REGULATORY COMPETITION IN INTERNATIONAL CAPITAL MARKETS: EVIDENCE FROM CHINA IN 2004-2005

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I.
INTRODUCTION

In recent years, the concept of issuer choice has been hotly debated within academic circles. Proponents of issuer choice argue that when foreign corporations gain access to U.S. capital markets, they should be allowed to follow the securities laws of the jurisdiction of their choice rather than the legal rules set down by the SEC. By depriving regulatory agencies such as the SEC of their regulatory monopolies, the institution of issuer choice would compel the agencies to improve the quality and efficiency of legal rules within their jurisdiction.[1] Meanwhile, opponents of issuer choice warn that regulatory competition would inevitably lead to a race to the bottom in which issuers would seek out jurisdictions with the least demanding regulations and the lowest level of investor protections, causing the overall quality of securities regulations to deteriorate.[2]

The question arises if empirical data can better answer whether adopting a regime of issuer choice would result in substantial benefits on the quality of securities regulations. Professor Howell Jackson and Eric Pan began a research project, based on a series of in-depth interviews with lawyers, investment bankers, and regulatory officials in Europe, in order to understand the empirical effect of issuer choice.[3] While

1. *See* Roberta Romano, *The Need for Competition in International Securities Regulation: A Response to Critics*, 2 THEORETICAL INQUIRIES L. 387 (2001); Stephen J. Choi, *Assessing Regulatory Responses to Securities Market Globalization*, 2 THEORETICAL INQUIRIES L. 613 (2001); Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000); Andrew Guzman, *Capital Market Regulation in Developing Countries: A Proposal*, 39 VA. J. INT'L L. 607 (1999); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE. L. J. 2359 (1998).

2. *See e.g.* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999); Hal S. Scott, *Internationalization of Primary Public Securities Markets*, 63 LAW & CONTEMP. PROBS. 71, 75 (2000).

3. Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999-Part I*, 56 BUS. LAW. 653, 654 (2001).

that project centered on practices in European securities markets that resembled an issuer choice regime, this paper seeks to shed light on the empirical effect of issuer choice on the quality of securities regulations by focusing on the capital raising practices of Chinese companies. Specifically, by conducting similar interviews with lawyers, bankers, and regulatory officials in Hong Kong who have experience with Chinese firms raising capital in the U.S., this paper aims to discover whether U.S. securities regulations create economic inefficiencies by inhibiting Chinese issuers from reaching willing U.S. investors.

Several clear conclusions emerge from the interviews. First, the argument that a primary or dual listing on a U.S. capital market allows an issuer to access a wider investor base is less compelling than it once was. Hong Kong has become a very substantial regional market in its own right, possessing the liquidity to support most of the large IPOs coming out of China. Thus, Chinese issuers, who want to reach a large investor pool yet do not wish to incur the costs and burdens associated with U.S. securities law, are no longer limited to U.S. capital markets. In fact, the large initial public offerings by state-owned enterprises that have been completed in recent years have listed only in Hong Kong or London. These enterprises have been able to gain access to U.S. investors through private placements to institutional investors, including growing numbers of hedge funds and private equity funds, pursuant to Rule 144A. This suggests that Rule 144A represents an attractive alternative for Chinese issuers who want to avoid the costs and delay of the SEC regulatory regime.

On the other hand, Chinese private technology companies continue to show significant interest in listing on NASDAQ. Interviewees point out that the NASDAQ provides the most attractive valuations for companies in the Internet and technology industries. Listing overseas also enriches parties responsible for building the listing companies, *e.g.*, entrepreneurs, management, employees, and early investors, by providing liquidity. Moreover, these firms often receive financing from foreign venture capital investors who expect exits via U.S. IPOs. Thus, NASDAQ is often the preferred listing destination for such companies.

This paper is organized as follows: Part Two provides an explanation of the interview methodology, and Part Three contains an in-depth discussion of the interview results, focusing on the options available to Chinese issuers. Part Three begins by exploring why the domestic capital markets in China are insufficient to satisfy Chinese issuers' capital needs and what changes can be expected going forward. It then discusses the capital raising practices of Chinese companies in U.S. capital markets and explains both the principal reasons behind these choices and the significant barriers faced by Chinese companies. The paper then proceeds to examine the Hong Kong capital markets and why they are becoming an increasingly attractive destination for Chinese issuers. The next section considers specific sectors, such as banking and technology, whose unique characteristics affect their capital raising practices. Then, the paper analyzes the different incentives faced by the different types of Chinese issuers, and the implications for the decision-making process of those issuers when raising capital in the U.S. The last section of Part Three presents alternative capital markets that are available to Chinese issuers. Part Four focuses on the globalization of international capital markets and what that means for Chinese issuers who are attempting to reach institutional and retail investors in the U.S. Finally, Part Five concludes the paper by summarizing the various discussions and their implications on the issuer choice debate.

A. *The Focus on China*

The diverse economic conditions of Asian countries and the varying levels of capital markets development in the region make it very difficult to generalize on the subject of Asian issuers. Thus, instead of undertaking an integrated inquiry into the capital raising practices of Asian issuers, this paper focuses primarily on Mainland Chinese issuers. The Chinese market is unique in that it encompasses two distinct types of issuers seeking to raise capital: state-owned enterprises (SOEs) in the process of privatization, and recently established private enterprises. The two types of issuers are faced with dissimilar capital raising alternatives and exhibit different characteristics in the way they approach the capital raising process.

Over the last several years, Mainland Chinese issuers have become an increasingly important economic force, and focusing on China's large and growing market provides sufficient scope for this paper. In the past, China's economic development has primarily been spurred by foreign direct investment. While this is still largely the case, in recent years, a growing proportion of foreign funds has been accumulated via the debt and equity offerings of Chinese firms in international capital markets, and, to a far lesser extent, in China's domestic markets. Chinese firms raised over $20 billion in 2005,[4] compared with approximately $14 billion in 2004 and $8 billion in 2003.[5] To put these numbers in context, between 1993 and 2001, China-based companies raised approximately $24 billion in initial public offerings in U.S. capital markets, and between 2001 and 2003, raised approximately $5 billion overall in U.S. capital markets.[6] After U.S. firms, Chinese firms are the second largest group of recipients of funds raised through global IPOs in 2005. China's economy grew at 9.9 percent last year, and Chinese statistics show a national economic output of $2.26 trillion allowing China to overtake the U.K. as the world's fourth-largest economy.[7] Several interviewees predicted that the pace of Chinese companies going public will almost certainly increase in the future.[8] Given the number of Chinese companies projected to come to market, it thus appears likely that within a few years, Chinese companies will constitute a significant and increasing portion of the market capitalization of international capital markets.

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4. Press Release, Ernst & Young, Larger Deals Drive Increased Global IPO Activity in 2005 Says Ernst & Young (December 12, 2005), *available at* http://www.ey.com/global/content.nsf/Russia_E/Press-Release_-_12_12_2005.

5. *2005 Report to Congress of the U.S.-China Economic and Security Review Commission*, 109th Cong. 54 (2005), *available at http://www.uscc.gov/annual_report/2005/annual_report_full_05.pdf* (hereinafter 2005 COMMISSION REPORT).

6. *China's Presence in Global Capital Markets*, 108th Cong. (2004) (written testimony of Amit Tandon, Managing Director of New York Global Securities, Inc.) (hereinafter TANDON).

7. Keith Bradsher, *Chinese Economy Grows to 4th Largest in the World*, N.Y. TIMES, Jan. 25, 2006, at C10.

8. *See, e.g.*, Interviews notes, US-B-3, US-L-3, US-R-1 (on file with the *Journal of Law & Business*).

II.
INTERVIEW METHODOLOGY

During January 2006, the author of this paper conducted interviews with nine individuals possessing extensive experience in securities work in Hong Kong and China. The interviewees were promised that their responses would only be used anonymously in order to encourage the most candid answers. Three of the interviewees were lawyers practicing in Hong Kong; three were investment bankers based in Hong Kong; two were general counsels of Chinese companies located in Shanghai, and one was a regulatory official with the Hong Kong Exchange and Clearings Limited. All of the interviewed attorneys were partners of major U.S. law firms, with at least 600 lawyers worldwide, in the practice of advising only on transactions that involve a substantial U.S. component. For each of the three firms, the Hong Kong office serves as the headquarters for their Asia practice, and boasts a staff of 14-20 professionals. The three attorneys are members of the New York bar and have had legal training in the U.S. They have been practicing for 12-18 years and have been involved with Asian issuers raising capital in overseas markets for a significant portion of their professional careers.

Two of the bankers interviewed are members of a U.S. bar and worked several years as attorneys in Hong Kong before transitioning into investment banking. Both have worked on transactions that involve a U.S. or an international component, and both have substantial familiarity with U.S. securities law. They work for major U.S. and European-based investment banks that employ over 20,000 and 68,000 employees, respectively. The third banker interviewed is chairman of Asian Investment Banking and a managing director at a prominent U.S. investment bank with over 50,000 employees worldwide. Over the course of the third banker's career, he has managed numerous transactions involving Chinese issuers seeking capital abroad.

One of the general counsels interviewed is the first U.S.-trained general counsel at a NASDAQ-listed Chinese Internet company, and participated in the capital raising process for his current firm. Previously, he worked in the Hong Kong office of a major U.S. law firm and gained substantial experience with securities offerings. The other general counsel interviewed is qualified under U.K., Singapore, and Bermuda law, and is currently working for a Chinese media company with U.S. financial backing. He has 7 to 8 years of corporate and securities law experience. Finally, the regulatory official at the Hong Kong exchange received his legal training in China, and had one year of U.S. legal training as an LLM student in the U.S. He has experience with Chinese companies raising capital in Hong Kong and has previously worked as a regulatory official at the Shanghai Stock Exchange.

Each interview lasted between forty-five minutes and an hour and a half. A similar set of questions was used for the lawyer and banker interviewees. These questions were based on those used by Professor Jackson and Eric Pan[9] and were aimed at eliciting substantive descriptions of how Chinese issuers approach the capital raising process, in particular when and how they decide to seek capital in the U.S. A central focus of the interviews was to explore the means by which Chinese issuers access U.S. capital markets – namely, through registered public offerings or private placements – and the extent to which the Sarbanes-Oxley Act of 2002 affected those access decisions. The questions also explored the role for advisors in the capital raising decision, as well as the alternative markets both within and outside of Asia that have been considered by Chinese issuers. The final section of the questionnaire was aimed at gathering general statistical information from the interviewees regarding the transactions with which their firms have been involved.

III.
How Do Chinese Companies Raise Capital?

In deciding where to raise capital, Chinese issuers can choose from four sets of markets: (1) China's domestic markets, (2) U.S. markets, (3) the Hong Kong market, (4) and markets in the rest of the world. One interviewee commented that the worst quality companies stay in China, while the best companies tend to raise money in Hong Kong or the U.S.[10] This paper will explore each of these markets in turn.

9. *See* Jackson & Pan, *supra* note 3, at 692-95.

10. *See* Interview notes, US-L-1 (on file with the *Journal of Law & Business*).

A. *China's Domestic Capital Markets: Why Companies Go Abroad*

In order to understand why Chinese issuers list on global capital markets, it is important to first grasp the significant gap between what China's underdeveloped domestic capital markets are able to provide and the financial needs of local companies. For many Chinese companies, raising money domestically is not a viable alternative, and, for this reason, they must turn to other sources of capital. There are several explanations for this corporate behavior. First, China's domestic capital markets are still in a nascent stage of development. A formal capital system did not exist in China until the establishment of the Shanghai Stock Exchange in December 1990, followed by the opening of the Shenzhen Stock Exchange a few weeks later. The establishment of these exchanges is part of the Chinese government's plan to further domestic economic reforms by increasing market influences in the economy and reducing the role of the heavily indebted and politically-driven state-run banks which currently supply Chinese businesses with ninety percent of their funding.[11] Over the past several years, however, the exchanges have encountered major hindrances in development[12] and have delivered poor returns. Between June 2001 and June 2005, the Shanghai Stock Exchange index lost over half its value and hit an eight-year low.[13] Furthermore, the Shenzhen and Shanghai stock exchange indices were the world's third- and forth-worst performers in 2005 because the smaller, state-owned manufacturers that dominate the markets were not strong contributors to

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11. *See Non-performing*, THE ECONOMIST, Mar. 20, 2004, at 18.

12. When the stock exchanges were first established, China underwent a period of "stock fever", and many citizens were eager to invest. In August 1992, over a million people waited in lines to buy applications for stocks being issued on the Shenzhen exchange. Once it was apparent that applications had run out, 50,000 people rioted through the streets, clashing with the police and leaving two dead. *See* 2005 COMMISSION REPORT, *supra* note 5, at 55.

13. *See Outlook Dims for China's Stock Markets*, AGENCE FRANCE PRESS, June 6, 2005. While this source was previously accessed by the Author, it is no longer available, and thus was not reviewed by the Journal staff prior to publication.

the growth of the economy. As of February 2006, the Shanghai Composite Index was still 43 percent below its 2001 peak.[14]

The weak stock performance of companies listed on China's capital markets has led to a widespread lack of confidence in the proper functioning of China's domestic exchanges. A number of interviewees believe this is largely due to the lack of market forces and transparency in the process of pricing listings on Chinese exchanges.[15] The *U.S.-China Economic and Security Review Commission's 2005 Report to Congress* cites the major problems facing the exchanges: frequent failures to set the IPO price by the time the prospectus is issued, poor regulatory supervision, rampant insider trading, frequent government intervention, inadequate corporate governance, disclosure, and accountability, and corruption.[16] Indeed, the Chinese government often manipulates the markets to advance its political agenda – such as the achievement of social and industrial policy objectives or the subsidization of SOE restructuring – without taking into account market-based considerations. For example, when the government became concerned about the strain on supplies of natural resources and raw materials, caused by rising investment in heavy industry, the China Securities Regulatory Commission (CSRC) attempted to prohibit firms in the steel, cement and aluminum sectors from undertaking new bond or share issues in order to limit the development of these industries.[17] The resulting decrease in market liquidity caused investors to be skeptical of potential returns and reliable payouts in China's equity and bond markets.[18]

The state's continued control over resource allocation is a huge factor in suppressing the development of China's domes-

14. Samuel Shen, *China Targets Overseas-Traded Companies as IPO Resumption Looms*, BLOOMBERG.COM, Feb. 10, 2006, http://quote.bloomberg.com/apps/news?pid=10000006&sid=arGgL3GaUgAo&refer=home.

15. *See, e.g.*, Interview notes, US-B-, 1US-GC-2, US-R-1 (on file with the Journal of Law & Business).

16. 2005 COMMISSION REPORT, *supra* note 5, at 55-56.

17. *China Risk: Alert – Resource Shortage*, EIU RISKWIRE, Mar. 3, 2004. Note from the NYU Journal of Law & Business: this source, while previously accessed by the Author, was temporarily unavailable, and thus was not reviewed by the Journal staff prior to publication.

