may not be appropriate. Some have raised the concerns that :

- (i) the general culture of Hong Kong is not conducive to the establishment of a high risk market (for example, some listed companies are sometimes criticised for their lack of regard to the interests of minority shareholders; that a Second Market with its higher risk/return profile may be dominated by rumour driven investors; that market manipulation may become rife);
- (ii) inability to regulate properly a high risk market may seriously damage the reputation of Hong Kong as an international financial centre;
- (iii) research by analysts within the securities sector on listed companies, particularly smaller companies, is often not available and/or is not of sufficient quality and accordingly does not meet the needs of investors;
- (iv) given the recent uncertainty in financial markets in the region, it is not the right time to establish a Second Market;
- (v) the experience of China Funds established by venture capitalists over the past years indicates that there may not be enough small companies which are able to meet investment criteria acceptable to investors;
- (vi) the establishment of the Second Market should be deferred until the Hong Kong economy is more closely integrated with that of the mainland of China; and
- (vii) as there may not be many companies which would wish to seek a listing on the Second Market, the high cost of establishing a Second Market may not be justified.

On this last consideration, the Exchange expects a net outlay of between HK\$100 million to HK\$200 million to cover start up cost and operating deficits in the initial years of operation before the Second Market can reasonably be expected to breakeven on an annual basis.

3) Theme of the Second Market

Whilst the perceived need to provide a forum for smaller companies to raise public capital has triggered the current debate concerning a Second Market, such a market cannot be justified by virtue of the small size of companies without having regard to the business potential of such companies. It is proposed that the Second Market should adopt a growth theme to target emerging companies (i.e. those companies which can demonstrate that with additional funding, they have a reasonable prospect of significantly developing or expanding their businesses) in need of additional capital to finance clear expansion or development plans in all industries and sectors. The stipulation that Second Market companies must have clear expansion or development plans is to satisfy the need of potential investors who are expected to require a thorough understanding of these smaller, less established and less familiar companies.

The Second Market will be established as an alternative market to the Main Board. Its main objective is to provide capital formation for emerging companies to facilitate their business development and/or expansion. The Exchange accepts that certain companies which can fulfil the listing requirements of the Main Board may choose instead to list on the Second Market.

4) Risk Profiles of Emerging Companies

Companies seeking a listing on the Main Board are required to meet minimum trading record as a pre-requisite for listing. Amongst other requirements is the attainment of HK\$50 million of profits (HK\$20 million in the most recent financial year and an aggregate amount of HK\$30 million for the two preceding years) attributable to shareholders in the three years prior to listing. Accordingly, companies listed on the Main Board are generally established and their past trading record might reasonably be expected to provide some gauge of future performance.

As emerging companies are less established and may not have achieved the trading and performance history requirements for Main Board companies, their desire to expand into what is likely to be unproven territory will increase the risk of business failure. Furthermore, the need for the Second Market to set lower entry requirements to accommodate smaller companies may present over-aggressive promoters and issuers with access to raise capital for ventures which have little or no realistic prospect of success. These two concerns will significantly increase the overall risks to investors of Second Market companies.

5) Target Investor Group

- 5.1) In recognition that the Second Market poses significant risks to investors, the Exchange believes the Second Market should target only sophisticated investors (i.e. professionals and knowledgeable retail investors) who are more likely to conduct a thorough and objective appraisal of the business aspects and the risks involved prior to investing in Second Market companies. In particular, the Exchange is of the view that other retail investors who lack a proper understanding of investment in high risk companies or who are rumour driven should not be encouraged to participate in this market. The features of the business and regulatory model proposed in this document are accordingly designed to cater for sophisticated investors.
- 5.2) The finding of a recent retail investor survey conducted by the Exchange has indicated that a typical Hong Kong retail stock investor has an average portfolio size of HK\$150,000 and an average transaction size of HK\$50,000. By setting a high minimum participation amount by reference to a typical retail investor which makes it more costly to invest in Second Market companies, the Exchange believes that many less knowledgeable retail investors who are driven purely on a speculative basis may be discouraged to invest in the Second Market.
- 5.3) The Exchange is of the view that the minimum transaction size for Second Market companies should be set at a level not lower than HK\$250,000. Nonetheless, the public is invited to comment on the appropriateness of this proposal and to indicate which of the following ranges of minimum transaction size would be most suitable for the Second Market: i) HK\$100,000 to HK\$150,000, ii) HK\$150,000 to HK\$200,000, iii) HK\$200,000 to HK\$250,000 or iv) an amount above HK\$250,000.
- 5.4) A company will determine the board lot size which is required to meet the minimum transaction size at the time of initial public offering by reference to the issue price of its shares. The board lot size so determined will be used for future trading of its shares after the company is listed on the Second Market irrespective of the

movement of its share price. The Exchange accepts that after a company is listed on the Second Market, the transaction value which is based on the prevailing share price and the board lot size determined at the time of initial public offering may fall below the prescribed minimum transaction size.

6) **Models for Second Markets in Other Jurisdictions**

Whilst many jurisdictions have established second or alternative stock markets which adopt some common features, there inevitably exist market and regulatory characteristics that are unique to particular jurisdictions. This is explained by the different circumstances that exist in each jurisdiction, including considerations such as market purpose, target investor groups, regulatory philosophy, legal and regulatory frameworks, stage of market maturity and other relevant factors. The Second Market model proposed in this consultation document has been formulated to take account of the circumstances prevailing in Hong Kong and accordingly a direct comparison of the Second Market with any of the second market models in other jurisdictions is not thought to be meaningful. Nevertheless, Schedule 1 lists the key features of some of the overseas second markets for readers' information.

7) **Overview of the Proposed Conceptual Features of the Second Market**

Having regard to the higher risks associated with investment in the Second Market, it is proposed that the Second Market will have the following key features which are discussed further in the ensuing sections:

- 7.1) **Entry Requirements:** The entry requirements in respect of track record will be lower than those of the Main Board in order to accommodate smaller sized companies which cannot meet the track record requirement for listing on the Main Board. (See section 8 below)
- 7.2) **Prominent Investor Risk Warnings:** The Second Market will adopt a "let the buyer beware" philosophy with prominent investor risk warnings highlighting the greater risks involved. (See section 9 below)
- 7.3) **Increased Disclosure Requirements:** In recognition that sophisticated investors will require a thorough understanding of Second Market companies which carry a high degree of risk, the Exchange will require more detailed and frequent disclosure so as to keep investors properly informed of a company's progress and future plans thereby permitting investors to make appropriate investment decisions. (See section 10 below)
- 7.4) **Sponsors to Assume High Professional Standards:** Sponsors of Second Market companies will be subject to pre-qualification requirements and will be obliged to adopt high professional standards in carrying out their work. It is proposed that prior to the listing of a company on the Second Market, the role of the Exchange will be confined to a review of the applicant's business based on a preliminary notification of listing and an examination of the Listing Documents to ensure that they comply with the provisions of the Companies Ordinance. (See sections 11 and 12 below)
- 7.5) **Corporate Governance:** To facilitate the compliance with listing obligations, the Exchange will require Second Market companies to adopt measures designed to

strengthen significantly corporate governance. (See section 13 below)

