

## Financial Transparency and Disclosure: China Progress on Corporate Governance

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**Abstract:** Recent negative publicity regarding fraud in Chinese public companies that entered the U.S. markets via reverse mergers has tended to paint all Chinese companies with the same toxic brush. Such capital markets' cynicism regarding Chinese listed companies is overblown and counterproductive. A recent study has shown that the performance of Chinese companies, when compared to their peers in the U.S. reverse merger market, was actually superior to their Western company counterparts. Notwithstanding, much can be done to improve important aspects of corporate transparency and disclosure in China. The authors examine corporate governance issues particularly endemic to China and offer observations to ameliorate perceived market dysfunction while building a bridge towards greater global capital market efficiency.

**Keywords:** reverse merger; corporate governance; company transparency; insider trading; related party conflicts

Recent negative publicity regarding alleged fraud, supposedly perpetrated by Chinese public companies listed in the U.S., primarily Chinese companies that entered the U.S. markets via reverse mergers,<sup>1</sup> has tended to paint all Chinese companies with the same toxic brush. Market perception of Chinese companies has suffered, and the pricing of many U.S. listed Chinese companies has been impacted. Since 2011, negative market perception has largely curtailed Chinese listings in the U.S. marketplace. Following a plethora of accounting scandals, depressed valuations, and perceived governance issues, many listed Chinese companies retreated from U.S. exchanges<sup>2</sup> and sought to "delist" through "privatization" transactions. Chinese fraud rhetoric has, at times, taken on strident tones, but such sentiments appear overblown when viewed through an empirical lens.

Recent empirical data demonstrates much performance-based criticism of Chinese companies listed in the U.S. is unsubstantiated and exaggerated, if not outright false. China's unique cultural and political underpinnings may compromise important aspects of financial reporting and transparency metrics, but China's integration into global capital markets is inevitable. A candid assessment of obstacles to more complete integration is timely, particularly given the efforts China has made and is making to address corporate governance issues.

This paper asserts that, while China's participation in international (particularly U.S.) capital markets has presented some challenges, many of the related criticisms have been overblown. To that end, we will first discuss several controversial issues, including negative publicity surrounding Chinese reverse

mergers, accounting issues and the tension between full disclosure and the legitimate need to protect state secrets, the discovery standoff between the Chinese government and the U.S. regulators, and the interplay between China's state capitalism and shareholder protections. Next, we will explore some of the evolving statutory and practical aspects of corporate governance in China as they relate to, among other things, shareholder rights, director independence, related party transactions, and insider information.

### **Challenges to China's Integration into International Capital Markets**

While there are challenging issues confronting Chinese companies integrating into international capital markets, such issues appear to have pragmatic and attainable solutions. In this section, we will discuss some of these issues and explore how they can be effectively managed to facilitate international cooperation.

#### ***China Reverse Merger Companies – An Empirical Assessment***

During the past decade, outside investment interests have taken aim at China, hoping to participate in its robust economy. Concern exists, however, regarding highly publicized corporate governance issues that may inhibit transparency and distort or obscure financial metrics upon which market analysts outside China rely. International markets remain cautious regarding Chinese investment and, in the U.S., securities fraud class suits and SEC enforcement actions proliferate against Chinese companies that went public through the reverse merger process.

The Sarbanes-Oxley Act was enacted in 2002 ("SOX"),<sup>1</sup> and was intended to, among other things, ensure the quality and transparency of company disclosures and the reliability of accounting information for U.S. listed companies. Gaps in SOX, which was designed to protect against accounting fraud and inaccurate or inflated stock prices, and in the U.S. securities laws and regulations,<sup>4</sup> have rendered judicial enforcement of claims against Chinese listed companies problematic. Lack of judgment reciprocity between China and the U.S. and the absence of a bilateral extradition treaty for criminal conduct have exacerbated problems in enforcing investor claims.<sup>5</sup>