18. *Id.*

tic capital markets.[19] Market forces cannot operate freely in China because the legal framework preserves a top-down management structure which may not produce economically efficient results even if laws are properly implemented.[20] Another problem is the lack of rights for minority shareholders who are often powerless to fight against cronyism, insider dealings, and rubber stamp shareholder meetings.[21] As foreign investors are forbidden from holding a controlling interest in Chinese firms (public investors rarely have access to more than 30 percent of shares[22]), the majority shareholder (the government, in the case of SOEs) need not heed minority investors' demands. This problem is not limited to companies listed in China. Hong Kong-listed China Mobile, for example, is 75%-controlled by its parent, China Mobile Communications, which has been able to inject assets into the listed company without consulting minority shareholders.[23] A third problem is the lack of a sound credit rating system. Companies are not allowed to approach a credit rating agency unless they have obtained permission from the government.[24] To exacerbate matters, firms are permitted to keep their credit ratings confidential under Chinese law; according to Standard & Poor's, Chinese companies frequently pull out of the ratings process if they receive a bad rating.[25] Moreover, rating agencies often find it exceedingly difficult to rate Chinese companies because of their poor corporate accounting practices.[26] Thus even when rating agencies do give high domestic credit ratings to

19. Donald Clarke, *Corporatization, not Privatization,* 7 CHINA ECON. Q.27 (2003).

20. Donald Clarke, *Corporate Governance in China: An Overview,*14 CHINA ECON. REV. 494, 494 (2003).

21. Steven Shi and Drake Weisert, *Corporate Governance with Chinese Characteristics,* CHINA BUS. REV., Vol. 25, No. 9, Sept.-Oct. 2002, at 40-41 (discussing the consequences of concentrated share ownership).

22. *Exchanges Woo Chinese Firms,* RED HERRING, Dec. 5, 2005, *available at* http://www.redherring.com/Article.aspx?a=14948&hed=Exchanges+Woo+Chinese+Firms.

23. Frederik Balfour, *The Appeal of Listing in Hong Kong,* BUS. WK. ONLINE, Jan. 18, 2006, *available at* http://www.businessweek.com/bwdaily/dnflash/jan2006/nf20060118_7512_db016.htm?campaign_id=rss_daily.

24. Joel Baglole, *A Huge Leap of Faith,* FAR Eastern Econ. Rev., Jan. 8, 2004, at 38-39.

25. *Id.* at 42.

26. *Id.* at 39.

Chinese firms, it is often based on the overall economy's impressive economic growth and the government's support of banks and SOEs rather than on a company's individual strength or industry's health.[27]

The interviewees also mentioned China's low corporate governance standards as another factor accounting for why both private and state-owned Chinese firms have been very active in international capital markets.[28] China's legal framework for corporate governance is largely contained within the CSRC's Code of Corporate Governance of Listed Companies in China, which was issued in early 2002 and raised standards for accounting procedures and information disclosure. In addition, the Certified Accountant Law (1993), Audit Law (1994), People's Bank of China Law (1995), Commercial Bank Law (1995), Securities Law (1998), and Accounting Law (1999) provide a framework for China's domestic capital markets.[29] However, as a result of inadequate enforcement capability, such regulations are not always implemented[30] Consequently, there have been criminal investigations related to eight listed companies, including an investigation of the chairman of the Shanghai-listed jeweler Diamond Co., who allegedly transferred $10 million in company funds into private overseas accounts and subsequently disappeared.[31]

Apart from the most blatant and serious criminal activities, other accounting problems also abound in China. A 2002 survey done by CSRC revealed that one in ten listed companies had doctored its books, and in January 2004 China's Finance Ministry reported that 152 firms had misstated profits by a combined $350 million.[32] It appears, however, that PRC officials are taking steps to bring Chinese firms in line with international accounting standards. China's Ministry of Finance has opened three national accounting institutes in Beijing, Shanghai, and Xiamen to train accountants in interna-

27. *Id.* at 40.

28. *See, e.g.*, Interview notes, US-B-3, US-L-1, US-R-1 (on file with the Journal of Law & Business).

29. Shi & Weisert, *supra* note 21, at 41.

30. *Id.* at 42.

31. Matthew Forney, *China's Market Maladies*, TIME INT'L (ASIA ED.), Feb. 7, 2005, at 42-43.

32. *Non-performing*, *supra* note 11, at 19.

tional accounting methods.[33] The Chinese government also put out a new requirement that publicly held companies report financial data every quarter, rather than every six months.[34] In January 2003, China's highest court stated that "shareholders could file individual or class-action lawsuits against companies that lie about their accounts."[35] Once this law was passed, about 900 lawsuits were filed against the approximately 1,200 companies listed in China at the time.[36] Moreover, accounting problems are not only limited to the issuers. Regulators and state-owned asset management companies have closed or taken control of nineteen brokerage houses since mid-2003 as part of an attempt to clean up shaky brokerage houses.[37] They have also established a $6 billion Fund to Protect Securities Investors, intended to shield investors from brokerage house failures.[38]

1. *Imminent Reform*

Chinese households collectively control about $1.8 trillion in savings, and "Chinese residents aren't getting a chance to invest in their own best businesses," says Malcolm Wood, an Asia-Pacific strategist with Morgan Stanley.[39] With a savings rate close to 50% of GDP in China,[40] Chinese domestic markets could potentially become rich sources of capital. The State Council has set forth a list of reforms necessary for improving the liquidity and transparency of its domestic capital markets, such as strengthening institutional investors, increasing financing channels for security companies, and attracting

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33. *China to Open Third National Accounting Institute*, PEOPLE'S DAILY ONLINE, Oct. 28, 2002, http://english.peopledaily.com.cn/200210/28/eng20021028_105769.shtml.

34. Baglole, *supra* note 24, at 42.

35. *China Finance: Banking on Growth*, EIU VIEWSWIRE, Jan. 17, 2003.

36. *Id.*

37. Zhang Shidong, *China Sets up Investor Protection Fund*, INT'L HERALD TRIBUNE, Sept. 29, 2005.

38. *China Unveils Rules for Fund to Protect Securities Investors*, WALL ST. J., Sept. 30, 2005, at C15.

39. Brian Bremner, *Where China's Top IPOs List: Offshore*, BUSINESSWEEK ONLINE, Jan. 9, 2006, http://www.businessweek.com/bwdaily/dnflash/jan2006/nf2006019_7318_db039.htm.

40. Andy Mukherjee, *If China's Government Spends, so will People*, BLOOMBERG NEWS, Feb. 9, 2006.

new sources of funds into the market.[41] In order to upgrade its security markets, the Chinese government has recruited Anthony Neoh, a former chair of the Hong Kong Securities and Futures Commission, as chief advisor to the CSRC. The government has also hired Laura Cha, a highly respected U.S.-trained lawyer with legal experience in both the U.S. and Hong Kong and former Hong Kong Securities and Futures Commission vice-chair, as CSRC vice-chair.[42]

Moreover, Zhou Xiaochuan, governor of the People's Bank of China, said in June 2005 that an open-door policy regarding foreign investors would help China integrate with global capital markets, and that the policy of allowing qualified foreign institutional investors (QFIIs) to invest in domestic markets was improving the ability of Chinese exchanges to price offerings more accurately.[43] Chinese domestic markets are currently open to foreign investors only to a very limited degree. Three types of shares are sold on the Shanghai and Shenzhen stock exchanges. "A shares" are held by residents of China, and only QFIIs that have received official approval to trade are allowed to buy shares on China's A-share exchanges.[44] At present, about half of the QFIIs are US firms, including Morgan Stanley Dean Witter, Citibank Global Markets, Morgan Chase Manhattan Bank, and Goldman Sachs.[45] "B shares" are open to foreign investors; they are denominated in Renminbi but payable in foreign currencies.[46] This market was originally established to boost domestic firms' access to foreign capital, but has met with only limited success - especially since Chinese companies listed overseas and foreign funds are allowed to buy yuan-denominated A shares.[47] "C

41. Richard McGregor, *China Finance: Beijing Plans Big Financial Markets Expansion*, EIU VIEWSWIRE, Feb. 3, 2004.

42. Ji Chen and Stephen Thomas, *The Ups and Downs of the PRC Securities Market*, CHINA BUS. REV., Vol. 30, No. 1, Jan.-Feb. 2003, at 36, 38.

43. *China's Stock Market has 'Bright Future' – Central Banker*, AFX ASIA FOCUS, June 1, 2005.

44. *FTSE Xinhua Index Series*, Oct. 29, 2004, *available at* http://www.ftse.com/xinhua/english/Indices/Downloads/FXIbrochure2004.pdf, at 2.

45. Christopher Torrens, *A Window Opens for Foreign Investors*, EUROMONEY INSTITUTIONAL INVESTOR, February 1, 2004, at 81.

46. *FTSE Xinhua Index Series*, *supra* note 44, at 2.

47. U.S.-CHINA ECONOMIC AND SECURITY REV. COMM'N., 108TH CONG., REPORT TO CONGRESS, at 83 (Comm. Print 2004) (hereinafter 2004 COMMISSION REPORT).

shares" are wholly owned by SOEs and are not publicly traded.[48]

As part of the overall plan to open up China's domestic markets, the government banned domestic share sales to avoid a flood of equity as companies pursued plans to make more than $200 billion of mostly state-owned stock tradable.[49] The government has also taken steps to encourage quality companies to list domestically in order to increase the attractiveness of the market. According to a draft document sent to brokerages for consultation earlier this year, the "CSRC has "proposed to relax some listing rules and recommended allowing Chinese companies listed abroad to raise funds locally by selling China Depositary Receipts."[50] The document stated: "Letting big red chips[51] sell shares and list domestically is good for the structural adjustment of the domestic securities market, and will enable domestic investors to share the fruit of China's economic growth."[52] The commission also said that it will continue to push big state companies to sell shares in the domestic market,[53] signaling that regulators are eager to have Chinese domestic markets better reflect the growing economy by adding larger and more profitable companies on the exchanges. Despite the Chinese government's enthusiasm for developing the domestic capital markets, many interviewees believe that it will still be at least five to ten years before Chinese companies can depend on domestic markets for their capital raising needs.[54]

B. *U.S. Capital Markets*

There are a number of ways that Chinese issuers can currently tap into the U.S. capital markets. Companies can do a public offering, such as the much-publicized NYSE listings by

48. *Id.*
49. *China Targets Overseas-Traded Companies as IPO Resumption Looms, supra* note 14.
50. *Id.*
51. "Big red chips" are Hong Kong-incorporated and operated companies that have controlling shareholders in Mainland China.
52. *China Targets Overseas-Traded Companies as IPO Resumption Looms, supra* note 14.
53. *Id.*
54. *See* Interview notes, US-B-1, US-B-2, US-L-1, US-GC-2 (on file with the Journal of Law & Business).

China Life in 2003 and China Netcom in 2004. As to the exchange of preference for Chinese issuers, NASDAQ and NYSE seem to be engaged in an ongoing battle for supremacy. Most interviewees agree, however, that except for certain industries, mainly high technology, Internet, or other entrepreneurial or up-and-coming companies, the majority of companies still prefer to list on the NYSE.[55] For example, SunTech Power, a profitable maker of photovoltaic cells and modules based in Wuxi in coastal Jiangsu province, completed a $395-million IPO on the NYSE in 2005.[56] However, while Chinese state-owned enterprises typically dual-list in both Hong Kong and the NYSE, private Chinese tech companies often do a single listing on NASDAQ, which has become more popular in recent years as more SOEs have shied away from public offerings in the U.S. Chinese issuers can also pursue a Rule 144A private placement, which allows them to access institutional investors in the U.S. after a public listing on another exchange. In terms of total proceeds over the past few years, SOEs are still dominant; more than ninety percent of funds raised by Chinese firms listing in the United States have been for SOEs, even though the Chinese private sector accounts for roughly sixty percent of the Chinese GDP.[57]

TABLE 1. NUMBER OF CHINESE OFFERINGS (BY OFFERING TYPES) IN THE U.S. BETWEEN 1996 AND 2005

Year	Private Placement	Public Offering Primary Market						Total Offerings
		NYSE	Nasdaq	SmCap	Hong Kong	Shelf Common	Total - Public	
1996	0	1	0	0	0	0	1	1
1997	0	3	0	0	1	0	4	4
1998	2	1	0	0	1	0	2	4
1999	0	0	1	1	0	0	2	2
2000	0	1	3	0	0	0	4	4
2001	0	2	0	0	0	0	2	2
2002	0	1	0	0	0	2	3	3
2003	1	1	1	0	0	0	2	3
2004	2	1	10	0	0	7	18	20
2005	4	1	8	0	0	15	24	28

Source: Thomson financial Services Data

55. *See id.* at, US-B-1, US-B-2, US-B-3, US-L-3, US-GC-1.

56. NYSE Calendar: Suntech Power Holdings Co, http://www.nyse.com/events/1134560227629.html (last visited Dec. 1, 2006).

57. *See* TANDON, *supra* note 6, at 30.

As illustrated in the table above, the number of Chinese offering in the U.S. has increased dramatically in the past two years. While NYSE offerings have been relatively constant over the last ten years, there has been a dramatic upsurge in the number of NASDAQ and shelf offerings. Rule 144A private placements[58] have also become an increasingly popular means for Chinese issuers to raise capital in 2004 and 2005. This mechanism allows companies to raise funds from U.S. institutional investors while avoiding the costs associated with meeting the disclosure and governance requirements mandated by Sarbanes-Oxley. Several of the interviewees noted that the 144A/QIB market is becoming more sophisticated and is an increasingly attractive way through which Chinese issuers can raise capital from the U.S.[59]

TABLE 2. TOTAL PROCEEDS OF CHINESE OFFERINGS (BY OFFERING TYPES) IN THE U.S. BETWEEN 1996 AND 2005

Year (in MM)	Private Placement		Public Offering Primary Market							Total Offerings
	Amt	%	NYSE	Nasdaq	SmCap	Hong Kong	Shelf Common	Total - Public	%	
1996	0.0	0.0%	216.8	0.0	0.0	0.0	0.0	216.8	100.0%	216.8
1997	0.0	0.0%	206.9	0.0	0.0	216.8	0.0	423.7	100.0%	423.7
1998	22.9	11.8%	116.2	0.0	0.0	55.4	0.0	171.6	88.2%	194.5
1999	0.0	0.0%	0.0	8.8	6.3	0.0	0.0	15.1	100.0%	15.1
2000	0.0	0.0%	546.0	217.9	0.0	0.0	0.0	763.9	100.0%	763.9
2001	0.0	0.0%	482.2	0.0	0.0	0.0	0.0	482.2	100.0%	482.2
2002	0.0	0.0%	681.2	0.0	0.0	0.0	2.1	683.3	100.0%	683.3
2003	1.7	0.1%	1,208.7	75.6	0.0	0.0	0.0	1284.3	99.9%	1286.0
2004	10.0	0.4%	991.7	1174.9	0.0	0.0	244.5	2411.1	99.6%	2421.1
2005	480.7	26.9%	395.7	758.2	0.0	0.0	155.7	1309.6	73.1%	1790.3

Source: Thomson Financial Services Data

Figures from Table 2 show that the amount raised in public offerings is generally much higher than that raised in private placements. However, 2005 saw a significant increase in private placement proceeds. The total figures from Tables 1 and 2 also show that, for 2003-2005, the average amount raised in NYSE public offerings was about $865 million, while the average amount raised in a NASDAQ public offering was roughly $106 million. This confirms the interviewed attorneys' obser-

58. Even though Thomson Financial Services does not distinguish Rule 144A offerings, instead classifying them under the general heading of "private placements," practitioners generally agree that all private placements coming out of China can be assumed to be 144A offerings.

59. *See* Interview notes, US-B-2, US-L-2, and US-L-3 (on file with the Journal of Law & Business).

vations that NYSE offerings tend to be much larger than NASDAQ offerings.