- 7.6) **Supervision and Enforcement by the Exchange:** The Exchange will utilise the powers available to the Exchange within the prevailing regulatory framework to supervise the market and implement an appropriate enforcement regime. In particular, a separate and dedicated unit will be set up by the Exchange to monitor compliance of listing obligations of Second Market companies and to take appropriate action in the event that a breach of listing obligation is identified. (See section 14 below)
- 7.7) **Educational and Promotional Programmes:** The Exchange will conduct educational and promotional programmes to educate and alert investors of the higher risk profile of Second Market companies. (See section 16 below)

8) Entry Requirements

To accommodate emerging companies which are less established and unable to meet the track record requirements for listing on the Main Board, the proposed main entry requirements of the Second Market are as follows :-

- 8.1) **Track Record:** Applicants will need to be able to demonstrate a track record of two years of "Active Business Pursuits" under substantially the same management and ownership, and to describe in a reasonable level of detail the company's progress and achievements during that period. This requirement is discussed further in section 10 under the heading "Increased Disclosure Requirements". There will be no minimum profit requirement set by the Exchange. In addition, applicants will need to demonstrate how these "Active Business Pursuits" are expected to result in the creation of a viable and profitable business enterprise.
- 8.2) **Minimum Public Float:** Companies will be expected to ensure that, immediately after initial listing, public shareholders hold the higher of:
- (i) HK\$30 million in value of the company's shares; and
 - (ii) at least 35% of the issued share capital.

Based on the results of a survey carried out by a consultant appointed by the Exchange in the third quarter of 1997 to gauge the capital needs of emerging companies, the proposed minimum public float of HK\$30 million reflects the level of new capital which was sought by many respondents to the survey. Furthermore, the Exchange believes that the proposed initial minimum public float of HK\$30 million represents the minimum amount which would justify a public listing and make it cost effective for issuers to list on the Second Market in view of the significant costs involved in the listing process.

- 8.3) **Minimum Holdings by Principal Shareholders and Restrictions on Share Disposals:** In order to demonstrate continuing commitment to the business which the Exchange believes is vital to the success of emerging companies, Management Shareholders and Financial Shareholders will be required collectively to hold at least 35% of the issued share capital at the time of listing. Following listing, the Principal

Shareholders will be subject to restrictions on disposals of shares. Management Shareholders will not be able to sell their shares for a period of two years after listing. Thereafter, from the date of expiry of the two year lock up, they will be allowed to sell no more than 25% (on a straight-line basis) of their individual holdings in any six-month period. For the Financial Shareholders, the lock-up will be one year and thereafter they will be free to dispose of their shareholdings. Any buyers of such shares will be subject to the provisions of the Hong Kong Code on Takeovers and Mergers. In addition, directors will be subject to the same Model Code adopted by the Main Board which governs their dealings in their company's securities.

Management Shareholders will be required to deposit their shares with an agreed depository throughout the lock up period as a safeguard that they will comply with the restrictions on disposal described above. However, Management Shareholders who at the time of listing on the Second Market have charged their shareholdings as security for a bona fide commercial loan taken for the direct benefit of the company will not be required to deposit their shares. If the charge is released prior to the expiry of the initial two year lock-up period, Management Shareholders will similarly be required to deposit their shares.

- 8.4) **Capitalisation:** The proposed minimum requirements for public float and holdings of Principal Shareholders imply a minimum market capitalisation at the time of listing of HK\$46.1 million. This is calculated on the basis that if the public float is at HK\$30 million which is the minimum requirement, then the market capitalisation of the minimum 35% portion held by the Principal Shareholders must be HK\$16.1 million (i.e. 35% of HK\$46.1 million).
- 8.5) **Issue of New Shares:** At the time of listing, companies will be permitted only to issue new shares to the public. The Exchange recognises that this requirement will not permit the Principal Shareholders to immediately sell their shares upon listing although a sell down of shares by the Principal Shareholders will be allowed after the expiry of the lock-up periods referred to above. This restriction is consistent with the main theme of the Second Market which is to provide a forum for emerging companies to raise capital for business development and expansion, and not to facilitate a means whereby promoters are immediately able to realise their investment.
- 8.6) **Minimum Number of Public Shareholders:** It is proposed that in any new listing, the number of public shareholders to be allotted shares must not fall below fifty and that no single public shareholder will be allowed to hold more than 10% of the issued share capital of a Second Market company.

9) **Prominent Investor Risk Warnings**

In response to the inherently higher risks associated with investment in emerging companies, the Second Market will be presented to investors as a high risk market. In particular, investors will be warned that the Second Market adopts the "let the buyer beware" philosophy and accordingly they should rely only on their own judgement. Guidance to investors will include prominent risk warnings on Listing Documents; highlighting that the Second Market is likely to be significantly more volatile than the Main Board, liquidity may

be low and that the number of business failures and insolvencies is likely to be greater. Investors trading in the Second Market will need to open separate accounts with brokers which will require an express acknowledgement of their understanding of the risks associated with their investments. The Exchange will publish and make available explanatory materials, hold seminars and work closely with the Securities and Futures Commission on initiatives to promote investor awareness.

10) Increased Disclosure Requirements

Issuers will be required to make full disclosure to enable investors to make an informed decision with regard to their investment at all times.

At The Time of Listing

It is proposed that the information to be contained in the Listing Documents will be similar to that required under the Main Board Listing Rules in respect of applicants to the Main Board. In addition, Listing Documents will contain two key statements to elaborate on an applicant's history and future prospects as follows :

10.1) A Statement of Active Business Pursuits:

10.1.1) This Statement will provide both qualitative and quantitative information about the progress and achievements of the company in the two calendar years prior to listing and to demonstrate that "Active Business Pursuits" have taken place over this period. To meet this test, an issuer will need to show that significant effort has been made in relevant areas of business activity during the two calendar year period under substantially the same management and ownership and explain the results of such efforts. It should be emphasised that the judgement as to whether an applicant has expended enough effort or made sufficient progress to justify listing must ultimately rest with the proposed issuer and its Sponsor. The principal purpose underlying the requirement to demonstrate Active Business Pursuits is first to give potential investors information on which to reach a judgement as to whether the applicant's business is likely to succeed, and secondly to make it more difficult for over-aggressive issuers and promoters to obtain a listing in the Second Market.

10.1.2) The description of "Active Business Pursuits" is likely to address, in respect of each key product or service, efforts made in respect of each of the following: (i) sales and marketing, (ii) production, (iii) product and/or process development, (iv) number, expertise and experience of managerial and key technical staff and turnover of these personnel, (v) licence application process, if applicable, and (vi) details of any joint venture and collaboration efforts, if applicable. In addition, the operating and industry environment under which the company has operated over the two years prior to listing should be described.

