LISTING DESTINATION OF CHINESE COMPANIES: NEW YORK OR HONG KONG?

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I. INTRODUCTION

The financial crisis that began in 2008 disrupted capital market activity and led to a decline in the number of IPOs worldwide. China was no exception to this trend, as reflected by the decline in IPOs on the country's stock exchanges, which fell by 35% in 2008 as compared to 2007.[1] Given this sluggish supply of new public offerings, the world's stock exchanges will increasingly compete for IPO listings.

Among the major financial capitals, China was the largest listing market in the world by funds raised in 2009.[2] In 2006, the Hong Kong Stock Exchange ("HKSE") raised more capital in its IPOs than the New York Stock Exchange ("NYSE") for the first time in history.[3] This pushed the HKSE to the number two spot in the world IPO market, trailing behind only the London Stock Exchange ("LSE").[4] This prompted multiple government officials in Hong Kong to claim that it had come of age as a true international financial center.[5] The HKSE continued to lead NYSE in funds raised through IPOs in 2007, though NYSE reclaimed its lead in 2008.[6] On the other hand, the declining IPO market along with the rise of the LSE have raised serious concerns in the United States, prompting the government as well as academics to look for explanations and suggestions for the NYSE to reclaim its status as the number one financial center in the world, including in-depth analyses from the legal perspective.[7] While most commentators have focused on comparisons between the NYSE and the LSE, this note focuses on a neglected but important area, the comparison of the IPO markets of Hong Kong and New York. In particular, it focuses on the choice of the Chinese companies, arguably the largest IPO clients in the world at present.

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[1] PriceWaterhouseCoopers, China/Hong Kong Capital Market Services Group, *Greater China IPO Watch 2008 12-13 (2009)*, *available at* http://www.pwccn.com/webmedia/doc/633795312509403786_gc_ipo_survey_rpt_jun2009.pdf.

[2] PricewaterhouseCoopers, *Funds Raised Through IPOs May Exceed RMB320 Billion in 2010*, Jan. 4, 2010, http://www.pwccn.com/home/eng/pr_040110.html.

[3] PricewaterhouseCoopers, *supra* note 1, at 12.

[4] *Id.* at 13.

[5] William Foreman, *Hong Kong Is No. 2 at Launching IPOs*, MERCURYNEWS.COM, Jan. 2, 2007, http://www.mercurynews.com/search/ci_4936287?nclick_check=1 (quoting Frederick Ma, Secretary for Financial Services and the Treasury of Hong Kong: "If China becomes a large economy rivaling the U.S., then Hong Kong will grow to the extent of New York and London.").

[6] PricewaterhouseCoopers, *supra* note 1, at 12.

[7] *See generally* Charles E. Schumer & Michael R. Bloomberg, *To Save New York, Learn from London*, WALL ST. J., Nov. 1, 2006, at A18. For legal analyses, see generally John C. Coffee, Jr., *Racing Towards The Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (2002).

A. Why Do Chinese Companies Matter?

According to the World Bank, China was the third largest economy in the world by GDP in 2008.[8] Since 2003, China has enjoyed a double-digit annual GDP growth, with 11.6% and 11.9% growth in 2006 and 2007, respectively.[9] It is predicted that China will soon take over Japan and become the second largest economy in the world.[10] Thus, there is little doubt that China is one of the most, if not the most, important developing economies in the world.

China is also home to some of the largest corporations in the world. According to the Fortune Global 500, in 2009, China is number five in terms of the number of corporations listed on the Fortune Global 500, which ranks the largest companies in the world.[11] The recent IPOs of some of these companies have a huge impact on capital markets around the world. For example, three of the top ten IPOs in the world in 2008 were from China.[12] The rise of the HKSE in 2006 can also be attributed to the IPOs of two mainland China banks, namely, the Bank of China and the Industrial and Commercial Bank of China ("ICBC"). These IPOs ranked number six and number one in world history in terms of size, respectively.[13] If these banks had decided to list in New York (either on NYSE or Nasdaq) instead of the HKSE, Hong Kong would have never taken the lead over New York. If China continues its growth, it is expected that the increase in capital demand will encourage more Chinese companies to seek IPOs overseas. Whichever market manages to meet this demand is going to have a better chance in dominating world IPOs markets.

B. Scope of this Note

Choosing a stock exchange for an IPO is an important decision for a company that can be determined by a number of factors. While it is impossible to identify them all, this note attempts to analyze the legal factors affecting choice of the listing venue for IPOs. Meanwhile, an equally important purpose of this note is to compare the two systems through the

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[8] World Bank, World Development Indicators Database (2009), *available at* http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf.

[9] World Bank, China Economic Indicators (2008), *available at* http://siteresources.worldbank.org/CHINAEXTN/Resources/chinaci.pdf.

[10] *China Economy Shows Strong Growth in 2009*, BBC, Jan. 21, 2010, http://news.bbc.co.uk/2/hi/8471613.stm.

[11] Fortune Magazine, Global 500: Our Annual Ranking of the World's Largest Corporations 2009, *available at* http://money.cnn.com/magazines/fortune/global500/2009/countries/Australia.html.

[12] PricewaterhouseCoopers, *supra* note 1, at 11.

[13] *Id.*

eyes of the Chinese companies. The note is organized as follows: section II will compare the initial listing requirements, particularly the financial requirements, of New York and Hong Kong; section III will compare the disclosure requirements of New York and Hong Kong, including requirements in the listing documents and the post-listing ongoing compliance responsibilities; and section IV will discuss the often-debated litigation risk for Chinese companies listing in New York and Hong Kong.

II. LEGAL REQUIREMENTS OF LISTING

A. Financial Criteria

The following discussion regarding listing in Hong Kong is confined to the Main Board of the HKSE.[14] Both the major exchanges in New York, namely NYSE and Nasdaq, and the HKSE have set forth detailed listing requirements. The starting point is the threshold financial requirements that the issuer must satisfy for listing.[15] The basic financial requirements of the HKSE are set forth in Rule 8.05 of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the "Hong Kong Listing Rules").[16] The major requirements are summarized in the table below:[17]

[14] The other board in Hong Kong, the Growth Enterprise Market (the "GEM"), has another set of different but similar listing rules. However, due to its limited success since its establishment, it will not be discussed in detail. In 2007, the GEM board only raised $0.2 billion, compared with $37.8 billion raised by the Main Board. Foreman, *supra* note 5, at 3.

[15] There is not a lot of academic writing on the comparison of listing between Hong Kong and New York. Out of the few articles that address relevant topics, such as Erica Fung, *Regulatory Competition in International Capital Markets: Evidence from China in 2004-2005*, 3 N.Y.U. J. INT'L L. & BUS. 243 (2006), and Joseph F. Daniels, *Comparing U.S. and Hong Kong Public Offering Regulation: How Cost-Effective is China's Primary Capital Market?*, 69 S. CAL. L. REV. 1821 (1996), none of them discusses any listing requirement under the Hong Kong Listing Rules, not to mention the financial requirements therein.

[16] Hong Kong Stock Exchange, Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited Rule 8.05 (2008), *available at* http://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/listrules.htm (last updated on Sep. 1, 2008) [hereinafter Hong Kong Listing Rules].