Finally, a handful of Chinese companies , mostly small and medium-sized private firms, gained listings in the U.S. through reverse mergers. Reverse mergers occur when a private company merges with a shell company that is already publicly listed but has no operations, and the private company thereby becomes public without having to go through its own listing application.[60] While the reverse merger can be quicker and less expensive than going public through an IPO, it does not provide many of the advantages available to a company that chooses to access the U.S. capital markets through the more traditional route.[61] A reverse merger often does not raise investor awareness because it does not benefit from the same publicity and interest raised in a traditional initial public offering and is often of limited interest for use in acquisitions since such securities are often thinly traded.[62] Due to increased regulation by the SEC, most time and cost savings associated with reverse mergers are now significantly reduced.[63] A back-door listing may still be useful under a very narrow set of circumstances, such as in the case of a Chinese company wishing merely to establish a position in the U.S. equity markets by being quoted on the pink sheets.[64] Overall, it is not a popular option with Chinese companies seeking to access U.S. markets.

1. *Reasons for Seeking Access to the U.S. Capital Markets*

The relatively greater liquidity, depth, and efficiency of the U.S. capital markets makes a listing valuable for firms in need of funds. Many of the interviewees commented on the overall market quality of U.S. exchanges. By providing deeper liquidity, lower volatility and tighter spreads than alternative markets, U.S. exchanges are able to reduce a company's cost

60. *Chinese Companies Looking at Reverse Mergers to List in U.S. – U.S. Consultants*, Forbes.com, May 25, 2005, http://www.forbes.com/markets/feeds/afx/2005/05/25/afx2054106.html.

61. Tom Locke, *Firm Rides Reverse-Merger Wave*, THE DENVER BUS. J., Aug. 6, 2004.

62. Simon Luk and Richard Yee, *U.S. Listing Options for Hong Kong and Chinese Companies*, Heller Ehrman LLP Publications (Aug. 1, 2003), http://www.hewm.com/en/news/article/article_2652.html.

63. *Id.*

64. *Id.*

of capital. Moreover, U.S. markets represent the largest pool of capital in the world. For a large Chinese issuer with substantial capital needs, U.S. markets are a natural source to approach.

Obtaining the best pricing is also an important consideration, and companies often choose the U.S. because of valuation reasons. Because of the high liquidity of the U.S. markets, there is generally greater demand for shares, which leads to more favorable pricing of shares for Chinese issuers. The pricing differential is especially large in certain fields, such as the high-tech/Internet industries; this will be explored later in the paper. Furthermore, one lawyer interviewee explained that U.S. valuations tend to be higher even when compared to a highly liquid market such as Hong Kong, due to differences in the capital raising processes.[65] The dominant way of raising capital in the U.S. is through the book building method, which often results in enhanced valuations. This is similar to the auction method, where the company (in conjunction with the underwriters) sets a price range, investors express how much they are willing to pay, and the company then makes the determination on the final offering price. In contrast, the fixed method is generally used in Hong Kong. With the fixed method, the underwriters and the company fix a price early on, and regardless of what subsequently occurs – for example, if the stock price drops significantly, or if there is massive demand – the issuer cannot adjust the initial offering price.

Profile and prestige are also important reasons for choosing U.S. capital markets. NYSE and NASDAQ listings are typically associated with greater analyst coverage and heightened media attention, especially for those listings that are connected to an equity offering. Widespread analyst coverage creates more sophisticated investors, which leads to more accurate pricing for Chinese issuers. Furthermore, companies are able to enjoy increased visibility along with a broadening of their investor base. However, such status considerations are declining in importance. According to one interviewee, U.S. deals have recently lost some of their sparkle due to the surge of high profile IPOs from Chinese companies that have by-

65. *See* Interview notes, US-L-2 (on file with the Journal of Law & Business).

passed U.S. equity markets.[66] The interviewee went on to claim that offering size and liquidity considerations no longer oblige Chinese companies to seek out U.S. market, as substantial amounts of capital are flowing into China.[67]

The U.S. is still associated with the highest standards of corporate governance. The Chinese government believes that listing SOEs on a U.S. stock exchange is an effective way to transform state assets into liquid stocks and to discipline operations. In fact, one lawyer interviewee went so far as to say that in comparison to private enterprises, raising capital is only a secondary objective for SOEs.[68] Funding considerations are less important than the brand recognition Chinese companies achieve through subjecting themselves to higher corporate governance standards. Similarly, small and medium-sized Chinese firms seeking to list in the U.S. are also improving transparency and accounting practices in an effort to adhere to SEC regulations. Thus, by forcing companies to institute effective bookkeeping and internal control systems, the stringent requirements of a U.S. listing actually present an opportunity for Chinese companies to increase their level of governance and familiarize themselves with more transparent disclosure practices. Nevertheless, some have argued that listing shares of state-run firms on global capital markets may not necessarily dilute state control and increase accountability to investors. As explained by Professor Donald Clarke, of the University of Washington School of Law:

China Telecom Corporation Limited (CTCL) is a shareholding limited company with shares listed on the New York and Hong Kong stock exchanges. Almost 80 percent of its stock, however, is owned by China Telecom Group Company, a traditional SOE with no shares that is directly owned by the Chinese government, while less than 12 percent of the equity was sold to the public. By creating a controlling subsidiary in the form of a shareholding company and selling a small proportion of its shares to the public, the parent SOE actually increased the value of assets under state control."[69]

66. *See id.*

67. *See id.*

68. *See id.* at US-L-3.

69. Clarke, *supra* note 19, at 28.

Overall, listing in the U.S. allows Chinese companies to enhance the viability and strength of their commercial brand, which helps them to gain the confidence of the investing public while also becoming more integrated into the global economic community. However, one of the interviewees commented that, following large-scale U.S. corporate scandals such as Enron and Worldcom, Chinese companies view American corporate governance as being no better than the rest of the world. This again undermines the importance of the prestige factor associated with a U.S. listing.[70]

Finally, listing in the U.S. permits profits denominated in Chinese currency to be converted to U.S. dollars; for companies that are planning an overseas acquisition, this provides an acquisition currency. This is especially important for foreign issuers that want to engage in mergers and acquisitions in which U.S. investors will be receiving securities of the foreign issuers , such as a stock for stock acquisition of a U.S. company.[71] A foreign issuer with common stock that is already publicly traded in the United States can typically complete such a transaction more quickly and easily than a foreign issuer without publicly traded shares.[72]

2. *Barriers to Accessing the U.S. Capital Markets*

Echoing Jackson and Pan's finding that cost is a major barrier to accessing U.S. capital markets,[73] all of the interviewees brought up the point that Chinese firms are wary of listing on the NYSE because of the high costs associated with such a listing. As one interviewee exclaimed, "prospectuses alone cost a million dollars!"[74] SEC disclosure standards were also frequently cited as a main reason for high listing costs. Management of Chinese issuers frequently lacks experience as to what type of information must be disclosed and why it needs to be disclosed. Bankers and lawyers often must educate issuers

70. *See* Interview notes US-B-3 (on file with the Journal of Law & Business).

71. Howell E. Jackson & Eric J. Pan, Regulatory Competition in International Securities Markets: Evidence from Europe in 1999-Part II, (Apr. 24, 2002) (unpublished manuscript, on file with the Journal of Law & Business).

72. *Id.*

73. *Id.* at 52.

74. *See* Interview notes, US-L-1 (on file with the Journal of Law & Business).

about the importance of running businesses in a way that investors can understand. Several interviewees also pointed out that Chinese corporate culture and corporate governance standards do not always facilitate the meeting of U.S. reporting requirements, as many Chinese companies lack robust bookkeeping systems and internal records.[75] Furthermore, the periodic filing requirements of the Securities Exchange Act of 1934 (for example, the filing of annual reports on form 10-K, quarterly reports on form 10-Q and periodic reports on form 8-K) impose significant costs on a company, and Chinese firms are concerned that they may be subject to additional requirements in the future.[76]

All of the interviewees mentioned the Sarbanes-Oxley Act of 2002 (SOX) as being particularly irritating to foreign issuers, because it goes beyond what has historically been the purview of U.S. financial securities regulation. Instead of focusing on disclosure, it actually requires certain types of governance arrangements, such as the appointment of independent directors. While listing in the U.S. provides the market perception of adhering to a 'higher' level of corporate governance standards – indeed, SOX was introduced as a direct consequence of the Enron scandal – all interviewees noted that Chinese issuers find several SOX requirements especially troublesome. One such troublesome requirement is section 302, which compels CEOs and CFOs to certify their company's annual and quarterly reports.[77] Even in cases where Chinese senior managers are not suspected of wrongdoing, they are wary of taking responsibility for accounting figures provided by others. Another difficult section is 404, which provides requirements for internal controls.[78] To comply with this section, external auditors have had to impose extremely cumbersome procedures on companies, and this imposition is often a real financial and operational burden on issuers. Additionally, many companies

75. *See id.* at US-L-3, US-B-1, US-GC-1.

76. *See Hearing on China's Strategy and Objectives in Global Capital Markets Before the U.S.-China Economic and Security Review Commission* (2005) (testimony of Robert G. DeLaMater, Partner, Sullivan & Cromwell LLP).

77. Alexander F. Cohen and D. Jamal Qaimmaqami, *The U.S. Sarbanes-Oxley Act of 2002: 2005 Update for Non-U.S. Issuers*, Latham & Watkins LLP Publications (July 1, 2005), http://www.lw.com/resource/Publications/_pdf/pub1298_1.pdf.

78. *Id.* at 1.

have had to retain an external lawyer to manage the requirements imposed by SOX, thus making a U.S. listing that much more onerous and expensive. The cost of complying with SOX financial-reporting standards are easily $1.5 million to $2 million a year.[79] In the eyes of these firms, SOX subjects them to an incremental flat tax. There are a number of companies that are currently in the process of de-listing from U.S. markets due to the "onerous hurdles" of Sarbanes-Oxley.[80]

One interviewee believes, however, that foreign issuers exaggerate the burden of SOX, as disclosure standards are not unreasonably difficult to meet.[81] In fact, the governance requirements under SOX dealing with the composition and responsibility of the audit committee and the board of directors are significantly lower for overseas issuers. Foreign companies are allowed to report on a half-year rather than quarterly basis, and annual reports can be filed six months after year-end rather than the requisite three months for U.S. companies.[82] Foreign issuers are also permitted to make certain confidential filings.[83] Moreover, the SEC embarked on a round table consultation with U.S. listed companies and their auditors on the application of section 404 of SOX in order to address concerns about the cost of complying with the new requirements, which went into effect in February 2005.[84] In early March it extended the deadline for compliance by one year for small and non-US companies.[85] Furthermore, should a shareholder or group of shareholders own more than fifty percent of the company, the NYSE listing rules provide an exception; qualifying companies are subject to more lenient requirements con-

79. Michelle Tsai & Lynn Cowan, *IPO Outlook: Chinese IPOs Stick Close to Home; Not Many Firms Make Debut in U.S. Amid Fears, Costs, and Strict Regulations*, WALL ST. J., Mar. 20, 2006, at C4.

80. Richard McCormack, *Growing Number Of Chinese IPOs Are Bypassing U.S. Equity Markets: Does China Pose A Financial Opportunity Or Threat?* MANUFACTURING & TECHNOLOGY NEWS, Sept. 1, 2005, *available at* http://www.manufacturingnews.com/news/05/0901/art1.html.

81. *See* Interview notes, US-L-2 (on file with the Journal of Law & Business).

82. Jamie Barr, *Accessing Overseas Capital – A Bull in the China Shop?* ASIAN COUNSEL, May 2005, at 27.

83. *Id.*

84. *Id.*

85. *Id.*

cerning directorial independence.[86] For example, PetroChina, which is 90 percent owned by China National Petroleum Corporation, is allowed to have only three independent directors on its 13-member board, although the NYSE normally requires independent directors to be in the majority.[87] One of the interviewees is currently advising a company with a similar ownership structure, and the interviewee does not find SOX to be a major concern.[88] Besides SOX compliance, the interviewee explains, a host of other market factors are responsible for the decreasing attractiveness of U.S. public offerings for Chinese issuers.[89]

In many cases, Chinese firms have found that a U.S. listing may not be worth the high costs. As one of the interviewees pointed out, not every industry enjoys a premium valuation.[90] Unless the issuer is in a high interest sector favored by U.S. investors, it may well find itself in an "orphan stock" situation in which investors and research analysts show little interest in the stock. China Yuchai International (CYD) is one such example – although it successfully listed on the NYSE in 1994, it consistently trades at lower multiples than comparable firms. Because of such experiences, many bankers are increasingly advising against U.S. listings unless there is a compelling story behind the stock that will attract investors.[91] Often, Chinese companies listed on U.S. exchanges can struggle for research coverage because their market capitalizations are less than $500 million.[92] Investment banks usually cover companies whose offerings they underwrite, but foreign issuers tend to have greater difficulties.[93] One banker suggested that, in general, a better strategy for Chinese companies is initially to list in home markets (such as Hong Kong) so as to gain support from domestic investors, and then to pursue a secondary list-

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86. Daniel Hilken, *New York Shy*, WEEKEND STANDARD, April 30 – May 1, 2005, *available at* http://www.thestandard.com.hk/stdn/std/Weekend/GD30Jp19.html.

87. *Id.*

88. *See* Interview notes, US-GC-1 (on file with the Journal of Law & Business).

89. *See id.*

90. *See id.* at US-B-1.

91. *See id.*

92. Tsai & Cowan, *supra* note 79, at 26.

93. *Id.*

ing in the U.S.[94] As U.S. public offerings generate the highest fees for the bankers and lawyers involved, advisors who persist in recommending U.S offerings frequently meet with skepticism from their clients.[95] Indeed, another banker interviewee has found that Chinese companies are pushing back far more often these days.[96]

Chinese issuers are also turned off by the delays associated with a U.S. offering. In addition to enduring time delays associated with an SEC review, in many cases, established SOEs must undertake a restructuring as part of its IPO preparation. The restructuring process can involve both financial and production-related restructuring in order to demonstrate management autonomy, transparency, and corporate governance. Similar to Jackson and Pan's description of European issuers,[97] the most common form of restructuring mentioned by all the interviewees is the need to reconcile local accounting standards with the U.S. Generally Accepted Accounting Principles (GAAP). This can be a difficult process because SOEs are large entities with numerous financial assets, and reconciliation often means sorting through mountains of data to determine what is essential in order for the particular listing to comply with SEC accounting rules. Accounting issues can be exacerbated when a company is completing a dual listing. For example, many Chinese companies dual-listed in the U.S. and Hong Kong maintain at least three sets of financial figures: one to comply with PRC accounting rules, another to comply with Hong Kong standards, and a third to comply with U.S. foreign issuer standards.

To complicate matters, operational issues are often targeted as well. One lawyer interviewee alluded to a transaction he worked on in which a company in the oil industry, like many other SOEs, owned a variety of ancillary assets that were not part of oil production but produced revenues for employ-

94. *See* Interview notes, US-B-1 (on file with the Journal of Law & Business).

95. *See id.*

96. *See id.* at US-B-2.

97. This requirement is imposed on all private foreign issuers who seek access to public U.S. capital markets, but not on those who limit themselves to making Rule 144A offerings into the United States. *See* Jackson & Pan, *supra* note 71, at 31.

ees.[98] Before listing was possible, the company was required to undergo a complex pre-IPO restructuring. However, as one interviewee pointed out, in many cases the necessity of restructuring is not specific to a U.S. listing; companies would have to undertake a similar process even if they had chosen to raise capital from investors in other countries.[99] Thus, the need for restructuring does not in and of itself represent a substantial barrier for Chinese firms seeking U.S. capital.