10.1.3) Whilst the above business activity headings would be applicable to most companies, it is recognised that certain companies may adopt different business activity headings which are more relevant to their particular

circumstances. The information contained in the Statement should be factual and of a nature which can reasonably be verified by the listing advisers. It is a key requirement that the Statement must not be misleading or omit material information. It is anticipated that this Statement, together with the proposed requirement to incorporate audited accounts of Second Market companies for the two years prior to listing in the Listing Documents, will provide investors with sufficient information to enable them to make an informed decision about the companies to be listed. In this regard, it is recognised that companies will be required to obtain exemptions from the existing requirement under the Companies Ordinance for financial information and an auditors* report in respect of the three years prior to the date of the Listing Document.

10.2) **A Statement of Business Objectives:**

10.2.1) This Statement will set out the company's overall objectives, market potential and likely financial trends with the principal assumptions and major risk factors clearly set out. In addition, the Statement will elaborate on the company's near term Business Objectives under each of the major business activity headings in the context of the expected operating environment, for the current financial period and for the two financial years thereafter. In explaining each Business Objective, the information will, where applicable, include the following:

- (i) strategies, critical paths and milestones to achieve the objective set. The company will also be required to indicate whether there will be significant collaboration with other parties in its future business pursuits and if so, to include a description of the other parties and the nature of the collaboration;
- (ii) deployment of significant human (number, category and seniority) and non-human resources (with relevant details) in terms of expected expenditure and timing; and
- (iii) sufficient analysis for investors to assess geographical and/or segmental considerations.

10.2.2) In the disclosure of Business Objectives, the Exchange accepts that companies need not divulge trade secrets or particularly sensitive information.

10.2.3) It is proposed that Second Market companies will be required to make a comparison between subsequent business progress and the Business Objectives described in the Statement of Business Objectives in their half yearly and annual reporting.

10.2.4) Investors may be misled if companies are allowed to change their Business Objectives shortly after listing. It is therefore proposed that subject to special circumstances which will require the approval of shareholders, other than the Management Shareholders, Second Market companies will not be

allowed to make any material alteration to their Business Objectives contained in the Listing Documents in the balance of the financial period during which listing takes place and the following two financial years. The Exchange, however, recognises that the setting of detailed Business Objectives which will be compared to subsequent performance and open to public scrutiny is an onerous requirement on issuers. It is proposed therefore that the setting of Business Objectives for public disclosure will only be required at the time of listing.

10.2.5) The information contained in the Statement of Business Objectives is primarily the responsibility of the companies' directors subject to review by Sponsors to determine the reasonableness of the underlying assumptions. A profit forecast will not be required.

10.3) Second Market companies will be required to provide a more detailed breakdown of the intended use of the offering proceeds by reference to a specific timetable than is presently the case for Main Board companies.

10.4) **Continuing Reporting Requirements**

10.4.1) Second Market companies will, amongst other requirements, need to disclose promptly any price sensitive information and to comply with requirements similar to those contained in Chapter 14 of the Main Board Listing Rules and the Model Code for Directors on dealing in securities.

10.4.2) Each Second Market company will be required to publish a quarterly financial statement, which need not be audited, to include a description of business progress and achievements over the preceding quarter.

10.4.3) The requirements in relation to annual and semi-annual reporting will be expanded to require a comparison between actual business progress and the Business Objectives contained in the Listing Documents. Upon the expiry of the two year sponsorship requirement (at the end of the second financial year after listing), this requirement to compare business progress and Business Objectives will cease.

10.5) All public information relating to an issuer will be filed with the Exchange and available for public access.

11) **Sponsors to Assume High Professional Standards**

Prequalification and Role of Sponsors

11.1) The role of Sponsors will be central to the creation of confidence in the Second Market. A key element of the proposals is the mandatory appointment by each company of a Sponsor to take responsibility for the initial listing and to provide expert assistance for two full financial years (i.e. in addition to the balance of the financial period during which listing takes place) after a company is listed. In circumstances where a company has failed to comply with its obligations under the Second Market Listing Rules, the Exchange would have the right to extend this

period.

Faced with the increased risks that are associated with Second Market companies, the Exchange believes that the highest level of professionalism and integrity will be required of Sponsors. To assure that Sponsors meet the high standards that are expected of them, it is proposed that the Exchange will introduce a pre-qualification scheme to regulate Sponsors of Second Market companies.

- 11.2) It is proposed that those who wish to act as a Sponsor of a new applicant to the Second Market will be required to demonstrate that they meet detailed eligibility criteria which will be incorporated as pre-qualification conditions under a new scheme to be administered by the Second Market Listing Committee of the Exchange. These criteria will include the following requirements :
- (i) It is holding appropriate registrations or exemptions under the Securities Ordinance (Cap. 333) which permit it to carry on business in Hong Kong as an investment adviser.
 - (ii) It has not been censured either privately or publicly by the Exchange or the Securities and Futures Commission in relation to any aspect of its business during the two years immediately prior to the application date.
 - (iii) It has sponsored or co-sponsored at least three applicants to the Main Board during the two years immediately prior to the application. In appropriate cases, this requirement could be waived if an applicant could show that directors or principals of the applicant had had direct responsibility for the requisite number of listing applications during previous employment.
 - (iv) It has minimum capital and reserves of HK\$50 million.
 - (v) It has at least two full time directors or principals each of whom must have a minimum of five years relevant experience in the financial services industry.
 - (vi) It has at least two supervisory grade staff each of whom has a minimum of three years relevant experience in the financial services industry.
 - (vii) It will undertake that each sponsorship assignment will be under the direct responsibility of a supervisor and that each listing application will be reviewed and approved by two directors or principals.
 - (viii) It will undertake to the Exchange that it will act independently of any Second Market company of which it is appointed Sponsor and of the Principal Shareholders of any such company. In addition, the Sponsor will undertake to avoid any situation which would give rise to a conflict of interest in the conduct of its role and, if any such circumstances should arise, the Sponsor will immediately bring such circumstances to the attention of the Exchange.

Further, the Exchange would reserve the right to impose additional requirements on

an applicant, if appropriate.

- 11.3) The Exchange intends to invite other suitably qualified professionals such as accountants and/or lawyers to undertake sponsorship of Second Market companies. In such circumstances, certain amendments to the above eligibility criteria will be made to accommodate these other professionals by virtue of the fact that as new entrants, they may not be able to fulfil some of the requirements. However, all persons wishing to act as Sponsors must have the requisite registrations with the Securities and Futures Commission.
- 11.4) The prime purpose of the Sponsor is to provide confidence to investors that in its capacity as an independent professional, it is satisfied with the following:
- (i) The company is in full compliance with all Second Market entry requirements.
 - (ii) Having made due and careful enquiry and examination, the company has made sufficient disclosure to enable investors to make an informed decision as to the nature of the proposed investment, that the presentation of the information is not misleading and there is no omission of any material information.
 - (iii) All Listing Documents are in full compliance with the Second Market Listing Rules and other requirements and proper due diligence has been carried out to confirm the accuracy of factual information stated in the Listing Documents.
 - (iv) Corporate governance procedures, as explained under section 13, required by the Exchange are in place.
 - (v) The company's directors have received advice and guidance from the Sponsor on their responsibilities under the Second Market Listing Rules.
- 11.5) In the discharge of their continuing responsibilities, Sponsors must undertake to be available to advise the company's directors on compliance with the Second Market Listing Rules, and to act as the principal channel of communication with the Exchange.
- 11.6) In addition, at the end of the financial period during which listing takes place and in each of the two financial years thereafter, the Sponsor will be required to prepare a report to be circulated with the company's annual accounts setting out the Sponsor's view as to the extent to which the company has met its stated Business Objectives and complied with the corporate governance and other requirements of the Second Market Listing Rules during the preceding year.
- 11.7) To emphasise the high standards expected of Sponsors in carrying out their responsibilities, the Exchange will formulate guidelines to underpin the obligations of Sponsors to issuers and investors. It should be emphasised that these guidelines will not be exhaustive and Sponsors will continue to be under an obligation to exercise their professional judgement to determine what level of due diligence is

appropriate for any particular company and the procedures which should be followed in the course of any due diligence exercise.