[17] Hong Kong Stock Exchange, Basic Listing Requirements for Equities ("Hong Kong Listing Rules"), Apr. 7, 2008, http://www.hkex.com.hk/eng/listing/listreq_pro/listreq/equities.htm. The table is derived from the HKSE website, *available at* http://www.hkex.com.hk/issuer/listhk/equities.htm.

	1. Profit Test	2. Market Cap/ Revenue Test	3. Market Cap/ Revenue/Cash Flow Test
Profit Attributable to Shareholders	At least HK$50 million (US$6.4 million) in the last three fiscal years (with [net] profits of at least HK$20 million (US$2.6 million) recorded in the most recent year, and aggregate [net] profits of at least HK$30 million (US$3.8 million) recorded in the 2 years before that)	—	—
Market Cap	At least HK$200 million (US$26 million) at the time of listing	At least HK$4 billion (US$513 million) at the time of listing	At least HK$2 billion (US$256 million) at the time of listing
Revenue	—	At least HK$500 million (US$64 million) for the most recent audited financial year	At least HK$500 million (US$64 million) for the most recent audited financial year
Cash Flow	—	—	Positive cash flow from operating activities of at least HK$100 million (US$13 million) in aggregate for the three preceding financial years

In order to qualify for the HKSE, an issuer must have a trading record of three financial years and satisfy one of the three tests above. As shown in the table, the logic of Rule 8.05 is to establish basic financial thresholds. The com-

pany must have proven its ability to make a certain level of net profits for its shareholders (i.e., pass the Profit Test) or compensate by having a much larger market capitalization, substantial revenue base, and/or strong cash flow (*i.e.*, pass the Market Cap/Revenue Test or the Market Cap/Revenue/Cash Flow Test). However, in practice, the majority of Hong Kong-listed companies qualify under the Profit Test.[18] In fact, pursuing listing under the Market Cap/Revenue Test or the Market Cap/Revenue/Cashflow Test is so rare that it would be regarded as an exception.

One of these exceptions could be found in the listing of Semiconductor Manufacturing International Corporation ("SMIC"), one of the largest semiconductor manufacturers in the world, which actually incurred substantial losses prior to its listing in Hong Kong.[19] As a result, it had to rely on passing the Market Cap/Revenue Test. However, even though the company clearly satisfied the Market Cap/Revenue Test, the prospectus showed that SMIC still applied for a waiver due to its failure to comply with the Profit Test.[20] It is likely that such requirement for a waiver was actually demanded by the HKSE itself. In addition, the first two risk factors set forth in the prospectus are (1) "our short operating history makes it difficult to evaluate our business and prospects" and (2) "we have incurred significant operating losses since our inception, may continue to incur substantial operating losses in the future and may not be able to achieve or maintain profitability."[21] While it is often said that risk factors are the "cheapest insurance" an issuer can buy, these risk factors, particularly the latter one, are rare.[22] Again, it is suspected to be a request by the HKSE.[23] In summary, the SMIC case clearly indicates great difficulties

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[18] While there are no readily available data on this, the author has had discussions on this issue with a number of leading legal practitioners in Hong Kong, and they all agreed with this observation. The interviewed practitioners requested to remain anonymous. They are partners and senior associates practicing at major international law firms in Hong Kong and all have substantial experience with the large IPOs in Hong Kong.

[19] According to SMIC's prospectus, since it was founded in April 2000, it had incurred significant operating losses, amounting to US$0.9 million in 2000, US$27.7 million in 2001, US$116.3 million in 2002 and US$72.7 million in 2003. Semiconductor Manufacturing International Corporation, Global Offering, at 23 (Mar. 8, 2004), *available at* http://www.hkexnews.hk/listedco/listconews/schk/20040308/LTN20040308000.htm (2004).

[20] "We have incurred net losses attributable to shareholders in each of the three years ended December 31, 2001, 2002 and 2003, respectively. Accordingly, we have requested and been granted by the Hong Kong Stock Exchange *a waiver from the requirements of Rule 8.05 of the Listing Rules* to have [satisfied the requirements under the Profit Test], to be permitted to list on the [HKSE] on the basis that we have or will have [satisfied the Market Cap/Revenue Test]." *Id.* at 6 (emphasis added).

[21] *Id.* at 23.

[22] Observation supported by interview conducted by author with a senior partner from an international law firm in Hong Kong, July 16, 2008.

[23] The HKSE could practically require SMIC to apply for a waiver on this matter as Rule 8.04 of the Hong Kong Listing Rules provides that the company and its business must, in the opinion of the HKSE, be suitable for listing. Hong Kong Listing Rules, *supra* note 16, Rule 8.04.

for a company to list in Hong Kong without satisfying the three-year profit-making track record required by the Profit Test.

In connection with the listing requirements under the New York regime, the Securities and Exchange Commission ("SEC") does not lay down any financial criteria. Instead, like Hong Kong, both NYSE and NASDAQ have set forth the relevant requirements. Upon first glance, while the specific thresholds vary among different divisions of the exchanges, they all utilize similar measuring tools, such as earnings, market capitalization revenues, and cash flow.[24] The NYSE has generally higher financial requirements than the NASDAQ.[25] The following table summarizes the relevant financial criteria of the NASDAQ Global Market, the middle-tier division on the NASDAQ market that is often chosen by Chinese companies seeking to list in New York:[26]

Financial Requirements	**Standard 1**	**Standard 2**	**Standard 3**
Stockholders' equity	$15 million	$30 million	N/A
Market value of listed securities **or** Total assets and Total revenue	—	—	$75 million **or** $75 million and $75 million
Income from continuing operations before income taxes (in latest fiscal year **or** in two of last three fiscal years)	$1 million	—	—
Operating history	—	Two years	—

In order to satisfy the financial criteria of the NASDAQ Global Market, a company must meet all of the conditions under at least one of the three standards above. Looking at these standards, Standard 1 is similar to the HKSE's Profit Test, substituting market capitalization (the market

[24] PATRICK J. SCHULTHEIS, ROBERT G. DAY, J. RANDALL LEWIS, SHAWN J. LINDQUIST & ROBERT G. O'CONNOR, THE INITIAL PUBLIC OFFERING: A GUIDEBOOK FOR EXECUTIVES AND BOARDS OF DIRECTORS A1-A3 (Bowne 3rd ed. 2008) (providing a good summary of the different listing requirements of each exchange).

[25] *Id.*

[26] *Id.* at A2.

value of the company) with stockholders' equity (the book value of the company). Standard 3 is similar to the HKSE's Market Cap/Revenue Test. While no standard requirement for the measurement of cash flow exists, the concept is similar nonetheless, so as the absence of an identical match of Standard 2 under the Hong Kong Listing Rules. However, despite these qualitative similarities, standards for the two exchanges are different in quantitative terms. First, NASDAQ's Standard 1 only requires a *pre-tax* income of one million, either in the latest fiscal year *or* two of the last three fiscal years. The Profit Test in Hong Kong requires US$6.4 million in the last *three* fiscal years (with *net* profits of at least $2.6 million in the latest fiscal year, and aggregate net profits of at least $3.8 million in the two years before that). By the same token, Standard 3 only requires a market capitalization of $75 million, while the Market Cap/Revenue/Cash Flow Test requires a market capitalization of $256 million, and the Market Cap/Revenue Test requires even more. In addition, the three-year operating history requirement is mandatory for all three tests in Hong Kong, while only Standard 2 has a requirement of two years of operating history.