Many of the poorer quality companies have trouble accessing the U.S. capital markets because they are unable to meet stringent initial requirements. The U.S. exchanges have set minimum requirements for market capitalization, trading volume, shareholders' equity, and earnings.[100] In addition, U.S. exchanges require a minimum percentage or number of shares to be held in public hands, a minimum number of holders or market-makers, and a minimum per share bid price.[101] There are certain industries, such as banks, that face particular difficulties in listing in the U.S.[102] There are specific SEC requirements regulating financial institutions,[103] and many Chinese banks lack the operational and management systems necessary to produce the information required.[104] Thus, it is not surprising that Chinese bank listings on the NYSE are very rare.

Litigation risk has also become a more significant factor for Chinese firms considering listing on the NYSE, according to a number of interviewees.[105] To Chinese firms, listing on the NYSE entails a much higher risk of class action lawsuits as compared to listing on another exchange, such as the Hong

98. *See* Interview notes, US-L-3 (on file with the Journal of Law & Business).

99. *See id.* US-B-1.

100. Kenneth R. Lamb, Judith L. Shepherd, Justin K. McAnaney, and Oliver P. s'Jacob, *Why US companies Should Consider AIM*, 24 INT'L FIN. L. REV. 39, 40 (2005).

101. *Id.*

102. *See, e.g., The Sarbanes- Oxley Act of 2002: Impact on and Considerations for Financial Institutions*, Gibson, Dunn & Crutcher LLP Publication (Sept. 20, 2003), http://media.gibsondunn.com/fstore/documents/pubs/SOX_Fin Inst.pdf.

103. *Id.*

104. *See* Interview notes, US-L-3 (on file with the Journal of Law & Business).

105. *See, e.g., id.* at,US-L-1.

Kong Stock Exchange. One interviewee explained that, in Hong Kong, there are no specific procedures for shareholders to bring class action lawsuits, and in the case of a negative judgment, the losing party must pay all legal fees.[106] In comparison, in the past several years, the U.S.-listed Chinese companies Netease, Asiainfo, UTStarcom, Chinadotcom, China Life, Kongzhong, 51job, and Sina have all been sued in U.S. courts.[107] Significant reputation damages are often associated with such lawsuits. Indeed, some of the most high profile Chinese companies have been mired in scandals since listing in the U.S. China Life, China's biggest insurer, issued the world's largest IPO in 2003, raising $3.4 billion.[108] The transaction was also significant because it was the first Chinese state-owned financial institution to be listed on a U.S. stock market.[109] Shortly thereafter, the company was investigated by the SEC for an alleged $652 million fraud that it had failed to disclose, accompanied by allegations of high-level insider dealings.[110] China Life's CEO and certain other directors were named as co-defendants.[111] Many found disturbing the protectionist relationship between Chinese companies and the Chinese government.[112] Jin Renqing, China's finance minister, came swiftly to China Life's defense after the scandal broke, claiming that the company had "behaved very openly" in the run-up to its IPO.[113] It is widely believed that Air China dropped a proposed secondary listing in New York and switched instead to London because of China Life's experi-

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106. See *id.* at US-GC-1.

107. *Hearing on China's Strategy and Objectives in Global Capital Markets Before the U.S.-China Economic and Security Review Commission*, 109th Cong. (2005) (statement of Howard Chao, Partner-in- Charge, O'Melveny & Myers LLP) (hereinafter CHAO).

108. *SOE Overseas Listing Unlikely to Be Halted by US Security Probe*, XINHUA NEWS AGENCY, April 7, 2004, http://www.china.org.cn/english/BAT/92394.htm.

109. Jayanthi Iyengar, *China: East meets West on the Nasdaq*, ASIA TIMES ONLINE, July 29, 2004, http://www.atimes.com/atimes/China/FG29Ad05.html.

110. Stanford Law School Securities Class Action Clearinghouse, Company and Case Information, http://securities.stanford.edu/1030/LFC04-01/index.html (last visited October 4, 2006).

111. *See id.*

112. Francesco Guerrera, *China Life Wins Support from Minister*, FIN. TIMES, April 2, 2004, at 26.

113. *Id.*

ence earlier that year.[114] Another Chinese company that came under attack was Semiconductor Manufacturing International Corp. (SMIC), the largest manufacturer of semiconductor chips in China, which launched a $1.8 billion IPO on the New York and Hong Kong stock exchanges in March 2004.[115] Taiwan Semiconductor Manufacturing, which had originally filed suit against SMIC on December 23, 2003, filed papers with a U.S. federal court on March 23, 2004, claiming it had new evidence proving that SMIC had stolen aspects of is chip design.[116] Perhaps more damaging to SMIC's reputation was the company's acknowledgement that an executive made "inaccurate statements" about the company's ability to meet expenditures through 2005, which it later retracted.[117]

Concerns about liability issues are not only limited to issuers, but extend to investment banks as well. One lawyer indicated that his law firm has advised, investment banks to be more cautious when recommending clients to raise capital in the U.S., because long-settled assumptions about the role of an underwriter, and the limits of that role, are crumbling.[118] After the Enron bankruptcy and the dot-com meltdown, a greater emphasis is being placed on underwriters to act as gatekeepers in securities markets. This emphasis is visible not only in legislation (e.g. Sarbanes-Oxley), but also in judiciary decisions. Specifically, the interviewee cited two key New York cases that threaten the long-held assumptions of U.S. underwriting practice: *In Re WorldCom, Inc. Securities Litigation,* 346 F. Supp. 2d 628 (S.D.N.Y 2004), in which the court emphasized the underwriters' role as gatekeepers; and *EBC I, Inc. v. Goldman Sachs,* 5 N.Y.3d 11 (N.Y. Ct. of App. 2005), in which the court permitted an issuer to pursue fiduciary duty claims against an underwriter based on the creation of an advisory

114. *See* Interview notes, US-GC-1 (on file with the Journal of Law & Business).

115. Daisy Ku, *UPDATE 2-Chip maker SMIC's IPO Priced at Top of Range-sources,* FORBES.COM, Mar. 12, 2004, http://www.forbes.com/newswire/2004/03/12/rtr1296.

116. Arik Hesseldahl, *Cross-Strait Chip War Heats Up,* FORBES.COM, March 23, 2004, http://www.forbes.com/2004/03/23/cx_ah_0323.

117. Steve James, *Wall Street Goes Cold on China IPO Deals,* REUTERS, Mar. 21, 2004; Laurie J. Flynn, *Chip Makers' War of Words Worsens,* HERALD TRIBUNE, Mar. 26, 2004.

118. *See* Interview notes, US-L-3 (on file with the Journal of Law & Business).

relationship.[119] According to the lawyer, the *In Re WorldCom* decision provides the most important guidelines on underwriter due diligence requirements in over a decade.[120] Although *In Re WorldCom* is presently confined to the due diligence and reliance defenses for public offerings, there exists a significant possibility that it could be applied to 144A offerings. The decision indicates that underwriters need to take heed of the post-WorldCom environment, and alter their due diligence practices to include a search for red flags. A "red flag" is a fact known or discovered by an underwriter or their advisors that gives notice that an issuer may be engaged in wrongdoing, even if this fact is already publicly available and has raised no alarm among public analysts. It is a concept with its roots in Rule 10b-5 fraud cases but imported by the Court into the realm of section 11. More worrisome for underwriters is the fact that standards of due diligence are not reduced in the shelf offering context. The court recognized that securities offered under a shelf registration are organized much more quickly than under "traditional" transactions; however, the SEC has resisted all attempts to lower the degree of diligence required of underwriters, and Judge Cote supported this in *WorldCom*.[121] Thus, because extensive inquiry is necessary to justify summary judgment based upon due diligence, underwriters may not blindly rely on expert disclosure and must make a greater attempt to verify information from management.

The *Goldman Sachs* case is significant because it is a reminder that the relationship between the underwriter and the issuer can often be much more than an arms'-length relationship; rather, it can actually be one of higher trust. Even though the court specified that the underwriting agreement itself does not give rise to a duty, relationships outside the contract can generate fiduciary duty.[122] In the case, eToys hired Goldman Sachs to advise it on a variety of issues. The specific obligation that flows from such a relationship is to disclose "material conflicts of interest" that would render the under-

119. See *id.*

120. *See id.*

121. *In Re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 669-671 (S.D.N.Y. 2004).

122. *See EBC I, Inc. v. Goldman Sachs*, 5 N.Y.3d 11 (N.Y. 2005).

writer's advice suspect.[123] The interviewee noted that the lack of guidance on what gives rise to an advisory relationship that leads to a fiduciary duty on the part of the underwriter is a cause for concern.[124] While underwriters can try to mitigate this risk – for example, by including language that explicitly denies any fiduciary duty in underwriting agreements – they must realize that courts may look beyond the language of the underwriting agreement in analyzing potential fiduciary duty claims.[125] Therefore, in order to minimize risks of litigation, underwriters must remain vigilant with respect to all aspects of securities transactions that involve raising capital in the U.S.

Overall, Chinese issuers' concern over liability issues are still limited to the extent that many of them have assets that are largely, if not totally, in China. Chinese courts are not subject to any treaty or convention obligating them to recognize the judgments rendered by courts in the U.S., which means that the chances of recovery for U.S. investors is low. U.S. investors can attempt to sue such companies in China, but they may find it difficult to enforce a judgment against a Chinese company in a Chinese court.

3. *Specific Instances in which U.S. Legal Considerations Have Changed the Issuer's Choice of Offering Options*

When asked whether any of their clients had changed the structure of their transactions due to perceived problems with accessing the U.S. capital markets, only two interviewees answered affirmatively.[126] One interviewee explained that advisors usually provide issuers with very good information as to the viability of a certain method of raising capital, and thus, once an issuer initiates the process, it is usually quite committed to pursuing it.[127] The one exceptional transaction mentioned by both a lawyer and a banker interviewee was the IPO for the Hong Kong subsidiary of Bank of China, BOC (HK).[128] According to the interviewees, BOC (HK) had originally con-

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123. *Id.*
124. *See* Interview notes US-L-3, (on file with the Journal of Law & Business).
125. *See id.*
126. *See id.* at US-B-1, US-L-2.
127. *See id.* at US-L-1.
128. *See id.* at US-B-1, US-L-2.

sidered listing in the U.S., but the bank ultimately decided against it.[129] While there was a sense that the SEC was nervous about vetting the listing application because of fraud issues in the Hong Kong branch of the BOC, the main problem was not a regulatory issue but rather revolved around BOC (HK)'s financial statements. The bank had offloaded some bad loans, and while HK GAAP recognized the disposition,, it was not recognized as a true sale under U.S. GAAP. As a result, the bad loans remained on the books of the bank and caused its financial statements to appear weaker under U.S. listing requirements. Consequently, the BOC (HK) decided not to list in the U.S. As mentioned earlier in this paper, accounting issues are by far the most common problem for Chinese companies. In some cases, it is nearly impossible to reconcile U.S. GAAP and Chinese GAAP; consequently, the Chinese company will decide to drop the U.S. component.

Another cited example is PetroChina, which was required to change its transaction and corporate structure in preparation for a U.S. listing.[130] The company was formed in 1999 out of a collection of China National Petroleum Corporation's (CNPC) high quality oil- and gas-related assets, and it carried out its IPO of a minority interest on both the Hong Kong and New York stock exchanges in April 2000.[131] According to the lawyer interviewee who worked on the transaction, PetroChina had operations in Sudan, which they spun off to the parent because of existing U.S. sanctions against Sudan.[132] The company had to modify the structure of the transaction to ensure that the proceeds of the transactions – money from US investors – would not flow through to the parent. This is a particularly interesting and relevant example because of the likelihood that similar concerns about security-related abuses will occur in the future. The U.S. Treasury Department has identified a Chinese bank, which it alleges is involved in money laundering activities that could be financing North Korea's nuclear

129. *See id.*

130. *See id.* at US-L-2.

131. U.S. DEP'T OF ENERGY, SECTION 1837: NATIONAL SECURITY REVIEW OF INTERNATIONAL ENERGY REQUIREMENTS 9 (Feb. 2006).

132. *See* Interview notes, US-L-2 (on file with the Journal of Law & Business).

weapons programs.[133] According to press reports, the U.S. Treasury Department is also investigating the Bank of China and another Chinese bank because of similar alleged activities.[134] Moreover, the *U.S.-China Economic and Security Review Commission's 2005 Report to Congress* states that there are indications that some publicly traded firms have connections to the People's Liberation Army (PLA) and other military-related activities.[135]

C. *The Benefits of Accessing Hong Kong Capital Markets*

All of the interviewees were unanimous in their observation of one recent development: the trend of Chinese issuers evolving away from U.S. listings and toward Hong Kong listings. Many of the interviewees credit China Construction Bank's (CCB) successful listing on the Hong Kong Stock Exchange (HKEx) on October 21, 2005, and the ease with which it raised US$9.23 billion, as providing confidence to Chinese companies that a substantial transaction can be successfully accomplished even without a U.S. dimension.[136] Prior to the CCB IPO, all of the large SOEs had listed on NYSE; the rationale being that the offering sizes were so large that the domestic markets lacked the capacity to absorb the offerings. CCB's IPO represents a watershed event in that a China concept stock was able to successfully list in Hong Kong alone.

The interviewees observed that, while in the past many Chinese firms have completed dual listings in both Hong Kong and the U.S., in 2005, a number of Chinese firms that sought to raise money in Hong Kong did so without a U.S. tranche.[137] Indeed, in 2005, there were no SOE or non-technology offerings by Chinese firms on U.S. exchanges. This prompted several interviewees to comment that China's strategy toward international company listings has shifted in recent years; increasingly, Chinese companies are attracted to exclu-

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133. Edward Alden, *U.S. Moves on Bank Accused of Illicit N. Korea Links*, FIN. TIMES (London), Sept. 16, 2005, at 6.

134. Glenn R. Simpson, Gordon Fairclough & Jay Solomon, *U.S. Probes Banks' North Korea Ties*, WALL ST. J., Sept. 8, 2005, at A3.

135. 2005 COMMISSION REPORT, *supra* note 5, at 63.

136. *See* Interview notes, US-B-1, US-B-2, US-B-3, US-L-1, US-L-2, US-L-3 (on file with the Journal of Law & Business).

137. *See id.*

sive listings in Hong Kong.[138] This is a marked difference from Jackson and Pan's findings that, in transactions where there is not a public offering in the United States, European issuers routinely choose to raise capital through transactions that reach U.S. institutional investors through 144A.[139]

The amount of capital raised by Chinese companies listing in Hong Kong has grown dramatically. In 2003, mainland companies raised $7.5 billion in Hong Kong.[140] This amount jumped to $12 billion in 2004 and $24.7 billion in 2005; in comparison, the total amount raised in Shanghai and Shenzhen combined was a mere $4 billion.[141] The average offering size of IPOs in Hong Kong has grown to $180 million, compared to the average U.S. IPO at $220 million.[142] Market capitalization of Chinese companies on the HKEx is now roughly $200 billion.[143] Moreover, interest from mainland companies in the Hong Kong market continues to grow.