- 11.8) Sponsors will be assessed on an annual basis to determine whether they should be permitted to continue to undertake the sponsorship of Second Market companies taking into account their past conduct and performance. Sponsors may be requested to furnish working records of past assignments to assess whether they have discharged properly their obligations under the Second Market Listing Rules. Sponsors will not be allowed to undertake further assignments for an appropriate period if it is considered that the integrity and reputation of the market has been impaired as a result of their conduct, or if they do not continue to meet the eligibility requirements. In the event that a Sponsor has committed serious misconduct, the Exchange will request the Securities and Futures Commission to take other disciplinary action which could include the withdrawal of all investment licences issued by the Securities and Futures Commission and held by the Sponsor.

12) Role of the Exchange in the Listing Process

- 12.1) The Exchange has considered the extent to which it is appropriate to vet Second Market Listing Documents. Currently, whilst a Sponsor is responsible to ensure that an issuer complies with all the basic qualifications for listing on the Main Board, the Exchange also undertakes a review of each listing application and the associated Listing Documents. The review of the Listing Documents is conducted for the purposes of ensuring that they comply with both the Main Board Listing Rules and the requirements of the Companies Ordinance. This review process is carried out at two levels: (i) the Listing Division vets each application and, as part of this process, requests the Sponsor to respond to specific enquiries and to provide such additional information and analysis as the Listing Division believes necessary. When this procedure has been completed, the Listing Division makes a recommendation to the Listing Committee highlighting any major issue and, in particular, any matter which the Listing Division believes will require the specific attention of the Listing Committee; and (ii) the Listing Committee then reviews the application and either approves or rejects the application. Nevertheless, the Exchange wishes to emphasise that while it currently reviews Listing Documents in respect of Main Board applications, it does not carry out any independent due diligence exercise nor does it make any judgement as to the commercial viability or investment merits of any applicant.
- 12.2) Considering that the Second Market has no profit requirement and the Exchange is not equipped to assess commercial aspects of applicants, it is proposed that the Exchange will only examine Listing Documents of Second Market companies for the purpose of ensuring that they comply with the requirements of the Companies Ordinance. The Exchange believes that Sponsors are better placed to assess commercial aspects underlying the Statements of Active Business Pursuits and Business Objectives which will be central components of each application. Further, the application process should lay emphasis on the requirement for Sponsor to verify factual information through the proper conduct of due diligence. It will be the responsibility of Sponsors only to put forward issuers which meet the entry requirements for the Second Market and Sponsors will be required to certify that all the requirements of the Second Market Listing Rules have been fulfilled. This

proposal should permit the overall listing process to be completed in a shorter period of time. To check that issuers and Sponsors have complied with the Second Market Listing Rules, the Exchange will carry out post-vetting of Listing Documents on a sample basis.

- 12.3) Nevertheless, as with a listing on the Main Board, the Exchange will have the absolute discretion to determine whether any listing application will be accepted or rejected. This discretion will be vested in the Second Market Listing Committee which will be constituted on a similar basis to the Listing Committee presently responsible for the approval of listings on the Main Board.
- 12.4) It is proposed that the Second Market Listing Committee will undertake a review of a preliminary notification of listing which each applicant would be required to submit at the outset of a listing application. The notification of listing will include the following basic information:
- (i) details including past records of each of the Principal Shareholders, directors and senior management;
 - (ii) name and corporate structure of applicant;
 - (iii) a general description of its business;
 - (iv) an outline of how the two-year Active Business Pursuit requirement is to be met and a brief summary of the proposed Statement of Business Objectives;
 - (v) summary of financial information; and
 - (vi) proposed size of the issue.
- 12.5) The sole purpose of this review of a preliminary notification of listing will be to give the Second Market Listing Committee an opportunity to determine whether the applicant is suitable for listing and has complied with the basic requirements for listing on the Second Market.

13) Corporate Governance Requirements

- 13.1) It is proposed that Second Market companies will be required to put in place and implement strong corporate governance measures with effect from the date of listing. Although some may see this as adding to the cost of running and managing a business, which for smaller companies may be burdensome, the Exchange views this requirement as particularly important as it reduces the risk of malpractice and facilitates the ability of companies to properly fulfil their listing obligations.
- 13.2) The following measures are proposed to be in place at the time a company lists on the Second Market and to be maintained after listing :
- (i) There exist adequate and effective systems of internal controls covering both financial and compliance requirements. These would include designating a member of senior management as a compliance officer and

preparing appropriate checklists designed to assist compliance with the Second Market Listing Rules.

- (ii) The accounting function is under the direct supervision of a full time qualified person who is either registered with an acceptable professional body (a list will be published by the Exchange designating these professional bodies) or has obtained tertiary qualification in accounting or an appropriate financial discipline.
- (iii) There must be at least two Independent Directors. The requirements for Independent Directors will reflect, amongst other requirements, the fact that there should be no conflict of interest between the Independent Directors and the company and the Principal Shareholders. It is a requirement that appointees would have relevant professional, business or specialist experience. In the event that the service of an Independent Director is discontinued, both the Independent Director and the listed company will need to publicly announce the reasons for the disengagement.
- (iv) There is in place an Audit and Compliance Committee chaired by an Independent Director, with appropriate powers and clear terms of reference which are required to be disclosed in the Listing Documents. The Audit and Compliance Committee is required to meet at least quarterly. The Exchange will issue guidelines to assist companies in the setting up of the Audit and Compliance Committee, such guidelines to include the appropriate powers and terms of reference for such committee.

13.3) The issuer must disclose in the Listing Documents how the directors and senior management are to be compensated. Unless the formula for revision of compensation is stated in the Listing Documents, proposed future increases in total compensation to any director or member of senior management (to cover both existing and new appointments) will be required to be approved by the Audit and Compliance Committee and disclosed in the annual accounts. In considering any proposed increase of compensation, the Committee will take into account all relevant factors including compatibility with industry norms.