The simple conclusion that could be drawn from this comparison is that a listed company in Hong Kong will be likely to satisfy the financial criteria of the NASDAQ Global Market, but a listed company of the NASDAQ Global Market may not satisfy the financial criteria of the HKSE. This conclusion appears to be more convincing considering the fact, as discussed above, that HKSE treats the Profit Test as a mandatory test. Accordingly, a company with two years of losses but with a stockholders' equity of 30 million could presumably be listed on the NASDAQ Global Market. This suggests that Chinese companies might choose to list in New York because they could not satisfy the financial requirements of HKSE. This is supported by the recent IPO trend. The author conducted research on ten Chinese companies, which listed in New York during the twelve months between November 2007 and October 2008.[27] Of these ten companies listed during this period, only five could qualify under the financial criteria of the HKSE. In fact, two of these companies suffered significant losses prior to their respective listings.[28]

Compared to the HKSE, the NASDAQ's lower thresholds might attract a larger number of companies. This has apparently given it an edge over Hong Kong in attracting these smaller companies. This is particular-

[27] These companies are ATA Inc., China Distance Education, China Mass Media International Advertising, ChinaEdu Corporation, Gushan Environmental Energy, RenoSola, VanceInfo Technologies Inc., VisionChina Media, WSP Holdings Limited, and Xinyuan Real Estate. All of these companies were priced during the said twelve months period. Details of their listing and financial information could be obtained in EDGAR at http://www.sec.gov/edgar.shtml.

[28] These companies are ATA Inc. and VisionChina Media.

ly so when one looks at the Chinese companies that have listed in New York over the said twelve-month period. The largest IPO is Xinyuan Real Estate, which raised $245 million. While $245 million is not a small deal, it cannot compare with the $22 billion ICBC IPO. However, the listing of these small companies appears to be the trend for the future. Among the twenty-nine Fortune Global 500 Chinese companies in 2008, twenty-one of them have already been listed on the NYSE, HKSE or LSE. In the future, one might expect to see more start-up or medium-sized companies from China listing their shares overseas. These companies may have substantial operations in China, but they may not have the necessary track record to satisfy the HKSE. If they could not satisfy the Profit Test, they may list on the NASDAQ, which not only has lower requirements, but also caters to technology, Internet, and communication firms.

On the other hand, in terms of corporate governance and protection of shareholders, Hong Kong appears to have the more stringent rules. The traditional view is that New York has the most stringent set of rules and regulations regarding corporate governance and protection of shareholders. While more detailed discussions will follow in Section III on the black-letter rules on disclosure requirements, the track record period requirement of HKSE serves as a powerful measure for shareholder protection. With a proven track record of profits, these Hong Kong-listed companies have presumably lower risks and hence offer a safer choice to investors. Indeed, the failure of the Growth Enterprise Market in Hong Kong could be attributed to the exemption from this track record period requirement.[29] The purpose of the Growth Enterprise Market is to attract start-up companies to list in Hong Kong. To do so, the HKSE designed a set of listing rules that mirror those of the Main Board except certain provisions, including the track record period requirements. However, the Growth Enterprise Market never fulfilled its potential due to the lack of quality participants.

The New York regime, on the other hand, has a lower financial threshold, but focuses on full disclosure and strong enforcement. While full disclosure and strong enforcement could definitely help, other than the sophisticated investors, who can navigate through a modern prospectus that includes complicated legal jargon and accounting statements? Accordingly, at least in this regard, Hong Kong is more effective in protecting the investors in general, especially in the case of an IPO where the

[29] However, it still requires a market capitalization of US$13 million and a cash flow of US$2.6 million in the last two preceding fiscal years, which are on par with the requirements of NASDAQ. Hong Kong Listing Rules, *supra* note 16, Rule 11.23(6) and Rule 11.12A(1). HKSE, Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited, Rule 11.23(6) and 11.12A(1) (2008).

foreign issuer has not previously traded its shares publicly and left the investors with few other benchmarks to judge the value of the companies.

B. Authorized Representative

Another listing requirement that could have an impact on corporate governance is the requirement of an authorized representative. On paper, both New York and Hong Kong require certain kinds of local representation. The Hong Kong Listing Rules require the issuer to have significant management presence in Hong Kong. This will usually require at least two directors holding residence in Hong Kong.[30] Although the HKSE sometimes waives this rule for Chinese companies, they usually need to provide other safeguards, such as having a senior management executive stationed in Hong Kong. Apparently, the rationale for having this rule is to facilitate communications between the companies and the regulatory authorities, a good corporate governance measure when the main operation of the issuer is in another jurisdiction. In connection with the New York regime, § 6(a) of the Securities Act of 1933 (the "Securities Act") requires an authorized representative in the United States to sign the registration statement of foreign issuers.[31] However, according to one recent article, most of the foreign issuers engage a third-party company to act as their authorized representative in the United States.[32] This is certainly the case for the U.S.-listed Chinese companies.[33] This third-party company performs no actual service to the issuers other than signing the registration statement to fulfill an official requirement.[34] In other words, a foreign issuer may fulfill this requirement by simply paying a small fee to a third-party company without having to have any actual representatives in the United States. This rule adds value to neither investors nor issuers, and its abolishment has been advocated.[35]

To summarize, the comparison of initial listing requirements of New York and Hong Kong shows that Hong Kong has more stringent requirements in certain areas than New York. In fact, when commentators discuss the competitiveness of the regulatory regime of New York, they almost universally assume that the regime of New York is stricter. For example, when discussing listing of the Chinese companies in the United States, one commentator believes that "[m]any of the poorer quality com-

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[30] Hong Kong Listing Rules, *supra* note 16, Rule 8.12.
[31] 15 U.S.C. § 77f(a) (1994).
[32] Bentzion S. Turin, *Foreign Issuers: The Duly Authorized Representative Requirement of the Securities Act of 1993*, 1 HOUS. BUS & TAX L.J. 26 (2001).
[33] This is confirmed by the practitioners the author has interviewed.
[34] *See* Turin, *supra* note 32.
[35] *Id.* at 40.

panies 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."[36] That is often the starting point for the discussion regarding whether these requirements are too stringent and whether the New York regime should be changed.[37] The vast majority of the discussions have been focused on the discussion of the New York rules and system with little or no detailed analysis on a particular foreign regime. However, the New York initial listing requirements are actually easier to comply with for Chinese companies. While all the major Chinese banks decided to list in Hong Kong instead of New York, including the US$22 billion Hong Kong listing of ICBC, it is mainly attributed to the Chinese banks' difficulties in satisfying the SEC's specific requirements regulating financial institutions in the United States.[38] As mentioned above, given the trend of smaller, privately-owned companies as the driving force for future overseas IPOs, it appears that New York (at least NASDAQ) is in a position to benefit from the comparatively lower initial listing requirements.