As a result, mainland companies have become an increasingly significant slice of the Hong Kong market. In 2005, Chinese companies accounted for 39% of the Hong Kong Exchange's capitalization, up from 30% in 2004and just 5% a decade ago.[144] According to data released on Jan. 13, 2006, mainland companies last year accounted for 46% of daily turnover and 91% of all new listings.[145] With $1.05 trillion in total market capitalization, Hong Kong is now the eighth-largest market in the world.[146] In fact, Vincent Chan, head of China research at Credit Suisse, commented in an interview, "Ten years down the road, the Hong Kong exchange will be mainly China stocks."[147] Indeed, Chinese stocks are coming to dominate the Hong Kong market. Mainland cell-phone operator China Mobile has the second-largest market capitalization on

138. *See, id.* at US-B-1, US-B-3, US-L-1, US-L-2, US-R-1.

139. *See* Jackson & Pan, *supra* note 71, at 12.

140. 2005 COMMISSION REPORT, *supra* note 5, at 12.

141. Balfour, *supra* note 23.

142. *More Chinese Companies Raise Funds in Hong Kong*, ASSOCIATED PRESS (ASIA), May 23, 2005, *available at* http://www.taipeitimes.com/News/worldbiz/archives/2005/05/23/2003256328.

143. CHAO, *supra* note 107, at 5.

144. Balfour, *supra* note 23.

145. *Id.*

146. *Id.*

147. *Id.*

the exchange at $9.3 billion, while China Construction Bank holds the No. 3 slot at $7.8 billion (HSBC Holdings, with headquarters in the U.K., is No. 1.). One banker interviewee predicts that the trend toward Hong Kong-only listings will continue as long as normal market conditions persist.[148] A number of factors make Hong Kong a logical destination for mainland companies. First, as several of the interviewees mentioned, HKEx is a large, deep, and independent financial market.[149] Foreign investors from all over Asia and the rest of the world have demonstrated a willingness to invest in Chinese companies listed only in Hong Kong. In addition, companies are growing more comfortable with the relative level of liquidity available on the Hong Kong market. All of the interviewees agreed that, while the U.S. has always been perceived as having deep investor liquidity, the U.S. market is becoming less and less prominent vis-à-vis the Hong Kong market. The pool of capital available in Asia is reasonably large, and overseas listings, especially secondary listings, do not necessarily deliver greater liquidity. Moreover, for China concept stocks in more traditional industries – those that are not in high-tech or internet-based businesses – the coverage and investor reception in Hong Kong is often greater than that available abroad. In addition, equity markets in the Asian region are experiencing strong growth; in 2005, stock sales in Asia surpassed those in the U.S. for the first time ever.[150] According to market data provider Dealogic, Asian equity sales rose to $138 billion, up 15% from the year before, whereas U.S. companies only made $114 billion in sales.[151] Issuance volumes have doubled in the last two years – in 2003, Asian companies sold only $78 billion of stock.[152] As a recent *Wall Street Journal* article noted: "Growing economies, strong stock markets and acquisitive companies are likely to drive another record year of equity sales – initial public offerings as well as follow-on stock sales and sales of bonds convertible into stocks – by companies in Asia."[153]

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148. *See* Interview notes, US-B-3 (on file with the Journal of Law & Business).

149. *See id.* at US-B-3, US-L-1, US-R-1.

150. Kate Linebaugh, *Equity Sales Top Those in U.S. and Feat is Likely to be Repeated*, WALL ST. J. (ASIA ED.), January 3, 2006, at 19.

151. *Id.*

152. *Id.*

153. *Id.*

Last but not least, underwriting and other transaction fees are much lower in Hong Kong relative to the U.S.

One of the most significant factors in determining whether a market is able to provide support for the share price of a company is the amount of research coverage the stock receives. Because investment banks, stock analysts, and other financial sector services have traditionally based their Asia operations in Hong Kong, a Hong Kong listing is often more likely to lead to adequate coverage of Chinese companies than a U.S. listing, particularly for companies in industries that are not especially favored by U.S. investors. Chinese companies have found a large pool of receptive investors in Hong Kong. As Hong Kong is now part of China and has always shared close cultural ties with the mainland, Hong Kong has many investors knowledgeable about and interested in investing in China. More importantly, unlike U.S. investors, Hong Kong investors understand the mainland business climate and perspective. As one interviewee succinctly put it, it is the "home country premium theory" at work , in that home markets tend to deliver the best valuations.[154] He cited China Telecom as an example: unlike investors in the Asia region who witnessed firsthand the popularity of SMS (mobile phone text-messaging), U.S. investors did not understand the company's business model, which depressed valuations.[155] He also recalled how the CEO of a major online gaming company in China commented in an interview that he had to educate American investors on how to do valuation of Chinese companies during road shows, and that listing in the U.S. often makes companies vulnerable to Wall Street dictating how they should run their companies.[156]

It appears that the reason why Chinese issuers are drawn toward a Hong Kong listing thus has more to do with the successful performance of the HKEx for China stocks and the receptiveness of Hong Kong investors rather than the desire to escape tougher regulations imposed by the U.S. Exchanges. In fact, one of the bankers interviewed disputed the idea that the difficulty of listing was a determining factor in whether a

154. *See* Interview notes, US-R-1 (on file with the Journal of Law & Business).

155. *See id.*

156. *See id.*

Chinese company chose to list in HK or the U.S.[157] While the perception is that the U.S. has the strictest regime for listing, he notes that Hong Kong probably has more rigid rules.[158] Although the U.S.'s initial requirements are more stringent, the system also reviews listing applications on a case-by-case basis; for example, in regards to connected-party transactions that have occurred within the company, the practice is acceptable under the U.S. system as long as the company makes adequate disclosure, whereas it may be subjected to the Hong Kong Exchange's merit-based review.[159] Thus, it is often no easier for Chinese companies to list in Hong Kong than in the U.S.

1. *Empirical Data as Corroboration of the Interview Results*

The author sought to determine whether empirical studies would corroborate the interviewees' anecdotal evidence suggesting that the HKEx provides sufficient liquidity for the stocks of Mainland Chinese issuers. The HKEx has conducted an internal study on the market turnover of Chinese stocks that are cross-traded in Hong Kong and the U.S.[160] The study looked at HK-listed stocks that were cross-listed on NYSE or NASDAQ at the end of 2004. All were listed in the form of American depository receipts (ADR); HK-listed stocks traded over-the-counter (OTC) in the US were excluded from the study, due to the unavailability of data.[161] The study results demonstrate that the level of trading activity in China-related stocks is significantly higher in Hong Kong than in the U.S.[162] These results may partially explain the increasing capacity of the HKEx to lure Chinese issuers away from the U.S. exchanges.

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157. *See id.* at US-B-1.

158. *See id.*

159. *See id.*

160. *See id.* at US-R-1.

161. Note that the exercise excludes stocks trading on the U.S. OTC markets, e.g., NASDAQ pink sheet market or ECNs. Among these stocks, some may be traded on the exchange at the same time and some may not. The turnover values of these OTC-traded Hong Kong stocks are unknown; therefore, the US data obtained for the study were incomplete. Nevertheless, the interpretation of the findings could be confined to exchange-trading only. *See id.*

162. *See id.*

There are two types of mainland Chinese company listings in the Hong Kong market: "H-shares," which are companies that are floated on the Hong Kong Exchange but incorporated in the mainland, and "red chips," which are companies incorporated and listed in Hong Kong with controlling Chinese shareholders. At the end of 2004, 28 stocks were cross-listed in Hong Kong and the U.S. (vs. 24 in 2003).[163] Among them, 20 were China-related stocks – 13 H shares, 6 red chips and 1 non-H share Mainland private enterprise (NHMPE).[164] The overall market share of Hong Kong in turnover[165] of China-related stocks dual-listed in the US was 79% in 2004, down from 81% in 2003 and its peak of 90% in 2002.[166] In addition, 13 out of the 20 China-related stocks saw the U.S. share of traded volume increase, collectively outweighing the market share gained by Hong Kong in the case of China Life.[167] This data is informative in two ways. First, trading volumes for dual-listed Chinese companies are significantly lower in the U.S. than in primary markets. This undermines the argument that Chinese issuers prefer U.S. capital markets because of their greater liquidity. The study also indicates, however, that the U.S. exchanges have been taking market share from the Hong Kong market, which suggests the increasing ability of U.S. exchanges to provide Chinese issuers with liquid markets. Indeed, the turnover value of China-related stocks in the U.S. accounted for 74% of U.S. turnover value of all cross-listed stocks in 2004, a significant increase from 43%

163. *See id.*

164. Semiconductor Manufacturing International Corporation (SMIC) was the first NHMPE cross-listed in Hong Kong and the US. The market shares for this stock in Hong Kong and the US in 2004 were 66% and 34% respectively. *See id.*

165. The daily turnover values of a target stock in the US were estimated by multiplying the stock's daily trading volume by the daily average stock price. The daily average stock price is the simple average of day-high and day-low price. Daily figures were aggregated into an annual figure for each stock. Annual turnover values in Hong Kong were obtained internally. Source of daily turnover volume and prices in the US is from Reuters, and list of ADRs was from Bank of New York.

166. *See* Interview notes, US-R-1 (on file with the Journal of Law & Business).

167. *See id.*

in 2003.[168] This signals increasing U.S. investor interest in China-related stocks.

There are also deeper levels of analysis that can be applied to the data. One pattern is that the U.S. market share of stock turnover for a China-related stock tends to be higher shortly after listing, but the market share generally falls off after that. For example, Hong Kong's market share for China Life increased significantly from 53% in 2003 (for the single listing month of December 2003) to 77% in the full year of 2004.[169] Thus, recent 2003-2004 dual listings may have contributed to the higher U.S. market share of stock turnover; many of the stocks may still be in their 'honeymoon period' in the U.S. Moreover, the claim that overseas listings provide greater liquidity is contradicted by the finding that, in 2004, with the single exception of the APT Satellite stock, Hong Kong held the majority market share for every China-related stock traded on three different markets – Hong Kong, U.S., and the U.K.[170]

One potential explanation for the relatively low volumes on U.S. and U.K. exchanges is technical difficulties related to the trading of PRC issuer's securities.[171] Since most trading takes place outside the official settlement systems on an over-the-counter basis, much of the activity may not be picked up in the exchanges' trading volume statistics.[172] Apparently, these issues are being worked on by the exchanges, and once settlement risk issues are resolved and trading is carried out on an order-driven basis, liquidity may improve significantly.[173]

2. *Lingering Issues*

While the attractiveness of the Hong Kong market for Chinese issuers is indisputable, there exist some concerns about Hong Kong's regulatory framework. One unresolved issue is that Hong Kong's stock exchange operates under an apparent conflict of interest: the same entity which operates

168. *See id.*
169. *See id.*
170. Hong Hong Kong's market share in the 20 China-related stocks traded on all three markets was 74%; those of the US and the UK were 19% and 8% respectively. *See id.*
171. Barr, *supra* note 82, at 28.
172. *Id*
173. *Id.*

HKEx and earns fees from such listings, Hong Kong Exchanges & Clearing, also has the authority to regulate the listings of companies.[174] Furthermore, the Chinese government's control over its SOEs listed on the HKEx combined with its influence over Hong Kong could present a conflict of interest down the line. More worrisome, however, is the lack of a statutory mechanism for inquiries regarding the financial reporting of companies listed on the HKEx.[175] In a survey conducted by the Hong Kong Exchange, local fund managers were most concerned about effective regulation of and information disclosure by Hong Kong's Growth Enterprise Market (GEM)-listed companies and Hong Kong-listed Mainland companies.[176] In October 2005, state-owned oil giant China National Offshore Oil Corp. (CNOOC) was rebuked by the HKEx for selective disclosure of information without shareholder approval.[177] State-owned Beijing Media Corp., after raising $116 million in its December 2004 HKEx listing, lost over a quarter of its share value and had two of its vice-presidents detained.[178] Not long after Bank of China's Hong Kong subsidiary listed in 2003, it became mired in a loan scandal.[179] In response, the Hong Kong Exchange undertook important regulatory reforms in recent years to improve its operations and governance standards. On April 1, 2004, the Hong Kong equity market banned so-called "back-door listings", or reverse mergers, which aims to prevent firms from injecting assets into shell companies and skirting disclosure requirements necessary for proper corporate governance enforcement[180]. Moreover,

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174. TANDON , *supra* note 6, at 29.

175. Natalie Chung, *Financial Reporting Watchdog Mooted*, CHINA DAILY, (HONG KONG ED.) Aug.10, 2005, at 4, *available at* http://www.chinadaily.com.cn/english/doc/2005-08/10/content_467706.htm.

176. Essie Tsoi, *Understanding Investors in the Hong Kong Listed Securities and Derivatives Market*, SFC QUARTERLY BULLETIN, July 2004, at 32. .

177. Andrew Batson, "CNOOC Receives Rebuke Over Selective Disclosure," *Dow Jones Newswires*, Oct.7, 2005.

178. Hanny Wan, *Beijing Media Shares Plunge on Corruption Probe*, BLOOMBERG.COM, Oct. 4, 2005, http://www.bloomberg.com/apps/news?pid=10000080&sid=aMqkwVLc1IyA&refer=asia.

179. Mark Clifford, *The Bank of China's Real Scandal*, BUS. WK. ONLINE, June 20, 2003, http://www.businessweek.com/bwdaily/dnflash/jun2003/nf20030620_4688_db065.htm.

180. Francesco Guerrera & Joe Leahy, *Hong Kong Slams Back Door*, FIN. TIMES (London), Mar. 22, 2004, at 24.

Hong Kong's regulatory authorities are securing enactment of a bill originally proposed in the Legislative Council which would establish a Financial Reporting Council[181]. This Council's primary responsibility would be to "conduct investigations and enquiries" to ensure the market functions independently and fairly[182]. Authorities hope that taking these steps will help "maintain investor confidence and uphold Hong Kong's standard of corporate governance"[183].

D. *Sectors with Unique Capital Raising Characteristics*

Due to the spectrum of Chinese enterprises seeking capital abroad, it is difficult to generalize about their behavior as a whole. In particular, there are certain sectors within China that, due to the nature of the industries and the special circumstances their companies face, exhibit distinctive trends in their capital raising practices. A deeper analysis of these sectors provides a more comprehensive understanding of the different considerations of Chinese issuers and their evaluation of the fundraising options available to them.

1. *The Banking Sector*

China's banking sector faces a myriad of problems. The top officials at China's financial sector regulatory agencies, the Central Bank, and the major state-owned banks are senior Chinese Communist Party (CCP) members, whose appointments are often dictated by political considerations[184]. In addition, large state-owned banks often do not conform to international accounting norms[185]. Furthermore, the banks hold a staggering portfolio of nonperforming loans (NPLs), estimated to have a current aggregate value between $350 billion and $550

181. Press Release, Hong Kong Special Administrative Region of the People's Republic of China, Bill Seeks to Establish a Financial Reporting Council (June 15, 2005), *available at* http://www.info.gov.hk/gia/general/2005 06/15/06150344.htm.

182. *Id.*

183. *Id.*

184. George Wehrfritz, *The Big Bank Chase*, NEWSWEEK (Int'l. Ed.), July 18, 2005, at 32, *available at* http://www.msnbc.msn.com/id/8525725/site/news week; *see also* TANDON, supra note 6, at v.

185. Wehrfritz, *supra* note 184, at 32.

billion[186]. These NPLs were generated through years of lenient, government-directed lending policies; state banks provided failing SOEs easy access to credit so they could continue expanding output and employment, which the government encouraged in an effort to maintain economic and social stability[187]. The banks also frequently provided loans without carrying out thorough due diligence, exacerbating the problem[188]. Finally, state-owned banks have been rife with extensive corruption. In the last year alone, tens of millions of dollars were stolen from Chinese banks, often by or with the complicity of bank officials. In March 2005, regulators uncovered an $18 million fraud at the Agricultural Bank of China; Zhang Enzhao, Chairman of CCB, submitted his resignation after implications that he had taken $1 million in kickbacks; investigators found over $122 million missing at a local BoC branch.[189] Thus, China's state-owned banks are not only saddled with a nonperforming loan crisis, but also face problems of fraud and non market-driven practices.