13.4) Consideration will be given to requiring companies to incorporate special provisions in their constitutional documents which would give shareholders the right to require a company to convene a general meeting for the purpose of considering a resolution to wind up the company :

- (i) if the company or its directors are subject to any public censure by the Exchange or the Securities and Futures Commission arising from any breach of the Second Market Listing Rules, undertakings or other regulatory requirements;
- (ii) if shareholders do not approve a material change to the Business Objectives as explained in section 10.2.4 and Management Shareholders do not feel it is acceptable to pursue the original Business Objectives; or
- (iii) if the company's Sponsor determines, at the end of the second financial year

following the financial period during which listing takes place, that a company has failed in a material respect to meet its Business Objectives and having taken account of the financial and trading position of the company and its prospects including any available profit projections, the Sponsor is of the view that public shareholders should be asked to vote on a resolution to wind up the company.

Management Shareholders would be required to abstain from voting on any resolution to wind up the company.

It is recognised that these special provisions may be controversial as the process to wind up a solvent company could pose practical difficulties and delays. Nevertheless the Exchange views these provisions as particularly relevant as a means to enable public shareholders to salvage any remaining value of a company when faced with situations described above. The public is invited to comment on the appropriateness of this proposal.

14) Supervision and Enforcement by the Exchange

14.1) The Exchange will monitor and enforce compliance relying on powers available to the Exchange within the prevailing legal and regulatory framework. In particular :

- (i) The relationship between the Exchange and Second Market companies will be governed contractually by virtue of the Listing Agreement, the Second Market Listing Rules and various undertakings.
- (ii) The role of the Sponsor, the scope of a Sponsor's responsibility and the eligibility of a Sponsor to participate in the Second Market will be governed contractually under a Sponsor's Agreement.
- (iii) Directors of Second Market companies will be required to submit a declaration and undertaking in similar form to the Form B specified under the Main Board Listing Rules.

14.2) The Exchange proposes to set up a separate dedicated unit to undertake these functions (the "Compliance and Surveillance Unit").

The Compliance and Surveillance Unit will examine Listing Documents for the purpose of ensuring compliance with the requirements of Companies Ordinance prior to companies being permitted to list on the Second Market. To check that companies have complied with the Second Market Listing Rules, it will carry out post-vetting of i) Listing Documents on a sample basis and ii) all announcements and circulars issued in relation to transactions falling within Chapter 14 of the Main Board Listing Rules, provisions corresponding to which will be incorporated into the Second Market Listing Rules. In addition, the Unit will examine annual and semi-annual reports with a view to checking that such reports comply with the obligation to include a comparison between actual business progress and Business Objectives contained in the Listing Documents.

14.3) The Compliance and Surveillance Unit will also investigate and seek a formal

response to unusual price or volume movements and/or commentary on press reports and/or market rumours. It is recognised that in the context of the Second Market with lower liquidity, unusual price or volume movements will have to be determined by reference to different and more flexible criteria from those considered appropriate for the Main Board.

- 14.4) In the event that a breach of the Second Market Listing Rules comes to the attention of the Compliance and Surveillance Unit, it would investigate the circumstances in which the breach occurred and either take action itself or, if appropriate, refer the matter to the Second Market Listing Committee for disciplinary or other action. The Compliance and Surveillance Unit would have the power to require companies to make announcements and to suspend the trading of a company's shares. It is anticipated that the Second Market would adopt a similar suspension policy to that in force on the Main Board. All other sanctions or disciplinary action available as a consequence of a breach of the Main Board Listing Rules will also be available in relation to any breach of the Second Market Listing Rules. In particular, breaches of the Second Market Listing Rules could result in the directors of the relevant company being sanctioned either publicly or privately. In extreme cases, the Second Market Listing Committee would have the right to delist a company although, in line with the current practice of the Main Board, it is expected that this power would be exercised sparingly.
- 14.5) As it is recognised that the entry requirements for the Second Market and the nature of the Second Market itself may result in an increased risk that over-aggressive issuers and promoters will be involved with Second Market companies, the question therefore arises whether the range of sanctions or penalties which the Exchange may apply in response to breaches of the Listing Rules will be sufficient to regulate the Second Market.
- 14.6) Under the current constitution of the Exchange, the Exchange Listing Rules are contractual and not backed by statutes. This lack of statutory backing limits the investigative power of the Exchange and the range of sanctions or penalties which can be imposed in response to a breach of the Second Market Listing Rules. In particular, the Exchange does not have the ability to impose fines or other penalties similar to those which may be imposed under the ordinances. In the Report on Financial Market Review issued by the Financial Services Bureau last month, it was recommended that the Exchange and the Securities and Futures Commission consider the introduction of measures such as application for court orders and mandatory remedies to strengthen the enforcement of compliance with the Exchange Listing Rules. The Report further stated that where statutory backing is required for these measures, the Government would be prepared to work on necessary legislative proposals as soon as possible. The proposal to strengthen the enforcement of compliance with the Exchange Listing Rules will be the subject of a separate study and any proposals to be implemented on companies listed on the Main Board will equally apply to the Second Market. It should be pointed out that in the United States, the same regulatory requirements apply to companies listed on the National Association of Securities Dealers Automated Quotations (i.e. NASDAQ) and on the New York Stock Exchange (i.e. NYSE).

15) Role of the Securities and Futures Commission

The Exchange will liaise closely with the Securities and Futures Commission on the regulation of Sponsors of Second Market companies. As with Main Board companies, the Securities and Futures Commission will investigate and regulate securities dealing and compliance with the SDI in respect of companies listed on the Second Market.

16) Educational and Promotional Programmes

The Exchange will seek to educate market participants and promote the Second Market by conducting programmes which would include the following :

- (i) Organisation of explanatory materials and seminars describing the Second Market and its operations.
- (ii) Use of practice notes, guidelines and other materials to inform issuers and market participants of their obligations under the relevant Second Market Listing Rules and to create a high level of transparency as to the interpretation of such requirements by the Exchange.
- (iii) Establishment and maintenance of all public information relating to an issuer which would be available to the public and market participants most likely through electronic means.

17) Trading and Settlement System

17.1) In consideration of the proposed high minimum transaction size which is likely to restrict the investor base and limit the level of trading activity, the Exchange's existing automated order matching system which works best with high trading volumes is not considered an appropriate trading system for the Second Market. It is proposed that the Second Market will adopt a display-of-interest trading platform which will allow brokers to initiate trading of shares in companies listed on the Second Market.

17.2) A Display-of Interest Trading Platform

A suitable medium for less active trading of securities is one which is accessible to all brokers and which allows those who wish to trade in certain securities to display the interest (this is commonly referred to as a bulletin board). Taking advantage of the current or soon-to-be installed facilities available to brokers, the Second Market could adopt either i) the Manual Trading System which is a sub-system of the existing Automated Order Matching System (AMS) or ii) a new web page to be developed by the Exchange, as the medium to allow brokers to post their trading interest, either dealing as principal or on behalf of customers. On seeing a broker's indicative interest in a particular stock on the display medium, other brokers would be able to communicate with the relevant broker, most likely through telephone, to negotiate stock trading. Once trades are struck between two brokers, the transaction details can be fed into the Exchange's existing electronic trading system (easily done under the Manual Trading System as it is linked to the existing AMS; with the web

option, some system enhancement is necessary) and pass through CCASS for settlement, on the same basis as trading transactions on the Main Board. A display-of-interest medium is simple in design and does not require substantial investment. The Exchange proposes to adopt a display-of-interest trading platform for the Second Market, most likely opting for the Manual Trading System in preference to the web option. All brokers who are eligible to trade on the Main Board will automatically be granted the right to trade in the Second Market.