III. DISCLOSURE REQUIREMENTS

This section compares the basic disclosure requirements of the two regimes. Part A will discuss the disclosure requirements of offering documents, while Part B will discuss the continuing compliance responsibility of the issuer, such as the duty to disclose annual reports.

A. Disclosure in Offering Document

If one looks at the major statutes under the two regimes, it appears that both require the issuer to disclose "material" information. Section 11 of the Securities Act attaches civil liability to a false registration statement. If any part of the registration statement contains an untrue statement of a material fact, or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading, an investor may sue for compensation, subject to a due diligence defense. To avoid civil liability, the registration statement must therefore disclose any such material facts. However, what is unclear here is the definition of

[36] Fung, *supra* note 15, at 267.
[37] *See, e.g.*, Coffee, *supra* note 7, at 1757–69.
[38] Fung, *supra* note 15, at 267.

materiality. In *TSC Indus., Inc. v. Northway, Inc.*,[39] the Supreme Court defined the materiality test as whether there is:

> [A] substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[40]

While this standard is sensible, the practical reality is that the issuer will have to decide ultimately what is "material" for its company after being introduced to this elusive concept by its lawyer. The difficulty lies in the fact that what constitutes material information varies from company to company. For this reason, although a set of quantitative benchmarks will be helpful, neither the SEC nor the courts have been able to clearly define "materiality." This is particularly the case for the management of the Chinese companies who are not familiar with the listing procedure and practices.

This practical difficulty in determining the materiality standard also exists under the Hong Kong regime. Section 40 of the Company Ordinance imposes liability to pay compensation to investors for their losses sustained by reason of any untrue statement (including the omission of material information)[41] included in the prospectus, subject to a due diligence defense.[42] While § 40 does appear to be very similar to § 11 of the Securities Act, the major difference is the strict liability imposed under § 11, namely that the investors do not need to show reliance or causation of the damages suffered with the misstatement or omission.[43] Despite this difference, § 40 still requires the disclosure of all material information of the issuer in the prospectus.

Apart from these general standards, more detailed disclosure requirements could be found under both regimes. In Hong Kong, when practitioners consider disclosure in the prospectus, they always refer to Form

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[39] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).
[40] *Id.* at 449.
[41] Hong Kong Companies Ordinance, No. 39, (1974) O.H.K., § 41(A).
[42] *Id.* at § 40(1).
[43] Daniels, *supra* note 15, at 1836–37.

I.D., the Basic Requirements for Content of the Prospectus.[44] Form I.D. sets forth the various items an issuer must include in the prospectus as required under the various rules and regulations, noticeably Appendix 1A of the Hong Kong Listing Rules and the Third Schedule of the Company Ordinance. The form must be submitted along with the draft prospectus at the time of the listing application to the HKSE to indicate compliance with the statutory content requirements. However, this is not to say the checklist creates a safe harbor for the issuers. Rather, it provides guidelines as to what to include. The same could be said for the detailed disclosure requirements set forth in Form F-1 under the U.S. regime, the form that is usually used for foreign private issuers.

Among these more detailed disclosure requirements, there is one substantial requirement under the Hong Kong regime that does not exist under the U.S. regime: the connected transaction disclosure. The connected transactions disclosure is a direct and unique product of the Hong Kong Listing Rules. In general terms, the connected transactions are similar to the related party transactions under the accounting system. While their definitions differ, the connected transactions and related party transactions mainly cover those transactions between the issuer and interested parties of the issuers, such as directors and shareholders. The idea is to disclose these transactions in the prospectus to the investors so as to prevent transactions that conflict with the interest of the investors. It must be noted that the disclosure requirement of the connected transactions in the Hong Kong prospectus is mandatory and in addition to the related party transactions that are disclosed under the accounting standards, *i.e.*, International Financial Reporting Standards or the Hong Kong G.A.A.P. Since the definitions are different, the Hong Kong legal counsel to the issuer must conduct an independent investigation with the issuer. This could be a major task for the issuer and its counsel for a number of reasons.

First, the definition of a connected transaction is extremely broad. A connected transaction is defined as a transaction between the issuer and a "connected person."[45] A "connected person" is a director, chief executive, or substantial shareholder (owning more than 10% of the voting power of the issuer)[46] and their associates (which, if for a natural person, includes all members of the extended family, such as in-laws, step-siblings, nieces, cousins, etc.; if for a company, its subsidiaries, holding companies, fellow subsidiaries of such holding companies, and companies in which more than 30% of its voting powers are owned by the aforementioned compa-

[44] Hong Kong Stock Exchange, Checklists and Forms, *available at* http://www.hkex.com.hk/issuer/nla/guidelines.htm.
[45] Hong Kong Listing Rules, *supra* note 16, Rule 14A.11.
[46] *Id.* at Rule 1.01.

nies taken together).[47] The definition is indeed so broad and complicated that it sometimes even puzzles seasoned practitioners, particularly when large Chinese state-owned enterprises are involved. For a typical Chinese state-owned enterprise, it can easily have more than one hundred subsidiaries. In addition, it is not uncommon among large state-owned enterprises in China to invest in new projects together or to cross-hold each others' shares, particularly if both state-owned enterprises are located in the same geographical area. By virtue of having another state-owned enterprise as a substantial shareholder of a subsidiary of the issuer, the second state-owned enterprise becomes a connected person and the issuer will have to disclose all the transactions between the two giant groups.

In addition, the HKSE has shown a willingness to go beyond the broad definition of connected parties in the Hong Kong Listing Rules for some particular situations.[48] For example, the Chinese automotive industry is heavily regulated by the Chinese government and prohibits foreign shareholders from owning more than 50% of the Chinese entity. As a result, most of the Chinese automotive companies are structured by way of joint ventures, with the foreign automotive manufacturers or part-makers, which import the technologies and know-how, owning up to 50% of the joint ventures.[49] A large Chinese automotive company could easily have more than fifty joint venture partners. Under the definition of the Hong Kong Listing Rules, a joint venture partner should not be regarded as a connected person of an issuer as the joint venture is not a subsidiary of the issuer. However, in the HK$4 billion IPO of Dongfeng Motor Group Company Limited ("Dong Feng"), the third largest automaker in China on the HKSE, the HKSE took the position that Dong Feng must regard all the joint ventures as if they were Dong Feng's subsidiaries. Under such a definition, the major joint venture partners of Dong Feng, such as Honda, Nissan, and Peugeot Citroen will all become connected persons to Dong Feng and would have to disclose all the transactions between the Dong Feng Group and these joint venture partners. Under this set of circumstances, it may prove difficult for Dong Feng to get the consent of its joint venture partners for the disclosure. For instance, Honda is not directly involved in the listing and would need to disclose information that might not ever have been disclosed in its home exchange, the Tokyo Stock Exchange. Adding to this problem is the on-going nature of connected transactions disclosure, which will be discussed in another section of this note. In the case of Dong Feng, the HKSE eventually granted the company a

[47] *Id.* at Rule 1.01 and Rule 14A.11.

[48] The Hong Kong Listing Rules allow the HKSE to deem a specific person as a connected person. *Id.* at Rule 14A.06.