Chinese government officials are aware that Chinese banks must continue to work toward establishing and rigorously enforcing sound and sufficient transparency, governance, and accountability regulations in order to maintain investor interest. In an effort to encourage Chinese banks to adopt international standards of capitalization and corporate governance, China has begun the process of listing its four leading state-owned banks on international exchanges.[190] As discussed earlier, China Construction Bank (CCB) raised $9.23 billion in its October 2005 IPO in Hong Kong, selling off a 13.5% stake. Even though the listing was highly successful in generating investor interest, Moody's Investor Service gave the bank's financial strength a very poor rating.[191] In fact, the

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186. *See China's Presence in Global Capital Markets*, 108th Cong. (2004) (statement of Pieter Bottelier, Assoc. Prof., Johns Hopkins Univ.).

187. *See id.*

188. Wehrfritz, *supra* note 184, at 32.

189. Agence France-Presse, *$18m Fraud Uncovered at Chinese Bank*, SYDNEY MORNING HERALD, March 12, 2005, *available at* http://www.smh.com.au/articles/2005/03/25/1111692620691.html.

190. Alexis Chui, *Listing of Chinese Banks Delayed*, ASIA TIMES ONLINE, June 7, 2005, *available at* www.atimes.com/atimes/China/GF07Ad03.html.

191. Jackie Horne, *China Construction Bank Rolls Out IPO*, FIN. ASIA, Sept. 27, 2005.

bank's own prospectus revealed CCB's shaky financial position: "Our allowance for impairment losses may not be adequate to cover future actual losses to our loan portfolio."[192] This warning, however, apparently failed to deter many investors.

On the heels of CCB's success, the Bank of China (BoC) set the price on its initial public offering near the top end of its price range and raised $9.72 billion in China's biggest IPO in May 2006[193]. BoC generated substantial demand for the offering; retail investors applied for more than 75 times the shares available, and institutional investors 20 times the amount[194]. Not to be outdone, the Industrial and Commercial Bank of China is looking to raise capital in late 2006 with a $10 billion IPO, and the Agricultural Bank of China is expected to follow in 2008[195]. Collectively, these four institutions account for approximately seventy-five percent of the PRC's total banking assets[196]. Smaller banks are also expected to sell shares in overseas markets; China Merchants Bank, regarded as one of China's best-managed lenders, is seeking to raise $2 billion, while Minsheng Bank and Citic Bank are planning listings worth about $1 billion each[197]. Overall, Chinese banks are expected to raise about $25 billion selling shares to investors this year[198]. Absent a dramatic change in economic circumstances, it appears likely that all of these public offerings will be solely listed in Hong Kong.

Although the listing of state-owned banks will likely continue to generate much excitement among investors, there are reasons to suspect that investor confidence may diminish going forward. China continues to use the expansion of bank credit as a way to promote growth and investment; total bank lending increased dramatically in 2003 and in the first quarter

192. Keri Geiger, *China Construction Bank Lists IPO Risks, but Demand Strong*, DOW JONES INT'L. NEWS, Oct. 5, 2005, *available at* Factiva, File No. DJI0000020051005e1a5000mn.

193. Kate Linebaugh and Keri Geiger, *Bank of China's IPO Pricing Shows Demand is Still Strong*, WALL ST. J., May 25, 2006, at C4.

194. Justine Lau, *Bank of China IPO Raises Nearly $10bn*, FIN. TIMES (London), May 25, 2006, at 28.

195. Linebaugh, *supra* note 150, at 19.

196. *Non-performing*, *supra* note 11, at 18-19.

197. Lau, *supra* note 194, at 28.

198. Linebaugh & Geiger, *supra* note 193, at C4.

of 2004 grew twenty-one percent over the previous year[199]. The *U.S.-China Economic and Security Review Commission's 2005 Report to Congress* notes that a massive lending binge has temporarily reduced the percentage of Chinese bank loans that are nonperforming; however, that binge is likely to lead to a new wave of NPLs in coming years, particularly if the Chinese economy continues to slow[200]. Moreover, while the large state-owned commercial banks are working to improve their lending practices, reform efforts have not been extended to smaller banks. Over sixty percent of incremental lending in China between the last quarter of 2002 and the second quarter of 2004 came from small banks that are mostly owned by local governments.[201] The modernization of China's banking sector demands close attention, as the potential fallout from widespread bank failures could have a substantial impact on global capital markets.

In addition, China's banking sector strategy extends beyond simply listing shares overseas. The government has also begun selling stakes in state-owned banks to Western firms, many of whom are eager to invest in China's financial sector in order to enter an expanding and potentially lucrative Chinese market. In December 2003, the China Banking Regulatory Commission granted approval to BNP Paribas (France) to purchase a fifty percent stake in the Industrial and Commercial Bank of China's joint venture bank, the International Bank of Paris and Shanghai.[202] This bank, renamed BNP Paribas (China) Limited, is China's first foreign-owned, locally incorporated bank[203]. Between January and October of 2005, foreign banks, including well-known institutions such as Bank of America, Royal Bank of Scotland, Deutsche Bank and HSBC, have agreed to invest more than $15 billion in Chinese lenders.[204] To the Chinese government, foreign ownership in the Chinese banking sector accomplishes more than simply

199. Brian Bremner et al., *Headed for a Crisis?*, BUS. WK., May 3, 2004, at 36.

200. USCC ANN. REP. 64 (2005).

201. *See Hearing on China's Strategy and Objectives in Global Capital Markets Before the U.S.-China Economic and Security Review Commission*, 109th Cong. (2005) (statement of Pieter Bottelier, Assoc. Prof., Johns Hopkins Univ.).

202. *China: Financial Services*, EIU BUS. CHINA, Dec. 8, 2003.

203. *Id.*

204. Kate Linebaugh, *Deutsche Bank Joins the Push into China*, WALL ST. J., Sept. 22, 2005, at C4.

raising capital to shore up local banks' balance sheets; these transactions offer a means to establish and cultivate international financial sector relationships that may be instrumental to aiding Chinese banks in the attempt to improve corporate governance methods. This is a significant priority for the banking sector in light of pending deregulation associated with China's WTO-entry commitments. Specifically, in 2006 the government will lift a variety of protectionist regulations, at which point Chinese banks will have to compete with foreign banks on equal footing[205].

Foreign investment in Chinese banks has spurred complaints from investors who believe that foreign banks are gaining early access to China's banking sector at bargain prices.[206] For example, Bank of America paid approximately $2.5 billion for an 8% stake in China Construction Bank, a transaction which valued CCB at 1.2 times book value. This represented a significant 40% discount to the book value that Chinese banking shares trade at in Hong Kong[207]. Lending support to the undervaluation argument, CCB's shares have jumped almost 25% since its IPO[208]. Similarly, a consortium of investors led by Royal Bank of Scotland is paying approximately $3 billion for a 10% stake in Bank of China in advance of its public offering[209]. This represents a valuation substantially below the two times book value at which analysts are predicting Bank of China will set its share price.[210] Both transactions demonstrate that the Chinese government has been willing to sacrifice higher valuations for foreign expertise in strengthening its banking sector.

2. *The Technology Sector*

Unlike Chinese SOEs, smaller, more entrepreneurial, and typically technology-focused Chinese firms continue to have a huge interest in listing on U.S. exchanges, in particular the NASDAQ Exchange (NASDAQ). As of December 31, 2005, there are 24 Chinese companies trading on NASDAQ, com-

205. Chui, *supra* note 190.
206. Bremner, *supra* note 39.
207. *Id.*
208. *Id.*
209. *Id.*
210. *Id.*

pared to 20 on the NYSE.[211] These companies are pre-dominantly in the Internet, wireless, and value-added telecommunications industries. Following the tech bubble burst in 2001, several years passed with almost no Chinese technology IPOs. As global economic conditions improved, however, the Chinese technology sector reemerged on the U.S. exchanges; in 2004, 10 Chinese firms listed on the NASDAQ, a tenfold increase from 2003.[212] Investor demand for Chinese technology companies was strong, driven by the offerings of well-known companies like online search engine Baidu.com and flat-screen advertising company Focus Media.[213] The recent wave of Chinese IPOs reflects the breadth of China's technology sectors: China Medical Technologies, the first Chinese medical device company went public in August and raised $96 million[214]; Vimicro, NASDAQ's first Chinese semiconductor company , went public on November 15, 2006.[215]

Chinese start-ups frequently turn to international capital markets to satisfy their financing needs, as domestic commercial banks are often not a reliable source of debt financing, and domestic capital markets present many limitations. Chinese listings are still very much controlled by the Chinese government, and government approval is required for every firm

211. Companies that are headquartered in Hong Kong may also be classified as Chinese companies if their business is primarily based in China and they derive substantially all of their sales from China. Sources: Thomson Financial Services Data, Yahoo! Finance (http://finance.yahoo.com). *See* Bank of New York ADR-DR Directory, http://160.254.123.37/dr_directory.jsp?country=CN (last visited Dec. 31, 2005). Press Release, Nasdaq Stock Market, Inc., NASDAQ President and CEO to Visit China (Oct. 18, 2005), *available at* http://www.nasdaq.com/newsroom/news/pr2005/ne_section05_104.stm. For more information on the classification of Chinese companies, see *China's Presence in Global Capital Markets*, 108th Cong. (2004), 24–28 (statement of Timothy P. Halter, Managing Dir., USX China Index).

212. Note from the NYU Journal of Law & Business: The Author compiled the above statistic from Thomson Financial's SDC Platinum Software, Global News and Merger & Acquisitions Databases, a proprietary service to which the Journal was unable to gain access. Therefore, the authenticity of the statistic could not be independently verified.

213. Balfour, *supra* note 23.

214. *Exchanges Woo Chinese Firms*, *supra* note 22.

215. Deng Zhonghan, *Vimicro's fresh perspective*, CHINA DAILY, Mar. 6, 2006, *available at* http://www.chinadaily.com.cn/bizchina/2006-03/06/content_535810.htm.

incorporated in China seeking a listing on an exchange.[216] Not only is the process time consuming, sometimes taking as long as four years, but the requirements, such as profitability and other financial thresholds, are often difficult for start-up companies to meet,[217] Moreover, a ruling by the China Securities Regulatory Commission provides that any restructuring undertaken by a company during its listing process would serve to restart the clock on the waiting period, even in a situation where the company was just about to satisfy the waiting period requirement.[218] These factors contribute to "a perception and a reality to the small and medium (private) enterprises that these stock exchanges do not want them"[219]. Moreover, obtaining approval from Beijing for IPOs is often a very political process, and an especially difficult one for private sector firms; often, Beijing's preference is to use domestic capital to privatize state owned enterprises rather than to help private companies flourish.[220] Thus, many private Chinese firms have chosen to incorporate themselves in small island jurisdictions such as Bermuda and the Cayman Islands[221], which positions them for capital raising in the U.S. markets.

One interviewee explained that the success of the Chinese Internet portal – namely, sina.com, netease.com, sohu.com and china.com – in raising capital from NASDAQ to see them through the post-bubble years changed the mindset of technology issuers in China.[222] U.S. investors are viewed as more technology savvy, and the higher level of investor interest results in better capital markets reception and subsequently greater liquidity for U.S. technology listings. Furthermore, listing on NASDAQ provides companies with a recognized global valuation. One interviewee commented that this is an encouraging trend that reflects the development of the corporate economy, as credible private players are looking for ways

216. *See Hearing on China's Strategy*, *supra* note 76, at iii (opening statement).

217. *Id.*

218. *See* TANDON, *supra* note 6, at 30.

219. *Id.*

220. *See Hearing on China's Strategy*, *supra* note 76, at iii-iv (opening statement).

221. *Id.* at 115 (testimony of Howard Chao, Asia Practice Head, O'Melveny & Myers LLP).

222. See Interview US-GC-2.

to access the market.[223] In general, stocks on NASDAQ receive greater industry-specific analyst research coverage which in turn generates investor interest and boosts valuations.

Hong Kong markets represent a poor alternative for start-ups. One interviewee noted that many young companies are unable to qualify for a Hong Kong main board listing because they fail to meet the 3-year profit requirement.[224] Moreover, the second board of the Hong Kong stock exchange, the Growth Enterprise Market (GEM), which allows listings by emerging Chinese companies, has proven to be a poor market both for IPO valuations, as measured by P/E (price to earnings) ratios, and for liquidity. One interviewee explained that small tech deals do not receive much attention on GEM.[225] As a result, Chinese technology start-ups often turn to NASDAQ, which hosts a large group of comparable companies. Beyond a market capitalization requirement, the only significant barrier to a NASDAQ listing is the high costs involved; such outlays can be especially difficult for start-ups because they lack strong, positive cash flows.[226] Despite the attraction of Chinese tech start-ups to NASDAQ, however, funds raised by Chinese firms on NASDAQ are still relatively low; as of October 2005, the 22 Chinese firms have raised about $15 billion, while six Indian companies had a combined capitalization of over $27 billion[227].

Most importantly, the interviewees pointed out that NASDAQ values technology companies at higher price multiples than other markets,[228] A recent *Wall Street Journal* article notes that some US investment groups are looking for ways to move Hong Kong-listed technology companies to the NASDAQ, where a more receptive audience can drive shares to a higher level.[229] Because the Hong Kong market is dominated by banking, real estate, and industrial shares, many tech compa-

223. Interview notes, US-L-2 (on file with the NYU Journal of Law & Business).

224. Interview notes, US-L-3 (on file with Journal of Law & Business).

225. Interview notes, US-GC-2 (on file with Journal of Law & Business).

226. *Id.*

227. *Exchanges Woo Chinese Firms, supra* note 22.

228. Interview notes, US-B-1, US-B-3, US-L-2, US-L-3 (on file with the Journal of Law & Business).

229. Laura Santini & Kate Linebaugh, *Nasdaq Reaps Asian Windfall,* WALL ST. J., Feb. 2, 2006, at C14.

nies, even those with a China story, have not done well. Various investment groups are attempting to arbitrage the valuation differences between the Hong Kong and U.S. markets. The *WSJ* article cites several recent examples of this trend. Superdata Software (Holdings) is a Chinese company that went public in Hong Kong in 2003 at 30 Hong Kong cents, or about 4 US cents, a share.[230] The company, which produces software for small and medium-size business, posted a 49% revenue gain in 2004, doubling its profits, tripling its share price, and causing its market capitalization to reach $100 million[231]. Superdata's founder and chairman believed that the company was still seriously undervalued, and with the help of New York-based hedge fund Och-Ziff Capital Management took the company private and de-listed it from Hong Kong's stock exchange.[232] According to Superdata's filing with Hong Kong regulators, it expects Profit Eagle (a new Cayman Islands company that now owns Superdata) to go public within 18 months on "an alternative, actively traded technology index", although it does not specifically mention NASDAQ.[233] Another interesting example is Golden Meditech, a Chinese medical device maker listed in Hong Kong. The company operates four separate healthcare units and owns 20% of a fifth company, China Medical Technologies, which it spun off last year in a NASDAQ IPO.[234] Just prior to the China Medical IPO, an investment unit of General Electric invested in China Medical, thereby positioning itself for a quick investment gain upon an IPO.[235] Simply comparing the valuations of the parent company Golden Meditech and the spun-off unit China Medical underscores the valuation gap that exists among exchanges. Golden Meditech currently has a $300 million market capitalization on the Hong Kong exchange and trades at about eight times earnings, while China Medical is valued at $1.16 billion, more than 50 times its previous 12 months' earnings[236]. According to the article, Goldman Sachs Group, the investment bank, and Newbridge Capital, a US private-equity fund with

230. *Id.*
231. *Id.*
232. *Id.*
233. *Id.*
234. *Id.*
235. *Id.*
236. *Id.*

offices in Asia, are jointly looking to carve out additional businesses from Golden Meditech; Goldman Sachs and Newbridge Capital are considering putting up capital to take private a unit that makes blood-purification equipment in order to combine it with a related business acquired from a publicly traded US health-care company, with the goal of eventually listing the new entity on NASDAQ.[237] These transactions demonstrate the increasing popularity of re-listing on NASDAQ for valuation purposes.