17.3) **Market Makers**

There is considerable debate worldwide on the merits of quote driven markets and the evidence is inconclusive whether this is superior to other trading systems. Some second markets for growth stocks are adopting either a full quote driven system (European Association of Securities Dealers Automated Quotation) or a combination of quote and order-driven systems (London Stock Exchange's Alternative Investment Market).

The adoption of a fully supported market maker system for the Second Market will require substantial changes to the present electronic trading system maintained by the Exchange. Furthermore, given the expected low level of trading activity and the small issue size, it is uncertain that the Second Market will generate sufficient interest amongst the broking community to assure a competitive quote driven market. For these reasons, it is currently not proposed to adopt a quote driven market maker system for the Second Market.

17.4) It is proposed that the clearing and settlement facilities for the Second Market will be provided by CCASS in accordance with the current practice of the Main Board except that trading of Second Market securities will be regarded as "Isolated Trade" in respect of which Hong Kong Securities Clearing Company Limited will not guarantee counter-party risks.

17.5) The Exchange intends to propose that the Government abolishes stamp duties on trading in shares of Second Market companies.

18) **Other Features of the Second Market**

18.1) **Accessibility**

A company wherever incorporated is bound by the laws and practices of the jurisdiction under which it is incorporated. The Second Market which allows companies incorporated in jurisdictions other than Hong Kong to list may pose additional risks to investors as the laws and practices of these jurisdictions are different from those prevailing in Hong Kong. The Exchange currently allows companies incorporated in Hong Kong, Bermuda, the Cayman Islands and People's Republic of China (in the form of H shares) to list on the Main Board. It is proposed that companies incorporated in these same jurisdictions will be allowed to list on the Second Market. However, in recognition that sophisticated investors may well be prepared to invest in growth companies incorporated in other jurisdictions, the Exchange is prepared to allow these companies to list on the Second Market provided that they would meet the following requirements:

- (i) fulfil all listing requirements of the Second Market;
- (ii) engage a Sponsor throughout the term of the company's listing to act as the channel of communication with the Exchange;
- (iii) prepare financial statements which conform with either International Accounting Standards or Hong Kong Statements of Standard Accounting Practice; and
- (iv) incorporate if necessary provisions in their constitutional documents which would enable them to comply with the Companies Ordinance requirements; and
- (v) highlight in the Listing Documents the problems that could arise by virtue of the fact that they are subject to statutory provisions of their respective jurisdictions.

It should be pointed out that certain overseas second markets (e.g. Alternative Investment Market (AIM) of the London Stock Exchange) also impose little restriction on the country of incorporation for companies which list on them.

The public is invited to comment on the appropriateness of this proposal.

18.2) **Underwriting Public Issues**

In consideration of the expected small size of the public offerings and to reduce the cost burden on issuers, it is proposed that companies which seek to list on the Second Market will not be obliged to engage an underwriter to take up shares which are under-subscribed in a public offering. It is proposed that companies may only proceed with listing if the amount raised meet the minimum subscription stated in the Listing Documents. Confirmations to this effect from Sponsors will be required prior to companies being permitted to list on the Second Market.

18.3) **Shareholders' Disclosures**

At present the SDI Ordinance requires directors, chief executives and persons holding 10% or more of the shares of a listed company to notify their shareholding interests and incremental changes in the size of their holdings to the Exchange and to the company. It is understood that proposals are under consideration to reduce the disclosure threshold to 5%. Nevertheless, in order to increase transparency of dealings in the securities of companies listed on the Second Market, the Exchange proposes to reduce the disclosure threshold to shareholdings of 5% for companies on the Second Market with effect from the establishment of the Second Market. Pending the introduction of any amendment to the SDI disclosure threshold, it would be a requirement of the Second Market Listing Rules that the obligation to make disclosure at the 5% level is incorporated as a provision of the constitutional documents of any applicant to the Second Market. Under the relevant provisions to be included in the constitutional documents there would be an obligation to make simultaneous disclosure both to the company and to the Compliance and

18.4) **Listing and Delisting on the Main Board and the Second Market**

Given the current proposal to establish the Second Market as an alternative market to the Main Board, it is proposed that companies which wish to transfer their listing from one market to the other will need to apply for delisting from the original market to be followed by an application for listing on the other market. Companies will need to comply in full with all the listing requirements of the relevant market and be subject to the same listing procedures as for any other applicant to the relevant market. In particular, a Second Market company which wishes to obtain a listing on the Main Board will be required to obtain approval from the Listing Committee of the Main Board.

18.5) **Issuer Costs**

Given the lesser resources generally available to emerging companies, the Exchange is mindful of the cost to issuers seeking to list on the Second Market. Nevertheless it must be acknowledged that cost to issuers is a direct function of investor protection. The additional disclosure and corporate governance requirements together with the need for a two year sponsorship which all contribute to the protection of investors will add to the cost of listing for Second Market companies.

Whilst the Exchange is prepared to set a low listing fee and to encourage competition by allowing other suitable professionals to act as Sponsors, it is determined not to compromise on measures to protect investors which it sees as necessary to regulate the Second Market. The Exchange recognises that the cost to obtain a listing may pose a barrier to entry for certain emerging companies.

19) **Summary of Regulatory Approach**

19.1) Given the different market characteristics that exist between the Second Market and the Main Board, the Exchange intends to promote the Second Market separately and the higher risks associated with investing in companies listed on the Second Market will be emphasised. In particular, investors will be warned that the Second Market is likely to be significantly more volatile than the Main Board; liquidity may be low and that the number of business failures and insolvencies is likely to be greater. The separate market approach is expected to highlight the different risk profiles and trading characteristics which will exist between the Second Market and the Main Board.

19.2) Besides market characteristics, it will be apparent from the above regulatory features proposed for the Second Market that its regulatory philosophy emphasises on enhanced disclosure rather than the combination of merit and disclosure based approach adopted by the Main Board. The additional disclosure requirements proposed for the Second Market are intended to make it more difficult for over-aggressive issuers and promoters to obtain access to the Second Market and to enable sophisticated investors to make an informed decision as to the merits of emerging companies which are likely to be less established and less familiar.