[49] DONGFENG MOTOR GROUP COMPANY LIMITED, PROSPECTUS, 105–07 (2005).

conditional waiver for the disclosure of the aforementioned connected transactions and instead required Dong Feng to install a substantial number of internal controls in its material joint ventures, so that Dong Feng could manage them as if they were its subsidiaries post-listing.[50] Even though the counsel to this deal claimed it was a victory for the firm and the issuer,[51] it could also be viewed as a delay to the listing of Dong Feng.

Besides, even if the deal does not involve companies with substantial affiliates, the work performed by the issuer and its counsel is still substantial. Unlike the related party transaction analysis performed by the auditors, lawyers are engaged in the IPO plan much later than the auditors do. The auditors would usually have a much better understanding of the intercompany transactions than the lawyers. Considering that the connected transaction has a broader definition than the related party transaction, it can be a sore spot for legal practitioners. While the HKSE is willing to grant waiver for exceptional cases like Dong Feng,[52] the negotiation for such a waiver with the HKSE presents a substantial task in itself.

The connected transactions thus have an impact on the pre-listing restructuring decision to be made by the issuer. Using the state-owned enterprise example above, the issuer may want to buy out the stake owned by the other state-owned enterprise in that small subsidiary if they have planned the listing carefully ahead. In addition, when a parent company desires to spin off a division of the company for listing purposes, it shall consider which part of the business to include. Usually, even if a part of the business is not to be included, services might still be provided by the excluded business to the issuer post listing. These services will be regarded as connected transactions and will be subject to ongoing disclosure and approval requirements. In other words, if the excluded business was included in the listed company in the first place, connected transaction issues would be prevented.

Another area that has a significant impact to the Chinese issuers is the Hong Kong Listing Rules' requirement for the inclusion of a property valuation report in the prospectus. This requirement is intended to deal with the common title issue of PRC properties. Under PRC property law, there are two property systems: the old system of land use rights and the new system of "long leases." Local land use laws also vary considerably,

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[50] *Id.*

[51] Herbert Smith LLP, *Dongfeng Clears Way for China Ventures to List*, IFLR, Feb. 2006, at 13. Interestingly, connected transaction matters are usually dealt with by the issuer's counsel, which was Slaughter and May in this deal. However, it was Herbert Smith, counsel to the underwriters, who obtained the waiver for the issuer.

[52] Hong Kong Listing Rules, *supra* note 16, Rule 14A.07.

and land use rights certificates are often incomplete or inaccurate.[53] It is also common for the holder of the land use rights certificate to transfer it to another party without authorization or to change the authorized use without notifying the original grantor. Such actions could invalidate the land use rights certificate.[54] For example, China Coal Energy Company Limited ("China Coal"), a large state-owned enterprise, purports to own twelve plots of land with a total area of nearly 0.8 million square meters for which it has not established proper legal title or received land use rights certificates.[55] As a result, when a Chinese issuer proposes an IPO plan, lawyers often expect to find illegal use of land.

Issuers must fully disclose the lack of legal title or land use certificates prior to listing shares in New York. Specifically, the SEC's Form 20-F, often used by foreign issuers listing shares in the United States, requires companies to "provide information regarding any material tangible fixed assets, including leased properties, and any major encumbrances thereon . . . [as well as] how the assets are held."[56] As a matter of common practice, an issuer would comment on the risks posed by faulty land titles and certificates in the MD&A section of the prospectus. The idea is that the disclosure of such information will allow the market to adjust the valuation of the company accordingly and allow investors to make informed decisions.

Comparatively, the HKSE takes one step further to require that valuations of and information on all the issuer's interests in land or buildings must be included in the prospectus by means of a valuation report prepared by an independent evaluator.[57] This valuation report shall include all material information, including, *inter alia*, description, age, terms, government rent, and all such other material information that has an impact on the property's value.[58] For properties in China, the valuation report should further include information regarding establishment of title. Practice Note 12 requires a valuation report to "state whether the relevant party has vested legal title to the relevant property . . . [and the] relevant document should also contain a statement of such fact and any material conditions affecting title."[59] These requirements will surely provide more valuable information to the investors.

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[53] SARAH BARHAM, IAN HALLSWORTH & MARIA JACKSON, THE PRACTITIONER'S GUIDE TO THE LISTING RULES 237 (1994).
[54] *Id.*
[55] CHINA COAL ENERGY CO., HONG KONG PUBLIC OFFERING PROSPECTUS 117 (2006), *available at* http://www.chinacoalenergy.com/eng/UpLoadFolder/200741610135531.pdf.
[56] Form 20-F, SEC, *available at* http://www.sec.gov/about/forms/form20-f.pdf.
[57] Hong Kong Listing Rules, *supra* note 16, at Chapter 5.
[58] *Id.* at Rule 5.05.
[59] *Id.* at Practice Note 12.

However, disclosure is not the last of the requirements for the HKSE. While the express requirement in the Hong Kong Listing Rules is disclosure only, there is an affirmative obligation in practice for the issuer to obtain proper title in case there is any defect. In most situations, the HKSE will push for satisfactory proof of title before listing. The complication of this problem is the time it takes to rectify the problem. A proper land use right may take a long time to obtain. Issuers may have to pay a market price for it, a payment they are reluctant to make since the local government would not have asked for such payment but for the requirement of the HKSE.

If obtaining the title proves too burdensome, the HKSE may grant a waiver on the condition that the issuer provides various safeguards. For example, in the listing of China Coal, apart from disclosing properties without proper titles, the following safeguards have been provided by China Coal: (1) its PRC legal counsel opined that there is no legal impediment in obtaining the proper title certificates; (2) China Coal Group, China Coal's parent, has undertaken to provide all necessary assistance to China Coal in order to apply for the proper title certificates; and (3) China Coal Group has undertaken to compensate against all losses due to any issue arising from failing to obtain the relevant certificate.[60] These measures are fairly common among those required by the HKSE. The goal is to ensure that the issuer, and thus its investors, will be protected in case any liability arises from such properties. In a more extreme case, the HKSE imposed a substantial ongoing measure to ensure that the issuer obtains proper titles subsequent to the listing. China Mobile (Hong Kong) Limited ("China Mobile"), currently the largest company listed in Hong Kong by market capitalization, had substantial land without proper legal titles at the time of its listing. Apart from the usual measures described above,[61] beginning in March 1999, the HKSE has required China Mobile to provide monthly updates regarding the status of the land titles.[62] In December 2004, China Mobile finally decided to sell four of the five properties for which it failed to obtain proper certificates for the parent company. For the remaining property, the company has continued provid-

[60] CHINA COAL ENERGY CO., *supra* note 55, at 118.

[61] For example, China Mobile's parent company indemnified it "from, inter alia, any losses or liabilities arising from the interference or challenge with the use or occupancy of the properties owned by [subsidiaries] then but for which long term title certificates have not been issued." HKSE Announcement, China Mobile (Dec. 20, 2004), http://www.hkexnews.hk/listedco/listconews/sehk/20041221/LTN20041221015.pdf.