E. *The Agency Problem: Conflicting Incentives of Different Players*

As part of the interview process, interviewees responded to the question of who they thought the key decision makers were in determining whether and how a Chinese company raises capital in the U.S. – management of the issuer, the banker, or the attorney. Their responses shed light on the decision making process that Chinese issuers go through when considering ways to access U.S. capital markets. While the interviewed bankers and lawyers reported that ultimately management is responsible for the decision about where to list, they also pointed out that Chinese management often does not have much experience with the U.S. capital markets.[238] As a result, they frequently base their decisions on recommendations from financial advisors and also on recent capital markets activity of other companies.[239] In particular, companies usually work closely with the Equity Capital Markets desks of investment banks in making capital raising decisions.[240] Alternatively, as one interviewee explained, companies backed by venture capital or private equity funds usually work closely with the existing investors, who typically have significant experience with the listing process.[241] Moreover, as companies in China are very much affected by their peers, bankers find themselves in a position from which they can exert substantial

237. *Id.*

238. Interview notes, US-B-1, US-L-3 (on file with Journal of Law & Business).

239. Interview notes, US-B-1 (on file with Journal of Law & Business).

240. *See* interview notes, US-L-2 (on file with Journal of Law & Business).

241. *See* interview notes, US-GC-2 (on file with Journal of Law & Business).

influence on companies' capital raising decisions and help to establish new market trends in how companies raise capital.[242]

To complicate matters, several interviewees pointed out that advisors are often conflicted in their listing decisions; while there may not be any compelling reasons to recommend listing in the U.S., underwriters earn the largest spreads on U.S. listings.[243] One interviewee observed that Chinese issuers are becoming increasingly sophisticated; in many cases, they are familiar with general issues because they consult regularly with banks, law firms and accountants in advance of a listing.[244] Presentations from bankers quantify the expected costs and benefits of a future capital raising event. Companies depend on lawyers to offer a legal perspective of what must be done to meet compliance requirements, and they rely on bankers to provide them information on whether the market is deep enough to support the listing.[245]

Furthermore, depending on the company type, different considerations may shape the listing decision. Under the current Chinese regulations, it is rare for management of SOEs to hold an equity stake in the business; typically, management teams who lack equity ownership do not support the idea of executing IPOs in the U.S. As one interviewee puts it, "It is all work, and things can only go wrong."[246] For these SOEs, the drive to list in the U.S. stems from government influence; management receives no extra incentives but must deal with a new range of issues. In contrast, the principal shareholders of smaller, more entrepreneurial technology companies are often the founders along with venture capitalists and private equity funds. These parties welcome U.S. IPOs because shares held by original investors in a domestically listed company are usually not tradable on the exchange and can only be sold in private transactions , thereby providing principal shareholders with no viable exits. Moreover, these entrepreneurs and venture funds generally hold options that tend to be worth more when there is a liquid, publicly traded stock underlying them. These financial incentives provide the motivation for navigat-

242. Interview notes, US-B-1 (on file with Journal of Law & Business).
243. *See* Interview US-B-2, US-GC-1, US-R-1.
244. Interview notes, US-B-3 (on file with Journal of Law & Business).
245. *Id.*
246. Interview notes, US-L-1 (on file with Journal of Law & Business).

ing through the arduous process of listing in the U.S. Indeed, companies with significant U.S. venture capital backing prepare themselves to access the U.S. markets from day one.[247]

Finally, many Chinese IT enterprises consider a NASDAQ IPO as the culmination of , as well as a public recognition of, their success. Entrepreneurs and managers of Chinese tech firms are frequently U.S.-educated and familiar with the U.S. capital markets environment. According to Howard Chao: "[C]ompanies of this type tend to be more familiar with U.S. disclosure rules, standards of corporate governance, and other market expectations. On average they tend to have higher management standards than many other Chinese companies. They tend to be more market-driven."[248]

F. *Alternative Exchanges*

In discussing the factors he typically considers when advising a Chinese company, one interviewee suggested that the industry of the company can play a significant role in determining where to list.[249] Listing preferences are partially dictated by industry standards even if they do not add any real value. For example, for sectors such as mining and natural resources, he would recommend listing in Canada or Australia, but London would be a more natural choice for gold mining companies.[250] As discussed earlier, however, the perceived reputation benefits of a western market listing have become less important to Chinese companies.

In addition to discussing the U.S. and HK, the interviewees addressed the other markets in which Chinese issuers have raised capital and whether they think these markets will become more attractive going forward. The interviewees' views on the popular alternative markets will be explored in turn.

1. *London*

Several interviewees mentioned that the LSE's establishment of an office in Hong Kong in 2004 demonstrates its commitment to attracting Mainland Chinese companies to its eq-

247. *See id.*
248. *Hearing on China's Strategy, supra* note 76, at 30 (statement of Howard Chao, Asia Practice Head, O'Melveny & Myers LLP).
249. *See* interview notes, US-B-2 (on file with Journal of Law & Business).
250. *Id.*

uity markets.[251] Martin Graham, LSE's director of marketing services, visited Beijing in May 2005 to promote London as a market for overseas Chinese listings.[252] As compared to the NYSE, the benefits of listing on the LSE include decreased disclosure and governance requirements and lower risk of class action lawsuits.[253] London's listing rules also bear much closer resemblance to Hong Kong's than do New York's; thus, for a mainland company that has already decided to list in Hong Kong, London represents an easier choice for a secondary listing. However, most of the interviewees had not personally worked on LSE listings, and did not consider it to be a very popular alternative.[254] One interviewee added that, in general, if a company decides not to list in the U.S., he does not see any compelling reasons why it would choose the LSE over HK.[255] Another interviewee concurred, and suggested that the general impression among both lawyers and management is that the LSE does not understand Chinese issuers.[256] He went on to comment that the London market has not proved itself and is perceived as providing few benefits to Chinese companies; thus, listing on the LSE provides little prestige yet still implicates the expenses associated with an overseas listing.[257] Currently, six Chinese companies trade on the LSE, and trading volumes of their stocks are reported to be relatively low.[258] One interviewee pointed out, however, that there are companies in certain industries that reap a greater benefit from listing on the LSE; London has been particularly successful at attracting companies in the mining, energy, banking, and medical and pharmaceuticals sectors.[259]

In recent years, London's Alternative Investment Market has actively pursued Chinese companies that might otherwise opt for NASDAQ, or Hong Kong's GEM board. It now lists 14

251. *See* Interview US-B-2, US-GC-2, US-R-1.

252. *London Stock Exchange Steps up Efforts to Attract Chinese Listings*, AFX NEWS LTD., May 29, 2005, *available at* http://www.forbes.com/markets/feeds/afx/2005/09/21/afx2237770.html.

253. *Id.*

254. *See* interview notes, US-B-1, US-B-2, US-L-1, US-L-2, US-L-3 (on file with Journal of Law & Business).

255. Interview notes, US-B-1 (on file with Journal of Law & Business).

256. Interview notes, US-L-1 (on file with Journal of Law & Business).

257. *Id.*

258. Barr, *supra* note 82.

259. *See* interview notes, US-B-2 (on file with Journal of Law & Business).

Chinese companies, including eight listings in 2005, up from four in 2004.[260] One example is EBT Mobile China, a non-British tech company with an American managing director, which chose to list on AIM instead of NASDAQ and raised approximately $7 million. Jim Reiman, EBT's Chicago-born chief executive, acknowledged that while EBT might have received a higher valuation on NASDAQ, AIM serves as an international market where an early to mid-stage small company with a limited track record could raise money.[261] Another significant AIM listing is that of Asian Citrus, the largest orange plantation operator in China, a listing which raised about $21 million.[262] The LSE calculates that the cost of floating on AIM is between 4.5-5 per cent of funds raised compared to 6-8 per cent in the U.S. .[263] Despite the attractions of AIM, however, to date there have been few major listings on the exchange. Undermining LSE listings is the ease with which Chinese issuers can place equity in the hands of European investors via private placements. If anything, one interviewee asserted, Chinese companies appear to be waiting for Shanghai to develop as a second market, despite the potential delay in such a development.[264]

2. *Japan*

Chinese firms are finding listing on Japan's Tokyo Stock Exchange (TSE) as an increasingly attractive alternative. The TSE is now aggressively courting companies in the Asia region; Mr. Moriyuki Iwanaga, who is in charge of implementing the new strategy at the TSE, commented, "We have a lot to offer companies in China and other fast-growing parts of Asia."[265] One attractive feature of raising capital in Japan is its "public offer without listing" (POWL) provision. According to Robert DeLaMater in his testimony before the U.S.-China Economic and Security Review Commission, "[t]his offering structure permits a company to conduct a public offering without being

260. *Exchanges Woo Chinese Firms*, *supra* note 22.
261. Kate Burgess, *London's Aim Steals a March on Nasdaq*, FIN. TIMES (London), Sept. 5, 2005, at 1.
262. *Exchanges Woo Chinese Firms*, *supra* note 22.
263. Burgess, *supra* note 261, at 1.
264. Interview notes, US-L-2 (on file with Journal of Law & Business).
265. Andrew Morse, *Tokyo Seeks to be All-Asia Stock Exchange*, WALL ST. J., Apr. 6, 2006, at C1.

required. . . to assume the burdens of a public listing and the ongoing disclosure and other obligations that a public listing would entail."[266] In late 2004, Xinhua Finance, the financial news wire partially held by Beijing's central news agency Xinhua, became the first non-Japanese firm to get a primary listing on the Tokyo Stock Exchange's Mothers Board.[267] One interviewee in particular was quite bullish about Japanese equity markets, especially as related to media and tech companies.[268] Many Chinese companies, he explained, believe Japan offers the "best bang for the buck," as it provides great liquidity and profiling at a lower cost than the U.S. .[269] Furthermore, because of the close proximity of the Asian markets, investors in Japan are familiar with the Chinese stock story.

3. *Singapore*

Finally, Singapore is also trying to gain prominence as a leading international securities market, but investors generally view it as a smaller and weaker market that provides companies with little liquidity post-filing. One interviewee suggested that companies only go to Singapore for political reasons.[270] However, because it is a more lax market with lower regulatory hurdles, Singapore often attracts Chinese companies that are unable to meet the requirements of the Hong Kong Exchanges & Clearing.[271] One interviewee indicated that, within Asia, Hong Kong is a more attractive market, and that this is especially true since Chinese issuers are still able to attract Singaporean investors even if they list in Hong Kong.[272] Indeed, Singapore is the largest Asian source of overseas investor trading in both cash and derivatives in Hong Kong.[273] This investment activity likely originates from international fund houses

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266. *Hearing on China's Strategy*, *supra* note 76, at 2 (statement of Robert DeLaMater, Partner, Sullivan & Cromwell LLP).

267. *See* Press Release, Mergent, Inc., Xinhua Finance Begins Trading on the Tokyo Stock Exchange Mothers Market (Oct. 28, 2004), *available at* http://www.mergent.com/publish/newsDetail230.asp (quoting Fredy Bush, CEO of Xinhua Finance).

268. Interview notes, US-GC-2 (on file with Journal of Law & Business).

269. *Id.*

270. *See* interview notes, US-B-3 (on file with Journal of Law & Business).

271. *Id.*

272. *See* interview notes, US-R-1 (on file with Journal of Law & Business).

273. Essie Tsoi, *Understanding Investors in the Hong Kong Listed Securities and Derivatives Markets*, SFC Q. BULL., Summer 2004, at 42, *available at* http://

that have based their regional operations in Singapore and are free to invest in overseas markets.[274]

IV.
THE GLOBALIZATION OF INTERNATIONAL CAPITAL MARKETS

Finally, an emerging theme from the interviews was that U.S. investors are becoming increasingly indifferent to where a company is listed.[275] As a result, making listing decisions on the basis of attracting a specific investor base is a less compelling factor that it once was. It was once the case that many large U.S. institutional investors could only invest in domestically-listed securities; in recent years, however, large mutual funds have changed their charters to allow their fund managers to invest in non-U.S. stocks.[276] In fact, many U.S. mutual funds have established portfolio allocation targets for Chinese stocks. As Michael Geczi testified before the U.S.-China Economic and Security Review Commission, "Given the globalization of world markets over the past decade, the issue of whether a PRC stock is listed in the U.S. or in Hong Kong has gotten very close to being irrelevant. The fact is, U.S.-based institutional investors do not limit their investments to shares listed only on U.S. exchanges."[277] While European companies' institutional investors have long maintained offshore operations, American companies have only recently changed their mode of operations.[278] The establishment of Asian offices for many large U.S. funds has contributed to the diminishing importance of U.S. listings. Previously, as one lawyer explained, a 144A listing required issuers and their professionals to do a road show and visit U.S. offices of investment funds in order to drum up interest.[279] This is no longer necessary since it has become easier for potential issuers to approach Asian branches of U.S. funds. Capital markets have become

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www.sfc.hk/sfc/html/EN/speeches/public/bulletin/sfc_bulletin/summer_04.html.

274. *Id.*

275. *See, e.g.*, interview notes, US-B-1, US-B-3 (on file with Journal of Law & Business).

276. Interview notes, US-B-2 (on file with Journal of Law & Business).

277. *Hearing on China's Strategy*, *supra* note 76, at 12 (testimony of Michael Geczi, Managing Dir. of The Torrenzano Group).

278. Interview notes, US-B-3 (on file with Journal of Law & Business).

279. Interview notes, US-L-1 (on file with Journal of Law & Business).

truly global, and this fundamental change has dramatically altered the traditional fund raising practices of Chinese firms.

American investors are particularly attracted to Chinese companies. Investors are looking for growth and value, and China, with an economy that is growing at 8% or 9% annually, provides that necessary growth. Large, well-managed SOEs are perceived to be high quality investment opportunities and have become the targets of large funds, no matter where they list. Because these companies are in high demand, they often do not pursue a U.S. public offering for valuation purposes; at most they will consider a 144A or dual listing. Investors are also especially attracted to the growth of the Internet in China, and thus Chinese technology companies are particularly popular investment targets.

While globalization is flattening the landscape of international capital markets, there is still a large base of U.S. domestic institutions and retail investors who only buy U.S.-listed securities.[280] For example, in the Hong Kong market, overseas investment activity is dominated by institutions; direct investment by overseas retail investors is quite minor (contributing to less than 5% of trading activity).[281] While a dual listing would enable corporations to access domestically-focused investors, one interviewee noted that this would only impact the initial valuation of the company, and thus is not a significant consideration.[282]

The enhanced presence of the Qualified Institutional Buyers (QIBs) in China has ensured a ready supply of foreign capital. In Hong Kong, there are a number of thriving U.S. and U.K. brokerage firms, many of which belong to large global conglomerate groups. These firms serve as the brokerage arms for executing orders channeled from their sister companies in their countries of origin. Another source of foreign capital is global investment banks' private wealth clients, who can access shares through the Asian offices of their banks.