A recent study undertaken jointly by professors from Stanford, Toronto, and Peking universities (the "Study") provides helpful information regarding the extent of alleged fraud by Chinese reverse merger ("CRM") companies. The Study compares CRM financial profiles to their U.S. counterparts, matched reverse merger peers and a group of exchange-industry-size matched firms. The Study concludes that, despite a virtual avalanche of negative publicity, much of which comes from self-interested short sellers,<sup>6</sup> there is little evidence that the U.S. capital markets have been harmed by admission of CRMs.<sup>7</sup>

Specifically, the Study addresses head-on the issue of whether CRMs are "toxic," including whether or not CRMs, as a separate asset class, substantially underperform comparable U.S. companies trading on the same U.S. exchanges. The Study examines a number of metrics to compare CRM performance, as an asset class, with non-Chinese peers, including post-listing stock returns, survival rates, changes in bid/ask spread, upward/downward exchange mobility, percentage of going concern qualified audit opinions, operating performance, and financial risk parameters.<sup>8</sup>

The Study points out that while corporate governance issues may exist with Chinese companies, positive economic factors apply to Chinese companies entering the U.S. markets via reverse merger that mitigate corporate governance detriments and enhance CRM performance, vis-à-vis U.S. reverse merger

peers. The Study explains that companies seeking reverse merger treatment in the U.S. generally exhibit a less desirable financial profile than IPO-eligible companies.<sup>9</sup> Painting with a broad brush, reverse merger companies ("RMs") are typically early stage companies that trade over-the-counter. CRMs, in contrast, are more often established companies, further on in their lifecycle, less speculative in nature, and more economically sound, than their U.S. RM counterparts. Relative to U.S. peers, the Study found the typical CRM economic profile more robust than U.S. counterparts and that a majority of RM firms were never eligible for more stringent IPO treatment.<sup>10</sup>

The Study found that through the end of 2011, CRM companies outperformed their U.S. counterparts in terms of profitability, current ratio, book leverage, operating cash flows, upward mobility in exchange tiers, percentage of firms with qualified audit opinions, survival rate, market liquidity, and percentage stock return. Despite negative publicity, empirical evidence does not show CRMs systemically more problematic than their U.S. peers, trading on the same exchanges.<sup>11</sup> Market characteristics of Chinese companies do, however, present analytical challenges for investors outside China.

#### *Accounting Issues and State Autonomy and Secrecy*

Before turning to Chinese corporate governance and what can reasonably be done to enhance transparency, we discuss a current impasse between forces in the U.S. seeking to protect investors and Chinese forces wishing to ensure, among other things, appropriate PRC economic autonomy. In response to perceptions of widespread fraud by China companies, the Securities and Exchange Commission ("SEC") initiated a broad investigation of Chinese firms accused of fraud, particularly those having gone public in the U.S. via reverse merger. The SEC demanded access to audit work papers of foreign public accounting firms, primarily the "Big Four,"<sup>12</sup> which provided audit opinions on many Chinese listed firms accused of fraud. The SEC was seeking to test the quality of the underlying audits.<sup>13</sup> The Big Four operate as separate entities in China and are subject to sometimes conflicting U.S. and Chinese legal rules.

In the U.S., for example, any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer is subject to the Sarbanes-Oxley (SOX) Act and the rules of the Public Company Accounting Oversight Board ("PCAOB"),<sup>14</sup> in addition to the related SEC rules issued under SOX.<sup>15</sup> Any foreign public accounting firm that plays a substantial role in the audit of the U.S. listed company is, likewise, subject to U.S. rules.<sup>16</sup>

Under U.S. interpretation, audit firms that participate in the audit of a foreign company listed on a U.S. exchange must produce related work papers upon SEC or PCAOB demand. Under Chinese law, audit work papers subpoenaed by U.S. authorities may not be produced if the documents contain information deemed a "state secret." China's State Secrets Law<sup>17</sup> can be problematic in that it may effectively preclude production of the private Chinese accounting and financial documents necessary for a securities fraud claim to be proven in the U.S., particularly where the operations of state-owned enterprises ("SOEs") are involved. The law provides severe penalties of five years in prison to death, and contains a broad and uncertain description of what constitutes a "state secret." All related proceedings are closed to the public. Because of this, the Big Four Chinese accounting firms have withheld financial records demanded by the SEC and/or PCAOB relating to their respective inquiries into alleged fraud by Chinese companies listed in the U.S.