[62] HKSE Announcement, China Telecom Ltd. (Mar. 31, 1999), http://www.hkexnews.hk/listedco/listconews/sehk/19990401/LTN19990401002.HTM. Subsequent HKSE Announcements regarding land use and property rights can be found by searching for Stock Code 00941 online at http://www.hkexnews.hk/listedco/listconews/advancedsearch/search_active_main.asp.

ing annual announcements on the HKSE.[63] Although the HKSE might not impose the same ongoing condition in every single case, it has constantly challenged listing candidates on various compliance issues and often requires affirmative action taken on the part of the listing candidates prior to listing. Disclosure alone will seldom be sufficient for getting a waiver.

The combination of the connected transactions and property valuation/title requirements imposes significant responsibilities and costs on the issuer. Like the higher minimum financial listing criteria discussed in Section II, these requirements appear to discourage Chinese companies from seeking listing in Hong Kong. However, from an investor protection perspective, the HKSE provides higher standards of disclosure regarding issuers' rights to use and transfer their real property assets. More importantly, the HKSE has shown a willingness in various cases at the time of listing application to go beyond the set requirements under the Hong Kong Listing Rules in order to protect potential investors. Again, this is quite different from the U.S. regime, which requires full disclosure at the time of listing and then relies upon active enforcement actions (to be discussed in Section IV below) to keep the issuers in line. In other words, the Hong Kong regime takes a more ex ante approach towards investor protection, while the U.S. regime takes a more *ex post* approach.

In practice, the Hong Kong prospectus might even go beyond basic disclosure requirements under the Hong Kong regime. Most Chinese issuers, particularly the larger ones, seeking to be listed in Hong Kong will also try to sell their shares to qualified institutional buyers ("QIB") in the United States, through private placements under Rule 144A of the Securities Act. While no official requirements exist, the market practice calls for preparing the offering document according to the same standard as in preparing for the registration statement for a registered IPO in the United States.[64] As a result, many Hong Kong IPO prospectuses are actually drafted by U.S. counsel. Presumably, the final product of the prospectus should use a disclosure standard that will satisfy both New York and Hong Kong requirements. Once again, the disclosure requirements set forth above challenge the notion that New York listings generally have more stringent disclosure requirements.

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[63] *Id.*

[64] "[E]ven if the securities will be offered in the U.S. under an available exemption from registration, U.S. counsel generally will strive to produce an offering document that contains the disclosure required in registered offerings to protect against 10b-5 liability and in order to be able to deliver a 10b-5 letter." Herbert Smith, *Hong Kong IPO Guide*, 2006, at 20.

B. Continuing Compliance

One of the most significant continuing compliance requirements comes in the form of annual reports. For New York-listed companies, they will generally be required to file an annual report in Form 10-K every year and a quarterly report in Form 10-Q every quarter.[65] These reporting requirements constitute some of the more stringent disclosure requirements of the New York regime. However, when they apply to foreign issuers, the SEC adopts a more lenient standard. The SEC exempts foreign issuers from releasing quarterly reports and only mandates that they file an annual report in Form 20-F. The timeline for filing Form 20-F is six months, which is much longer than that of the 10-K.[66] In addition, a New York-listed company will generally be required to file current reports in Form 8-K when material events occur.[67] Again, this would not apply to a foreign private issuer who is only required to file Form 6-K regarding information that is filed with a foreign stock exchange on which its securities are listed. In practice, however, the New York-listed foreign companies still must disclose to the U.S. public any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions pursuant to NYSE and NASDAQ rules.[68]

In connection with the Hong Kong regime, the HKSE requires a Hong Kong-listed company to provide its annual report no later than 21 days before the date of the issuer's annual general meeting and in any event no later than four months after the end of the financial year to which it relates.[69] In addition, a Hong Kong-listed company shall send to its investors either an interim report or a summary interim report no later than three months after the end of the first six months of each financial year.

While the Hong Kong reporting requirements appear to be more stringent, it must be recognized that the New York regime requires more detailed disclosure in annual reports. Many items required to be disclosed under Form 20-F reflect those of Form F-1 as both refer to the disclosure requirements contained in Regulation S-K. Thus, Form 20-F could be regarded as an annual update of Form F-1.

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[65] *See* JIM BARTOS, UNITED STATES SECURITIES LAW: A PRACTICAL GUIDE 130 (Kluwer Law International 3d ed. 2006).

[66] *Id.* at 131. The deadline for 10-K filing is seventy-five days for accelerated filers and ninety days for non-accelerated filers. Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, Securities Act Release No. 8644, Exchange Act Release No. 52,989, 17 C.F.R. § 210, 229, 240, 249 (2005).

[67] BARTOS, *supra* note 65, at 130–31.

[68] SCHULTHEIS ET AL., *supra* note 24, at 222.

[69] Hong Kong Listing Rules, *supra* note 16, at Chapter 13, Rule 13.46.

The last point on continuing compliance addresses the situation in which listed companies are required to disclose and seek shareholder approval for certain transactions. The HKSE has identified two major types of transactions that would trigger the need for shareholder approval. The first type is the connected transaction that was mentioned above. The issuer's responsibilities regarding connected transactions continue beyond the listing. After the disclosure and, if applicable, the approval of such transactions in the prospectus, the issuer will need to disclose and/or seek independent shareholder approval regarding new connected transactions on an ongoing basis, depending on the significance of such transactions. Basically, the benchmark for deciding whether independent shareholder approval is required depends on the size of the transaction (exceeding approximately US$1.2 million) and the financial strength of the company (to be decided by a set of ratios, such as revenue and market capitalization).[70] If the transaction does not meet the benchmarks, it may still be subject to disclosure unless it is *de minimus*. Another type of transactions that have similar disclosure and approval requirements is known as notifiable transactions, which are principally acquisitions and disposals by the listed company.[71] The mechanism is similar to that of connected transactions. Depending on the size of the transaction versus that of the company, shareholder approval will be required. Generally, if a transaction involves acquisition or disposal that is more than 25% of the company (as calculated according to the set ratios), then shareholder approval requirement will be triggered. Accounting reports will also be required if the transaction in question is significant.[72]

Under the New York regime, there are certain situations in which shareholder approval is required for particular types of transactions. For instance, NYSE requires shareholder approval in cases where issuances of 20% or more of a listed company's common stock occur.[73] However, foreign issuers are effectively exempt from these provisions by way of easily obtained waivers.[74] This practice has also been approved by the SEC.[75] As there is no additional disclosure requirement on related party transactions, issuers are only obligated to update their list of related party transactions in the annual report. There are also no shareholder approval requirements for related party transactions. Thus, at least as far as ongoing disclosure requirements are concerned, the Hong Kong Listing

[70] *Id.* at Chapter 14A, Rules 14A.33 and 14A.34.
[71] *Id.* at Chapter 14, Rule 14.1.
[72] *Id.* at Chapter 14, Rule 14.33.
[73] New York Stock Exchange Listed Company Manual, Section 312.03(c), http://nysemanual.nyse.com/lcm/help/lcm-rules-map.html.
[74] Coffee, *supra* note 7, at 1822.
[75] *Id.*

Rules provide more protection to minority shareholders. In fact, the disparity of treatment on foreign issuers in the New York regime has been questioned.[76]

However, this disparity produces a byproduct in which Chinese companies have an incentive to take advantage of these more lenient treatments. The Hong Kong Listing Rules impose a higher burden on these Chinese issuers listing in Hong Kong. The time and cost of holding a shareholder meeting to decide on a significant transaction will surely be much longer and higher due to the Hong Kong requirement, not to mention the risk of rejection of the proposed transaction at the shareholders' meeting.