- 19.3) In light of the differences in market characteristics and regulatory philosophy that exist between the Second Market and the Main Board and to emphasise these differences, it is proposed that the Second Market will be established as a separate market under a new division of the Exchange with its own Second Market Listing Rules, governing structure and management.
- 19.4) Instead of establishing a separate market, the Exchange has also considered lowering the Main Board's entry requirements or creating a separate Chapter under the Main Board Listing Rules to accommodate emerging companies. These alternatives are not preferred to the separate market approach for the following reasons :
- (i) Emerging companies with more business failures, higher volatility and low liquidity may damage the reputation of the Main Board.
 - (ii) A market which adopts a common theme, has its own easily identifiable characteristics and which embodies principles and rules which can be consistently applied is generally viewed favourably by market participants. In light of the different market characteristics and regulatory philosophy that are associated with emerging companies, the creation of a separate Chapter under the Main Board may confuse market participants.

20) Specific Questions Arising out of the Consultation Paper

Comments on all aspects of the consultation paper are solicited. Nevertheless, views in respect of the following questions would be of particular interest to the Exchange:

- (i) Is there a need for a Second Market?
- (ii) Should the Second Market target only sophisticated investors?
- (iii) Is raising the minimum transaction size an effective barrier of entry for uninformed and rumour-driven investors?
- (iv) What should be the minimum transaction size? (HK\$100,000 to HK\$150,000, HK\$150,000 to HK\$200,000, HK\$200,000 to HK\$250,000 or an amount above HK\$250,000)
- (v) Are the proposed entry requirements appropriate for the Second Market?
- (vi) Is it acceptable that the Principal Shareholders should be required to lock up their shares? Are the proposed lock up periods for the Management Shareholders and Financial Shareholders appropriate?
- (vii) Is the "let the buyer beware" approach underpinning much of the additional disclosure requirement acceptable?
- (viii) Is the concept of "Active Business Pursuits" as an alternative to the current requirement to show a three year profit track record acceptable?
- (ix) Is the Statement of Business Objectives required by investors and/or is it too

onerous or impractical for issuers to satisfy?

- (x) Are the continuing reporting requirements and, in particular, the requirements for quarterly reports and a comparison of business progress with Business Objectives too onerous?
- (xi) Are the eligibility criteria proposed for Sponsors appropriate, particularly the requirement that Sponsors must have adequate capital and reserves to address the concern that Sponsors with inadequate financial strength may a) be under greater pressure or temptation to take on sponsorship of Second Market applicants which have little prospect of success and/or b) be unable to discharge properly the obligations as Sponsors?
- (xii) Is it adequate that the Exchange would only review a preliminary notification of listing and examine Listing Documents for the purpose of ensuring compliance with the requirements of the Companies Ordinance?
- (xiii) Are the proposed corporate governance requirements appropriate?
- (xiv) Is it appropriate to give shareholders the opportunity to consider a resolution to wind up a company in circumstances where there has been material non-compliance with obligations under the Second Market Listing Rules, a material change in Business Objectives which is not approved by shareholders or a sustained failure to meet Business Objectives?
- (xv) Should consideration be given to facilitate the current winding up process given that this could give rise to practical difficulties and delays?
- (xvi) Is a display-of-interest trading medium appropriate for the Second Market?
- (xvii) Should the Second Market allow overseas incorporated companies to list and if so what should be the additional requirements?
- (xviii) Would many companies be deterred from listing on the Second Market because of high costs?
- (xix) Should the Second Market be an entirely distinct market from the Main Board? Would it be sufficient for the Exchange to either lower its Main Board's listing requirements or introduce a new Chapter under the current Exchange Listing Rules to accommodate smaller companies?

SCHEDULE 1:
MAJOR FEATURES OF SELECTED OVERSEAS SECOND MARKETS

	KLSE 2B	MESDAQ	SESDAQ	ROSE	AIM	NASDAQ
General						
Governance/Management	Governed & managed by KLSE	Self regulation with direct oversight of Securities Commission	Governed & managed by SES sub-committee	Self regulation with direct oversight of Securities and Futures Commission	Governed by sub-committee of LSE but managed as a separate department	Self-regulation with direct oversight of Securities and Exchange Commission
Issuer types	Domestic small & medium sized companies	Mainly technology-related companies (domestic & foreign)	Domestic small & medium sized companies	Domestic small & medium sized companies including start-ups	Wide range of small & emerging companies including start-ups (domestic & foreign)	Technology related companies including start-ups
Investor protection features	Disclosure requirements, contract note warning & shareholders moratorium	Disclosure requirements, shareholder moratorium & retention of sponsor for five years (adviser shall act as sponsor for one year after listing)	Disclosure requirements & contract note warning	Disclosure requirements	Disclosure requirements, shareholder moratorium, services of nominated advisers & brokers at all times	Disclosure requirements, on-going requirements & retention of three registered & active market makers
Listing Requirements						
Paid-up capital	RM10-40 (HK\$20-80) Mil (RM1=HK\$2)	RM2 (HK\$4) Mil upon listing comprising ordinary shares with a par value of RM1 each & NTA - upon listing normally not less than par value	None	NT\$50 (HK\$11) Mil (NT\$4.5 =HK\$1)	None	NNM - NTA (Alternative 1) US\$6 (HK\$47) Mil or (Alternative 2) US\$18 (HK\$140) Mil or (Alternative 3) US\$ 75 (HK\$585) Mil NSM - NTA US\$4 (HK\$31) Mil (US\$1=HK\$7.8)

Track record	Three years	None for technology companies and one year for others	Three years - less may be considered	Zero to three years depending on business nature	None	NNM - (Alternative 1) nil or (Alternative 2) two years or (Alternative 3) nil NSM - one year or MC US\$50 (HK\$390) Mil
Profit requirements	KLSE stated that the companies must have achieved an average pre-tax profit of not less than RM2 (HK\$4) Mil per annum & pre-tax profit of at least RM1 (HK\$2) Mil per annum for the past three years	None	None	Combined annual revenue & net profit before tax must be 2% of gross capital for each year, for the last two years. None for qualified technology companies	None	NNM - (Alternative 1) annual pre-tax income US\$1 (HK\$7.8) Mil in most recent year or in two of last three most recent years & (Alternatives 2 & 3) nil NSM - net income US\$750,000 (HK\$5.8 Mil) in most recent year or in two of last three most recent years (in lieu of NTA requirement)
Continuity of management	Yes, but Listing Rules do not specify the duration of management continuity	Not stated in Listing Rules	No	No	No	Not available
Continuing disclosure requirements	Semi annual reports, immediate release of price sensitive information (Same as per MB)	Semi annual reports & immediate release of material information	Semi annual reports, immediate release of price sensitive information (Same as per MB)	Disclosure of price sensitive / relevant events in timely manner	Semi annual reports & immediate release of price sensitive information	Quarterly reporting, prompt disclosure of material information & adherence of a set of quantitative maintenance criteria
Shares in public hands	Between 25% to 50%	Between 25% & 49%	500,000 shares or 15% (whichever is greater) when dealing starts but not normally greater than 50% of issued & paid-up capital	Min. 10% or 5 Mil. shares & at least 300 public shareholders	None	NNM - (Alternative 1) 1.1 Mil shares worth US\$8 (HK\$62) Mil & (Alternative 2) 1.1 Mil shares worth US\$18 (HK\$140) Mil NSM - 1 Mil shares worth US\$5 (HK\$39) Mil