*What is Really at Stake in the Discovery Standoff Between China and the U.S.?*

China is plainly entitled to domestic prerogatives and the U.S. to defend investor rights. At issue is whether Chinese companies will be afforded access to the substantial liquidity provided by U.S. markets or whether China companies will look inward to mainland China or Hong Kong for capital and, conversely, whether the U.S. may lose the benefit of adding world-class enterprise activity to its markets. A corollary issue is whether China private companies, in non-sensitive sectors, will be allowed to raise capital abroad, subjecting them to foreign regulation. If China SOEs possess information they deem too sensitive to endure foreign regulatory scrutiny, they may not be permitted to raise capital abroad. Chinese and U.S. regulators have sought to negotiate a solution.

The SEC, the PCAOB, the China Securities Regulatory Commission ("CSRC"), and the Chinese Ministry of Finance have held ongoing discussions regarding cross-border accounting practices. However, on January 23, 2014, an SEC Administrative Law judge, Cameron Elliott, fired a shot across the bow by suspending the Chinese Big Four from practicing before the SEC for six months, during which the Big Four cannot audit China companies listed in the U.S.<sup>18</sup> This decision, which raises the stakes between the U.S. and China, seems to empower the PCAOB to revoke Chinese audit firm registrations to practice in the U.S. if they do not provide work papers subpoenaed for inspection. Such a ruling could lead to a delisting from the U.S. of SOEs and other enterprises that may possess information China's state secrets law protects. Currently, any Chinese auditing firm resisting a request for work papers relating to a Chinese company listed in the U.S. may arguably be banned from auditing U.S. listed companies. If such Chinese auditors were banned, all U.S. listed Chinese companies could, arguably, be removed from U.S. exchanges. The implications for U.S. based multinational companies ("MNCs") are serious because if an auditor plays a material role in the audit of an MNC, e.g., relating to Chinese operations, such auditors must be PCAOB registered. Thus, MNCs could encounter serious problems getting their Chinese operations audited.

*China's State Capitalism and its Information Environment*

China's information regulatory environment for its companies is on par with Western financial community requirements, generally. Pursuant to the China Securities Regulatory Commission ("CSRC") 2008 Annual Report, one of the primary objectives of the CSRC is to "give priority to protecting the legitimate rights and interests of investors... and maintain the principles of an 'open, fair and just' market."<sup>19</sup> Transparency is the foundation of such protection, as disclosure and accurate financial reporting provide the market with information on which to make informed decisions. Although the CSRC has recently adopted Western-style regulations and standards promoting transparency and strong corporate governance,<sup>20</sup> significant issues remain, and systemic weaknesses still need to be addressed.

According to the National Bureau of Economic Research ("NBER") project "Capitalizing China" (the "Project"), Chinese listed company reporting remains opaque, despite regulatory action designed to foster transparency.<sup>21</sup> Per the Project, such opacity appears to be a function of local institutions and arrangements that create adverse financial reporting incentives. The Project also concluded there are four key areas where China's financial information environment is significantly impacted by state controlling ownership of listed firms, including the government's control of capital markets, limited legal protection of property rights, lack of local auditor independence, and the importance placed on social networks and

political connections.<sup>22</sup>

China is often thought to represent a new breed of capitalism – “State capitalism.” As such, the mechanisms and infrastructure of Chinese capitalism, as well as their concomitant influence on corporate governance practices and financial transparency, present challenges to financial observers outside of China. The State’s central role has given rise to approximately one hundred mammoth SOEs controlled, directly and indirectly, by national government organs.<sup>23</sup> Controlling interests in these firms are held by a central holding company known as the State-Owned Assets Supervision and Administration Commission of the State Council (“SASAC”).<sup>24</sup>

The role of the State as majority shareholder in China’s dominant companies remains a subject of debate. How does this shareholder structure, separate and distinct from a traditional Western model, influence and/or fundamentally transmute corporate governance principles relating to such issues as minority shareholder rights, board of director independence, related party transactions, and insider information?