Most U.S. retail investors can only hold Chinese equities through their mutual funds. The typical China-focused mutual fund ("China Fund") invests sixty percent of its assets in Hong Kong stocks, with the remaining forty percent split be-

280. *Id.* (on file with Journal of Law & Business).
281. Tsoi, *supra* note 273, at 41.
282. Interview notes, US-B-3 (on file with Journal of Law & Business).

tween mainland and Taiwan firms.[283] These funds often invest in other countries in the region or companies that have a presence in China.[284] Because many retail investors are unable to access accurate and timely information about shares listed on Chinese exchanges in Hong Kong, Shenzhen, and Shanghai, they rely exclusively on mutual fund managers to make investment decisions based on their on-the-ground research.[285]

Jackson and Pan commented that European issuers found as a substantial issue the apparent tendency of shares held in ADR form in the U.S. to "flow back" to the issuers' primary market in Europe.[286] Generally, however, the interviewees did not think that securities flow-back has been a major concern for Chinese issuers.[287] The only anecdotal evidence offered was the significant flow-back for shares from London to Hong Kong after Air China's listing in London in December of 2004.[288] One interviewee mentioned that flow-back can occur when the ADR tranche of a listing is not large enough to support adequate U.S. trading volumes, thereby leading investors to prefer trading in the more liquid home market shares.[289] This has rarely been a problem because companies that choose to list in the U.S. are typically substantial enough to issue a large ADR tranche; moreover, companies often anticipate flow-back and take steps to alleviate its impact.[290] Finally, because there have been fewer dual listings recently, flow-back has not been a significant issue; unlike European issuers that simultaneously list on a European exchange[291], Chinese companies that list exclusively on NASDAQ do not have major Asian trading markets that create incentives for investors to trade in.

283. Len Boselovic, *Heard Off the Street: China Funds Can Offer Nice, Bumpy Ride*, PITTSBURGH POST GAZETTE, Feb. 23, 2004, *available at* http://www.post-gazette.com/pg/04054/276031.stm.

284. *Id.*

285. *See id.*

286. Jackson & Pan, *supra* note 71, at 61.

287. Interview notes, US-B-1, US-L-1, US-L-2 (on file with Journal of Law & Business).

288. *See* interview notes, US-GC-1 (on file with Journal of Law & Business).

289. Interview notes, US-B-1 (on file with Journal of Law & Business).

290. *Id.*

291. Jackson & Pan, *supra* note 71, at 63.

V. CONCLUSION

The current SEC regulatory regime certainly poses some difficulties for Chinese issuers seeking access to the U.S. capital markets. Wary of greater liability under Sarbanes-Oxley, and the possibility of being sued in U.S. courts, Chinese companies are raising capital in other markets, such as Hong Kong. Receptive investors have enabled Chinese companies to raise very substantial amounts of capital on other exchanges, and the increasing ability of U.S. investors to participate on foreign exchanges has made it easier to tap U.S. investors without having to directly access U.S. capital markets. Just as Professor Jackson and Eric Pan pointed out that Rule 144A offers European issuers an important alternative path to raise capital in the United States[292], Chinese issuers are also increasingly turning to U.S. private placements alongside local offerings. What this implies for the issuer choice debate is that instituting regulatory competition may not actually have a meaningful effect on issuers, many of whom have already discovered alternate means to access U.S. investors without the costs and delay of the SEC registration process.

Thus, to a certain degree, an issuer choice regime of sorts already exists for Chinese issuers. Similar to the European issuers whom Jackson and Pan found were dissatisfied with the success of past public offerings in developing long-term market interest in the U.S.[293], Chinese issuers find that public listings may not always generate a strong U.S. following. In order to avoid more stringent securities regulations, Chinese issuers often choose to list in Hong Kong instead of the U.S. with no significant repercussions. Moreover, the size and liquidity advantages of U.S. markets have lessened in the eyes of Chinese issuers. In 2001, Jackson and Pan found that certain European offerings, particularly in the context of large-scale state privatizations, were so large that they almost inevitably included a public U.S. offering.[294] Recently, however, large SOEs in China have no qualms about listing in Hong Kong alone. In certain industries, such as technology, in which companies are unsatisfied with the profit requirements and the merit-based

292. *Id.* at 4.
293. *Id.* at 29.
294. *Id.* at 24-25.

approach of the Hong Kong GEM board, however, Chinese issuers maintain a strong preference for exclusive listings on NASDAQ.

Exchanges in London, Japan, Singapore, and Mainland China are also under competitive pressure to improve their regulatory regime in order to attract Chinese companies. This has essentially created a seller's market for Chinese companies and may lead to less effective systems of investor protection. In general, demand has been so high for Chinese offerings that companies have had little incentive to improve their transparency. Despite the fact that many Chinese firms continue to disclose only the minimum required information, their issues have been many times oversubscribed. The China Life IPO, for instance, generated $80 billion of demand while only seeking to raise $3 billion through its offering.[295]

Paul French of AccessAsia in Shanghai describes the situation: "It [is] a seller's rather than a buyer's market and. . .[that] makes the investment process far more speculative than it might appear. Given pitiful dividends and hazy results, most investors are betting on China's future" rather than the futures of the specific Chinese companies in which they are investing.[296] Concerns about corporate governance and transparency will likely remain until there are more stringent regulatory requirements; calls for tougher regulations, however, probably will not occur until the IPO rush slows down. Moreover, it appears difficult to rely on gatekeepers to monitor the quality of company disclosure. Some analysts have estimated that Chinese IPOs are expected to generate approximately $550 million in profits and fees for securities firms assisting companies in the listing process. Although this figure represents only one third of the fees derived from U.S. listings, it surpasses income attributable to European listings for the first time.[297] In competing for business, it is unclear whether underwriters have sufficient incentive to exercise appropriate vigilance when seeking out material risks to investors as part of their due diligence efforts. Therefore, although regulatory

295. Iyengar, *supra* note 109.

296. *See, e.g.*, Debbie Harrison, *Beware the Sting in the Dragon's Tail*, FIN. TIMES (London), July 30, 2005, at 22.

297. *Hearing on China's Strategy*, *supra* note 76, at 115 (statement of Howard Chao, Asia Practice Head, O'Melveny & Myers LLP).

competition may be the panacea for the weakening popularity of U.S. exchanges, regulators must also be cognizant of the massive fallout that could occur should they condone lower disclosure standards.

APPENDIX A

Interview Form – Foreign Issuers Seeking Access to U.S. Capital Markets

Name of Interviewee:
Email Address:
Position:
Firm:
Date:

Preliminary Questions

For Lawyers:

How many years have you been practicing law?
Of which bars are you a member?
How many lawyers are there in your firm?
How many lawyers are there in the Hong Kong office?
What percentage of the lawyers in the Hong Kong office are members of a U.S. bar?
Where is the headquarters of your firm?

For bankers:

How many years have you been in the industry?
How many bankers are there in your firm?
How many bankers are there in the Hong Kong office?
How many bankers are there in the capital markets department?
Approximately what percentage of the bankers in the Hong Kong office are U.S.-educated?
Where is the headquarters of your firm?

General Information

Approximately how many transactions involving Chinese issuers raising capital in the U.S. market has this office worked on in 2004 and 2005?
What is the percentage breakdown between equity and debt?
What is the percentage breakdown between primary and secondary offerings?
With how many of these transactions were you directly involved?
What was the range of size of offerings (U.S. $)?

What was the average size of the issuers in terms of market capitalization?
What is the percentage breakdown between issuer and underwriter representation for your firm?

Offering Options

Of the transactions involving sale of securities into the U.S., what is the percentage breakdown among public offerings, Rule 144A offerings, and traditional private offerings?
In the public deals, typically what percentage of the deal is sold into the U.S.?
How are the shares typically held, in ADR form or offshore?
In 144A deals, what percentage of the deals is typically sold to U.S. investors?

The Menu of Choices

What are the main reasons for Chinese issuers to access U.S. capital markets?
What are the main barriers for Chinese issuers in accessing U.S. capital markets?
Have any of your clients encountered actual problems with accessing the U.S. capital markets (in particular, due to new requirements of the Sarbanes-Oxley Act)? Please describe.
Have any of your clients changed the structure of their transactions (including those who have dropped the U.S. component entirely) due to perceived problems with accessing the U.S. capital markets (in particular, due to new requirements of the Sarbanes-Oxley Act)? Who was responsible for making that decision? Please describe.
In addition to the U.S. market, in what other markets have Chinese issuers raised capital? LSE/AIM?
How do these markets compare to the U.S.? Do you think these markets will become more attractive going forward? Lighter regulatory regime?
If a Chinese issuer chooses not to enter U.S. capital markets, can and do U.S. investors find alternative ways to invest in such an issuer in offshore markets?

Role for Advisors

Do you typically assist issuers in deciding how to access U.S. capital markets?

What are the factors that you typically consider, both in regards to when and how Chinese issuers should access the U.S. capital markets, and the various ways of accessing U.S. markets?

Who are the most important individuals in deciding whether and how to raise capital in the U.S. – management of the Issuer, the banker, or the attorney?

Securities Flow-Back

Are you aware of any transactions in which shares sold into the U.S. are originally taken in ADR form, and are exchanged overtime from the ADR depository in return for original shares?

To what extent are issuers concerned about flow-back?

APPENDIX B: CHINESE COMPANIES LISTED ON U.S. EXCHANGES

As Of: December 31, 2005

NASDAQ:

Company	Ticker	Exchange	Listing Date
Actions Semiconductor Co.	ACTS	NASDAQ	12/5/05
Vimicro International Corp.	VIMC	NASDAQ	11/18/05
China Medical Technologies	CMED	NASDAQ	8/9/05
Baidu.Com, Inc.	BIDU	NASDAQ	8/4/05
Comtech Group Inc.		NASDAQ	07/15/05
Focus Media Holding	FMCN	NASDAQ	7/12/05
China Techfaith Wireless Communications	CNTF	NASDAQ	5/5/05
Hurray! Holding Company	HRAY	NASDAQ	2/3/05
Ctrip.com International	CTRP	NASDAQ	12/15/04
The9 Ltd.	NCTY	NASDAQ	12/14/04
Ninetowns Digital World Trade Hlds.	NINE	NASDAQ	12/8/04
eLong Inc.	LONG	NASDAQ	10/28/04
China Finance Online Co. Ltd.	JRJC	NASDAQ	10/15/04
51job Inc.	JOBS	NASDAQ	9/29/04
KongZhong Corp.	KONG	NASDAQ	7/9/04
Shanda Interactive Entertainment	SNDA	NASDAQ	5/13/04
Tom Online	TOMO	NASDAQ	3/11/04
Linktone Ltd	LTON	NASDAQ	3/9/04
Ctrip.com International	CTRP	NASDAQ	12/12/03
Sohu.com Inc	SOHU	NASDAQ	7/12/00
Netease.com Inc	NTES	NASDAQ	6/29/00
Sina Corp	SINA	NASDAQ	4/13/00
Asiainfo Holdings	ASIA	NASDAQ	3/3/00
Qiao Xing Universal Telephone Inc.	XING	NASDAQ	02/18/99

Company	Ticker	Exchange	Listing Date
Beijing Beida Jade Bird Universal Sci-Tech	BJBJY	OTC	12/20/05
Ping An Insurance Group	PNGAY	OTC	3/28/05
Chinacast Communication Holdings	CCHYY	OTC	12/6/04
Harbin Power Equipment Company	HPECYP	OTC	12/1/04
Hopewell Highway Infrastructure	HHILY	OTC	4/26/04
China Oilfield Services	CHOLY	OTC	3/26/04
Far East Pharmaceutical Technology	FEPTF	OTC	3/2/04
Tianjin Capital Environmental Protection	TCEPY	OTC	12/23/03
Jiangxi Copper Co.	JIXAY	OTC	10/7/03
Travelsky Technology	TSYHY	OTC	12/27/02
Jiangsu Expressway Co.	JEXYY	OTC	12/23/02
Angang New Steel Company	ANGGY	OTC	12/6/02
Guangzhou Pharmaceutical Company	GZPHY	OTC	6/21/02
Zhejiang Expressway Co.	ZHEXY	OTC	2/14/02
Datang International Power Generation	DIPGY	OTC	9/4/01
Zhejiang Southeast Electric Power Co.	ZHJGYP	OTC	9/11/97
Shanghai Jinqiao Processing Dev. Co.	SJQIY	OTC	7/1/96
Shanghai Lujiazui Finance & Trade Zone Development	SLUJY	OTC	7/1/96
China Shipping Development	CSDXY	OTC	3/1/96
Tingyi (Cayman Islands) Holdings Corp.	TINGYP	OTC	2/1/96
Tsingtao Brewery Co.	TSGTY	OTC	2/1/96
Shanghai Tyre and Rubber Co	SIRHY	OTC	10/1/95
Guangzhou Shipyard International	GSHIY	OTC	7/13/95
Shanghai Waigaoqiao Free Trade Zone	SGOTY	OTC	5/1/95
Qingling Motor Co.	QIGPP	OTC	8/11/94
Shenzen S.E.Z. Real Estate and Properties	SZRY	OTC	8/1/94
Yizheng Chemical Fibre Co.	YIRPP	OTC	3/25/94
Shanghai Chlor-Alkali Chemical Co.	SLLBY	OTC	3/1/94
Shanghai Erfangji Co.	SHFGY	OTC	12/1/93
Sinovac Biotech Ltd.	SVA	AMEX	
Tiens Biotech Group USA Inc.	TBV	AMEX	

NYSE:

Company	Ticker	Exchange	Listing Date
Suntech Power Holdings Co.	STP	NYSE	12/14/05
China Netcom Group Corp Hk Ltd	CN	NYSE	11/16/04
Semiconductor Manufacturing International	SMI	NYSE	3/17/04
China Life Insurance	LFC	NYSE	12/17/03
Huaneng Power Intl	HNP	NYSE	8/19/03
China Telecom Corp.	CHA	NYSE	11/14/02
Aluminum Corp of China	ACH	NYSE	12/11/01
CNOOC Ltd	CEO	NYSE	2/27/01
China Petroleum & Chemical Corp.	SNP	NYSE	10/18/00
China Unicom	CHU	NYSE	6/21/00
Brilliance China Automotive	CBA	NYSE	4/17/00
PetroChina Co Ltd	PTR	NYSE	4/06/00
Yanzhou Coal Mining	YZC	NYSE	3/31/98
China Mobile (Hong Kong)	CHL	NYSE	10/22/97
China Southern Airlines	ZNH	NYSE	7/30/97
China Eastern Airlines	CEA	NYSE	2/04/97
Guangshen Railway	GSH	NYSE	5/13/96
Jilin Chemical Ind	JCC	NYSE	5/22/95
China Yuchai Intl	CYD	NYSE	12/16/94
Sinopec Shanghai Petrochemical Co.	SHI	NYSE	7/26/93

Source: Thomson Financial Services Data, Yahoo! Finance (http://finance.yahoo.com), Bank of New York ADR-DR Directory, (http://160.254.123.37/dr_directory.jsp?country=cn)