One might argue that the New York regime is more burdensome than other regimes because of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). In fact, there have been a lot of criticisms as to the burden that Sarbanes-Oxley imposes upon U.S.-listed companies and the U.S. financial market,[77] such as the huge increase in compliance costs,[78] the requirement of the CEO and CFO to certify the accuracy of financial statements filed with the SEC,[79] and the delisting of listed companies.[80] On the other hand, some also support the Act. For example, the additional costs of Sarbanes-Oxley are arguably not wasteful as evidenced by a valuation premium attached to a NYSE listing over a London listing. Another argument states that Sarbanes-Oxley cannot be used to explain the declining New York capital market as that trend started well before its passage.[81] The author does not intend to repeat the debates regarding the merits of Sarbanes-Oxley. Instead, the focus is placed on the comparison of comparable corporate governance measures under the Hong Kong regime.

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[76] "The principal reason [for the disparity] was probably that, at the time the SEC approved this distinction in 1987, foreign issuers represented only a small fraction of both the securities listed or traded on U.S. exchange . . . Foreign issuers now account for nearly 17% of the NYSE listings, not the 2% to 3% level of the 1980s. More importantly, many foreign issuers now trade principally in the United States. For these issuers, the burden no longer seems disproportionate. In addition, if the purpose of the listing rules is investor protection, it is hard to understand why investors trading on U.S. exchanges need or deserve more protection in the case of U.S.-incorporated companies and less in the case of foreign-incorporated issuers. If anything, the latter class of companies presents higher risks." *Id.*

[77] *See generally* Daniel L. Goelzer, *Auditing Under Sarbanes-Oxley: An Interim Report*, 7 J. BUS. & SEC. L. 1, 8 (2007); John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 311 (2007); Scott Malone, *Sarbanes-Oxley taking toll on foreign IPOs*, REUTERS.COM, Nov. 14, 2005, http://www.reuters.com/articlePrint?articleId=USSCH48099520051114.

[78] Malone, *supra* note 77, at 5.

[79] *See* BARTOS, *supra* note 65, at 156.

[80] Beth Carney, *Foreign Outfits Rue Sarbanes-Oxley*, BUSINESS WEEK (Dec. 15, 2004), *available at* http://www.businessweek.com/bwdaily/dnflash/dec2004/nf20041215_9306_db016.htm.

[81] *See* Coffee, *supra* note 77, at 241–42.

First, Sarbanes-Oxley is actually not as stringent as most people think regarding foreign issuers. The certifications of the CEO and CFO, which attach personal liabilities on the accuracy of financial statements, are "one of the main planks" of Sarbanes-Oxley.[82] However, as noted above, being a foreign issuer, a Chinese-listed company in New York only needs to file its annual report once. Thus, its CEO and CFO only need to provide such certifications once per year, unlike their counterparts in the United States who would also need to sign for the quarterly reports.[83] In addition, with six months instead of the maximum of 90 days to release the financial statements in the annual report, the CEO and CFO of a foreign issuer will also be more comfortable with the financial data contained therein. In any event, the main effect of this rule places more emphasis upon the responsibilities of the CEO and CFO rather than imposing new liabilities as they are liable as signatories to the 20-F anyway.[84]

While the Hong Kong regime does not have such a rule regarding the CEO and CFO of a listed company, the Hong Kong Listing Rules do require the sponsor (usually the underwriter) to certify, *inter alia*, that the issuer has established procedures, systems, and controls (including accounting and management systems) that are adequate with regard to the obligations of the new applicant and its directors to comply with the Hong Kong Listing Rules and other relevant legal and regulatory requirements. These requirements are sufficient to enable the new applicant's directors to make a proper assessment of the financial position and prospects of the issuer and its subsidiaries, both before and after listing. In addition, the issuer is also required to appoint a compliance advisor (who may be the sponsor or someone who acted as a sponsor) subsequent to the listing.[85]

Another major reform of the Sarbanes-Oxley is the requirement of independent audit committees, which is regarded to be the "most important and sweeping revision."[86] The Sarbanes-Oxley requires the audit committee be composed of independent directors. Members must be financially literate and the issuer must disclose whether any member is an audit committee financial expert.[87] Comparatively, the Hong Kong Listing Rules also require an audit committee to be set up and to be comprised of non-executive directors only, with a majority of them and the chairman being independent non-executive directors. This committee must also in-

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[82] *See generally* Malone, *supra* note 77.
[83] *Id.*
[84] *Id.*
[85] Hong Kong Listing Rules, *supra* note 16, at Chapter 3A, Rule 3A.19.
[86] *See* Coffee, *supra* note 77, at 1825.
[87] *See* BARTOS, *supra* note 65, at 157.

clude at least one independent non-executive director with appropriate professional qualifications or related financial management expertise.[88]

The comparisons above are not really intended to show that Hong Kong has a more stringent corporate governance regime than Sarbanes-Oxley. Instead, it is an effort to show that other international stock markets also design certain corporate governance rules along the line of Sarbanes-Oxley.

The last point in this section addresses the difference in the role of governing authorities regarding the information disclosure process. Due to the vast amount of listed companies under the supervision of the SEC, the SEC actually does not review all types of filings before they are declared effective. For example, the SEC generally will not review Form 8-K filed by listed companies. Also, the SEC only reviews selected post-listing registration statements of listed companies, such as those for secondary offerings or shelf registration utilizing Form F-3. The SEC even reviews annual reports randomly. In fact, prior to the passing of Sarbanes-Oxley, the only type of filings that the SEC would definitely review was the registration statement.[89] The rationale is that these documents pose the biggest risks to investors due to the lack of public trading record of these issuers.[90] Sarbanes-Oxley now requires the SEC to review an issuer's annual report at least once every three years.[91] The lack of review is largely due to the SEC being understaffed.[92] Therefore, their overall mechanism for ensuring compliance is through the professional parties involved, such as counsel, auditors, and investment bankers, along with substantial enforcement actions both by the SEC and securities lawsuits (to be discussed in Section IV below) if and when legal issues arise. However, Hong Kong's regime adopts a more micro-managed vetting system. In practice, all filings, including the announcements, circulars, and reports filed by the issuers, must be vetted by the HKSE before they can be publicly filed. For important filings, such as those relating to notifiable transactions discussed above, the HKSE often gives substantial comments as to the information that has to be disclosed. This enhances the accuracy of information when it first becomes available to the public.