All of these challenges to China’s participation in international capital markets, and others that will undoubtedly arise in the future, appear to be solvable through thoughtful cooperation among the interested parties. China’s remarkable evolution in economics and governance sets the stage for its appropriate ascendancy to a responsible role among global corporate citizens. The successful evolution of Chinese corporate governance statutes, as discussed below, will facilitate this transition.

### **Corporate Governance in China**

#### ***Shareholder Rights in China***

China has made great progress in establishing and developing its securities market in recent years, but its protection of shareholder rights remains a subject of continuing criticism. SOEs are subject to substantial government ownership and individual shareholders frequently lack meaningful influence over entity decision-making. Shareholders often have limited access to corporate information and, where they do have access, they often lack sufficient knowledge or expertise to effectively evaluate corporate performance. Opportunities for related-party transactions abound, and, in many cases, outright misappropriation of corporate assets threatens shareholder wealth maximization.

Reconciling the twin goals of shareholder wealth maximization and maintaining the interests of the State is a challenge. China’s 1998 Securities Law prohibited some forms of market misconduct, e.g., insider trading, market manipulation, and inaccurate disclosure, and a 2005 revision set stringent requirements regarding information disclosure and provided for increased legal responsibilities on shareholders and officers that control listed companies.<sup>25</sup> Such legal provisions have improved the integrity of shareholder rights, but in the view of some, current law continues to over-emphasize the government’s role in companies and markets, to the detriment of shareholder rights. The CSRC is charged with ensuring the orderly, lawful operation of the market, but its enforcement efforts have been hampered by resource constraints and conflicts arising from its roles as China’s primary market regulator and promoter of listed corporations.

In principle, shareholder rights are guarded by China’s courts. However, China’s legal system has not had significant historical experience adjudicating the complex legal issues that frequently arise in

securities litigation. Some courts have refused to hear investor securities fraud cases, nominally, because courts lack operational-procedural rules on how private securities suits can be brought.<sup>26</sup> Lack of financial incentives in bringing securities suits, substantial filing fees, underdeveloped group litigation rules, and a lack of judicial infrastructure, have substantially impaired private enforcement and, in fact, are widely understood to be a disincentive for public investors to prosecute frauds which would otherwise protect shareholder rights.<sup>27</sup>

Current law, for example, restricts the scope of cases for which civil compensation may be sought. Relief can be sought in misrepresentation cases, which include cases involving false or misleading statements, material omissions, or improper disclosures, but other forms of abuse, e.g., insider trading and market manipulation, are not well-defined and have been thought, for that reason, to have deprived defrauded investors of compensation even where the CSRC has determined liability and/or imposed administrative penalties against the wrongdoers in issue.<sup>28</sup>

Contingency fee arrangements to compensate attorneys are generally prohibited in China, and if an action fails, investors must reimburse the expenses of prevailing defendants. If an action is successful, investors may not be able to recover lawyers' fees from the losing party and, coupled with an absence of litigation funding in China, shareholders are widely thought to have been dissuaded from even trying to sue when plainly meritorious claims exist. In addition, fearful that listed companies could become targets of public anger over widespread fraud, and, in light of apprehension that floodgates may be opened to many securities cases, the Supreme People's Court ("SPC") has effectively denied would-be plaintiffs from using Article 55 litigation rules used to bring civil compensation claims that are generally regarded as robust.<sup>29</sup> In a mature economic and legal environment, aggressive shareholder action is seen as protective of shareholder rights and serves as an impediment to most forms of corporate governance abuse, including insider trading, officer conflicts of interest, and forms of related-party abuse.<sup>30</sup>