Shareholder moratorium	Yes - one year, thereafter maximum disposal 15% per year	Yes - one year, thereafter maximum disposal 20% per year	No (May impose a moratorium of one year for major shareholders or such other period)	Yes - two years for principal shareholders, then maximum disposal 20% every six months	Yes if less than two years of income, moratorium is one year	No
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Note:

KLSE = Kuala Lumpur Stock Exchange; 2B = Second Board, MESDAQ = Malaysian Exchange of Securities Dealing & Automated Quotation

SES = Stock Exchange of Singapore, SESDAQ = Stock Exchange of Singapore Dealing and Automated Quotation System

ROSE = Taiwan's Over-the-counter stock market

AIM = Alternative Investment Market, LSE = London Stock Exchange

NASDAQ = National Association of Securities Dealers Automated Quotations, NNM = NASDAQ National Market, NSM = NASDAQ SmallCap Market

MB = Main Board, SM = Second Market

NTA = Net Tangible Asset, MC = Market Capitalisation

Schedule 1 is for reference only; therefore the Exchange takes no responsibility for its contents, makes no representation as to its accuracy or completeness and expressly disclaims any liability whatsoever for any loss howsoever arising from or in reliance upon the above information. Some of the rules and regulations may also not be clear-cut and is subject to interpretation. The respective exchanges have not been consulted and for detailed analysis, please refer directly to the relevant exchanges.

SCHEDULE 2:**COMPARISON OF MAJOR FEATURES BETWEEN THE EXCHANGE'S MAIN BOARD
AND THE PROPOSED SECOND MARKET**

	Main Board	Second Market
Types of securities	Equities, debts, derivatives and investment vehicles	Equities only
Theme of market	Various, including capital formation for larger and more established companies, exit strategy, increasing corporate profile, etc.	Capital formation for smaller and emerging companies
Acceptable jurisdictions	Hong Kong, Bermuda, the Cayman Islands and People's Republic of China in the form of H-shares	All jurisdictions allowed
Investor access	Whole spectrum of retail and institutional investors	Sophisticated investors only
Track record	Profits of \$50m (\$20m in most recent year and \$30m in the two preceding years)	No minimum profit requirement but must demonstrate two years of 'Active Business Pursuits'
Minimum capitalisation	Market cap. of \$100m at the time of listing	Implicit market cap. of \$46.1m at the time of listing
Minimum shares in public hands	25% (but can be 10% if issuer's market cap. exceeds \$4 billion)	Higher of \$30m and 35% of issued share capital
Minimum holdings by Principal Shareholders	No minimum holdings by Principal Shareholders. Controlling Shareholders refer to those who together control 35% or more of voting power. Restrictions on disposal by Controlling Shareholders apply	Management Shareholders and Financial Shareholders collectively to hold at least 35% of issued share capital at time of listing. Restrictions on disposals apply
Issue of shares to the public	Adequate spread of shareholders i.e. not less than three holders per \$1 million, with minimum 100 holders	Number of public shareholders should not fall below 50 and no single public shareholder should hold more than 10% of issued share capital
Initial Public Offering	Existing shares can be issued	Companies permitted to issue only new shares to the public
Issue of prospectus	Yes	Yes
Role of the Exchange in the listing process	Exchange's Listing Division to review each listing application and to pre-vet the associated Listing Documents, thereafter recommends to Listing Committee for approval/rejection	Second Market Listing Committee to review notification of listing intention and the Compliance & Surveillance Unit to examine Listing Documents to ensure compliance with Companies Ordinance requirements
Sponsors	Sponsors must be acceptable to the Exchange to give impartial advice to issuers and must agree to observe guidelines set out in Model Code for Sponsors. Requirement to have a sponsor will end once applicant is listed (H-share issuers must retain sponsors for at least three years after listing)	Sponsors will be subject to pre-qualification requirements and issuers must retain a Sponsor for at least two years after listing

Listing Document to include report by Reporting Accountant	Required	Required
Disclosure obligations	<p>A prospectus must contain details of the following:</p> <ul style="list-style-type: none"> • Issuer • Advisers • Securities for which listing is sought • Issuer's capital • Group activities • Financial information and prospects • Management • Use of proceeds • Material contracts/documents <p>A profit forecast is generally encouraged</p>	<p>Information covered in prospectus will be similar in scope to that of Main Board, but must also provide two additional statements:</p> <ul style="list-style-type: none"> • A Statement of Active Business Pursuits • A Statement of Business Objectives <p>More detailed breakdown of use of proceeds A profit forecast is not required</p>
Continuing disclosure obligations	Annual and semi-annual reporting	<p>Same requirement as per Main Board, in addition:</p> <ul style="list-style-type: none"> • Issuers are required to publish quarterly financial statement • Annual/semi-annual reporting to include comparison between actual business progress and Business Objectives
Corporate governance	<p>Need to:</p> <ul style="list-style-type: none"> • Appoint two non-executive directors • Establish an audit committee with clearly defined terms of reference • Requirement for directors' education • Audit committee to review and supervise financial reporting process and internal controls 	<p>Adequate and effective systems of internal controls covering financial and compliance requirement, including having:</p> <ul style="list-style-type: none"> • A senior compliance officer • A qualified person to supervise the accounts • Two independent directors (with relevant experience) • An Audit and Compliance Committee to be chaired independently and which will meet quarterly • Requirement for directors' education • Senior Management compensation to be approved by Audit & Compliance Committee & to be disclosed in annual accounts
Suspension/resumption of trade	An issuer must have sufficient operations or assets to warrant continued listing	Same suspension/resumption policy as per Main Board, but with special provisions for the shareholders to wind up the issuers
Surveillance, compliance and enforcement	<p>Listing Division to:</p> <ul style="list-style-type: none"> • Vet listing announcements/ circulars and annual/semi annual reports • Investigate unusual price or volume movements/market rumours, possible breaches of the Exchange's Listing Rules 	<p>A separate and dedicated Compliance & Surveillance Unit to:</p> <ul style="list-style-type: none"> • Post-vet Listing Documents on a sample basis to check compliance with Second Market Listing Rules • Post-vet announcements/circulars and annual/semi annual reports • Investigate unusual price or volume movements/market rumours, possible breaches of Second Market Listing Rules
Role of SFC	Investigate and regulate securities dealing and compliance with SDI	Same as per Main Board

Trading system	Order driven	Display of interest - provision of a Bulletin Board
Prominent risk warning	No	Yes
Education & promotional programmes	Investors education/promotion undertaken by Corporate Communications sometimes through roadshows and by Membership in conjunction with external parties	Greater emphasis on education and promotional programmes and establishment of a public library through electronic means
Membership	Existing Exchange members	Existing Exchange members
Clearing and settlement	CCASS	CCASS but Isolated Trade

Note: Schedule 2 is for reference only, therefore for more accurate interpretation of the Main Board Listing Rules and for further explanation of the proposed Second Market regulatory model, please refer to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Ltd. and the main text respectively. The Exchange accepts no liability (whether in torts or contract or otherwise) for any loss or damage arising from any inaccuracies or omissions.