Putting together all the discussions related to the disclosure requirements between the two regimes, we can again observe some fairly strict rules and an active role taken by the HKSE. Meanwhile, the New York

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[88] Hong Kong Listing Rules, *supra* note 16, at Chapter 3, Rule 3.21.
[89] Norman Bartczak, Address at Columbia Law School (Sep. 8, 2008).
[90] *Id.*
[91] Sarbanes-Oxley, 408(c), *available at* http://www.sarbanes-oxley-act.biz/SarbanesOxleySection408.htm.
[92] John Coffee, Oct. 8, 2008, Panel Discussion on the Current Financial Crisis, *available at* http://www.law.columbia.edu/law_school/education_tech/streaming/live.

regime takes a more liberal approach to overseas issuers, even when it comes to the application of Sarbanes-Oxley.

IV. LITIGATION RISKS

There have been a lot of discussions regarding the impact of high litigation risks associated with a New York listing.[93] At first glance, the availability of class actions, a litigious private bar with contingency fee arrangements, punitive damages, and jury trial in civil cases are all valid factors.[94] On the other hand, one may also want to look at the small number of securities class actions.[95] In addition, the passing of the Private Securities Litigation Reform Act of 1995 also made it more difficult for securities class actions.[96] However, the impact of litigation risks goes deeper than the above. First of all, it is argued that despite the relatively small number of securities class actions, a much larger number of securities class actions have been settled before they ever reached trial, and this created large settlements over the recent years.[97] Furthermore, the deterrent effects of litigation go beyond the litigation itself and work constantly in the mind of the issuers at the time they make decisions. This is especially important for the New York regime, which, as discussed above, relies on the strong enforcement mechanism.

One commentator has suggested that the litigation risks might not be as high for Chinese issuers.[98] This is because most of these Chinese issuers do not have operations or assets in the United States, making enforcement of judgment there extremely difficult. There is also no international enforcement treaty between the United States and China, so it is very unlikely for a Chinese court to recognize such judgments.[99] However, reputation risks should go deeper than the commentator suggested. Since the lawsuit against alleged financial fraud of China Life, the largest insurer in China, there have been a number of lawsuits filed against the New York-listed Chinese issuers.[100] If these issuers do not

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[93] For an excellent discussion on the impact of enforcement on U.S. competitiveness, see Coffee, *supra* note 77.

[94] *Id.* at 266.

[95] Steven Labaton, *Earnings Restated? Don't Blame a Lawsuit for it*, N.Y. TIMES, Feb. 3, 2006, *available at* http://query.nytimes.com/gst/fullpage.html?res=980CEFDF163EF930A35751C0A9609C8B63&sec=&spon=&pagewanted=2.

[96] *Id.*

[97] *See* Coffee, *supra* note 77, at 273–74.

[98] *See* Fung, *supra* note 15, at 271.

[99] U.S.-China Economic and Security Review Commission, *Public Hearing on "China and the Capital Markets": Testimony by Howard Chao* (Aug. 11, 2005), *available at* http://www.uscc.gov/hearings/2005hearings/written_testimonies/05_08_11wrts/howard_chao_wrts.php.

[100] *Id.*

have assets to satisfy the potential judgments, why do litigants, many of whom are experienced class action lawyers, keep bringing actions against Chinese issuers? One explanation could be the potential damages to reputation as a result of these lawsuits. Such reputation risks could lead to settlements with the plaintiff and thereby eliminate the problem with enforcement of judgments. Prolonged litigation could have a devastating effect on stock price and put pressure on management. In addition, the annual report requires the disclosure of potential and ongoing litigation, thereby forcing the company to disclose negative news therein. When the reputation and the stock price of the company are at risk, Chinese-listed companies would find themselves in a tough position to defend the lawsuits outside of the United States. Most U.S. law firms in China or other parts of Asia also do not have a litigation practice in general, making the availability of high-end litigation advice limited. As a result, litigation risks could still be significant for the Chinese-listed companies.

Comparing the litigation risks of Chinese-listed companies in Hong Kong, the corresponding risks appear to be much lower. The difference in the legal system apparently plays a significant part. Class actions are virtually impossible in Hong Kong. There are no punitive damages or contingency fees. Jury trials are not available in civil cases other than libel cases. In short, the ingredients of classic securities class actions are not available. In addition, as mentioned above, if a plaintiff wants to sue under Section 40 of the Companies Ordinance, he or she must show reliance on a misrepresentation, which is not required under Section 11 of the Securities Act. This rather hands-on, paternalistic approach by the HKSE also helps to prevent litigation from occurring. The market practice of the IPO process in Hong Kong also contributes to the higher accuracy of the prospectus. Before an underwriter files a listing application, its Hong Kong counsel will invariably prepare a verification note, which is a document that verifies the accuracy of almost every sentence of a prospectus. Although this practice is often criticized by practitioners as tedious and time-consuming, there is no doubt of its positive effect on the accuracy of the prospectus.

Finally, instead of relying on litigation, the HKSE often makes use of public sanctions against Chinese companies. A recent article suggests that reputation sanctions by stock exchanges in China could have a strong policing effect on Chinese-listed companies.[101] While the study does not discuss sanctions imposed by the HKSE, it suggests that the Chinese stock exchanges modeled their practice on Hong Kong.[102] This indicates

[101] Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 COLUM. L. REV. 929 (2008).
[102] *Id.* at 948.

that public sanctions by the HKSE could also be an effective means of redress against Chinese companies.

V. CONCLUSION

Throughout this note, comparisons have been drawn between the requirements of the New York regime and the Hong Kong regime. They are not intended to be exhaustive as there could be much more to compare. However, it is hoped that one may recognize the high standards the HKSE imposes on its listed companies are on par with those of New York in many respects. Indeed, in more than one area, Hong Kong could be said to have even stricter investor protection requirements. Besides, instead of relying on the threat of serious consequences as a result of noncompliance, the Hong Kong regime adopts a hands-on, paternalistic approach to manage the listed companies. Again, this is not to suggest Hong Kong has a better system overall than New York, but just to show that there are alternative ways to achieve desirable governance over listed companies. Chinese issuers are given two different but comparable choices for their potential listing. Ultimately, it comes down to which regime has a more fitting set of requirements for the Chinese companies in question. From these comparisons, one may also be able to recognize a tension between attracting Chinese companies to seek listing and investor protection. Whenever one regime has a stricter requirement than the other regime, it seems to drive away the issuer and benefit the other regime. This is particularly so for smaller Chinese companies seeking listing overseas in the future. Unlike the big state-owned enterprises, these smaller companies might not have the resources to fulfill the various requirements. On the other hand, the stricter rules benefit investors in their own exchange by offering more transparency and protection. It is expected that this tension will always exist, but the key is for each regime to find the right balance for itself.

With the current financial crisis and the restructuring of the investment banking industry, the future of the IPO market is very uncertain. There is also a growing demand in regulatory reform. While the financial crisis is not caused by IPOs, it could lead to substantial reform in the entire regulatory landscape. The last two years have also shown how world financial markets are inter-related to each other. As a result, there appears to be a need for a certain type of integrated global securities law that would promote transparency and standardize certain risky securities products. The first step to develop such a body of laws, or for existing regulatory regimes to harmonize with each other, is to understand the dif-

ferent systems, which this note has set out to achieve. While it is hard to predict what kind of landscape will result when the dust settles, this note strives to provide a framework to understand both systems, thereby allowing the stock exchanges to find the right balance and enabling Chinese companies to make the right choice.