According to one recent Study, only about 15% of suit-eligible companies have been sued – a company is suit-eligible where the CSRC or another Chinese administrative authority has already sanctioned it for misrepresentation in disclosure documents.<sup>31</sup> Because the finding of wrongdoing has already been made in such cases, one would think they would be attractive as securities suit targets. Nevertheless, more than 80% of these companies have not been sued, and only a handful have been the subject of legal liability findings.<sup>32</sup> One authority estimates claimed damages represent less than 5% of the losses public investors incurred due to securities fraud.<sup>33</sup> Yet, even if Chinese regulators punished some securities market offenders, lack of wide, effective enforcement would continue to encourage misappropriation and fraud. The risk of being caught and penalized is so slight as to be negligible -- whereas the potential gain from engaging in such abuse can be great.

China's laws and regulations are evolving to meet the challenges of China's expanding commercial environment, an environment that spawns complex legal issues.

#### *Director Independence in China*

China's securities regulators have established formal requirements for director independence. Exchange listed companies are required to be operated "in an independent manner" with directors "independent from the listed company that employs them and the company's major shareholders."<sup>34</sup> The law mandates that directors "diligently perform their duties for the best interests of the company and all the

shareholders."<sup>35</sup> The Code of Corporate Governance for Listed Companies sets forth rules governing independent directors, as well as financial regulators, including the CSRC, and related party transactions.

China's companies must consider the PRC's general welfare, not just public shareholder interests, and for this reason, director independence in China does not mean independence from government involvement in governance matters.<sup>36</sup> This is unsurprising, as the State is, itself, a controlling shareholder in a majority of listed companies. SOEs are, for good reason, often viewed as vehicles for the implementation of State policies, and this includes control over certain industries. As such, they are not solely committed to maximizing shareholders' wealth. In this respect, China's corporate directors have been criticized for not prioritizing investor returns and many, in fact, are bureaucrats and politicians who must balance their fiduciary duties towards the State with their obligation to public shareholders. There is little question that, on occasion, China's directors have advanced State interests by, for example, maintaining depressed prices for essential products, enforcing state birth control policies among employees, or pursuing urban full-employment policies.<sup>37</sup> Where politically connected chief executives are concerned, the Board faces challenges in monitoring and disciplining company management.

If international involvement and requisite capital is to find its way into China's SOEs, the influence of the State with respect to the particular corporate entity should be disclosed. State ownership, *per se*, is not necessarily adverse to shareholder rights. Relevant information regarding controlling interests should be provided and should be sufficient to inform shareholders regarding the effect of State interests on shareholder profit maximization. Any attendant conflicts should be disclosed under appropriate corporate governance principles. Assuming adequate transparency and disclosure, the market may determine related risk factors, if any, and incorporate such risk into pricing. If individual corporate State control involves "state secrets," the materiality (both qualitative and quantitative) of the withheld state secret information (as opposed to the precise "content" of the information) regarding the financial statements of the corporation should be disclosed so investors can make informed decisions and entertain appropriate value adjustments for any perceived attendant risk.

Another problem is that where Chinese non-State owned companies are involved, they are frequently controlled by family members or small groups where that control may negatively impact other shareholders through increased agency costs. A common criticism is that majority stakeholders place their own directors on boards, circumventing independence requirements by, for example, having non-relative family representatives (who are really committed to family, not shareholder, interests), serve.<sup>38</sup> Even institutional shareholders often lack sufficient shares to place members on boards that are truly independent and, for that reason, cannot prevent self-dealing transactions by controlling shareholders and/or their allies. Increases in board size and numbers of directors have helped the situation, but State primacy over shareholder rights and low institutional investor board presence is a continuing challenge. Director loyalty to the State, according to many, trumps fiduciary obligations to shareholders.<sup>39</sup>

#### ***Related Party Transactions***

Related party transactions, which often divert funds from shareholders to controlling persons or entities, is widely perceived to be a serious problem, undermining the capacity of China companies to optimize shareholder profits.<sup>40</sup> Even where the State is not the largest shareholder because directors, as discussed, often owe their Board positions to another large stakeholder to whom primary allegiance is owed, director

independence may be undermined.

In 2003, the CSRC, along with the State-owned Assets Supervision and Administration Commission ("SASAC"), a government department governing state-affiliated controlling shareholders, issued a notice addressing funds transfers by listed companies to their controlling shareholders, as well as those shareholders' affiliates, and listed company guarantees of the financial obligations of controlling shareholders or those shareholders' affiliates.<sup>41</sup> The notice prohibited certain funds transfers from the listed company to the controlling shareholders or their affiliates and set forth provisions related to external guarantees by the listed company for the benefit of its controlling shareholder or any 50% or more such shareholder-owned subsidiaries.<sup>42</sup>

The 2003 notice limits the aggregate amount of listed company external guarantees to less than 50% of net assets in the most recent fiscal year and forbids guarantees for any debtor carrying excess leverage.<sup>43</sup> The notice institutes supermajority/direct shareholder approval requirements for external guarantees, two-thirds of the board *or* mandatory general shareholders' meeting approval.<sup>44</sup> These provisions, though helpful, are widely perceived as insufficient to constrain related-party transactions. This is because the controlling shareholder in a PRC listed firm is likely to control all or most of the directors,<sup>45</sup> and a required supermajority at the board level is not a serious impediment. Controlling shareholders are likely to simply use majority voting power in the general shareholders' meeting to assure required approval is obtained.

In 2005, another CSRC notice was issued together with the newly established China Banking Regulatory Commission that reasserted value limits on guarantees and required company articles of association to set forth the board's approval authority with respect to external guarantees. The notice requires a supermajority (two-thirds) board approval for guarantees within approval authority or for external guarantees that must be submitted to the shareholders' meeting, board approval and then shareholder majority approval, but with the proviso that both the controlling shareholder and its affiliates not be permitted to vote. The 2003 and 2005 notices provide for controlling shareholder joint and several liability on non-conforming external guarantees. These CSRC notices suggest a recognition that controlling shareholders have a duty to their firms and/or minority holders of the public float consistent with a long CSRC campaign to articulate fiduciary duties for controlling shareholders.

### ***Insider Information Regulation***

Inside information refers to information that concerns a company's business or finance or undisclosed information that might have a substantial effect on the market price of company securities. Trading on inside information is both unlawful and widespread in China, as it is in many countries, and the problem has been recognized and frequently discussed.<sup>46</sup> China has addressed insider trading through a combination of laws, regulations, and guidance promulgated by regulators and its law is fast evolving. The following is a quick overview of China's insider trading law, beginning in the 2005-2006 period, running through the present.

The 2006 PRC Securities Law ("Securities Law") addresses insider trading in eight articles.<sup>47</sup> Article 73 prohibits persons with knowledge of inside information from using it to trade securities.<sup>48</sup> Persons "with knowledge" include statutory insiders, including corporate directors and officers, as well as supervisors, managers, deputy managers, and other corporate and/or holding corporate senior managers.



Lower-level employees may be “insiders” if they obtain employment-related inside information, and large shareholders and outsiders who participate in trading pursuant statutory duties or private contracts, may also become “insiders.”<sup>49</sup> Securities Law Article 75 defines “inside information” as information that is not made public because, in the course of securities trading, it concerns the company’s business or financial affairs or may have a “major effect” on the market price of the company’s securities.”

Article 75 non-exhaustively sets forth types of facts regarded as inside information, including the major events listed in Article 62, examples of which include company plans concerning distribution of dividends or increase of registered capital, major changes in the company’s equity structure, security for the company’s debts, and, also, the “major events” listed in Article 67, which includes its own catch-all -- “other information” -- in Article 67(12).

Such “major events” include significant changes in business guidelines or the scope of business in which a company engages, decisions regarding large investment or asset purchases, or the entering into or loss of contracts material to company business. It might also include undertaking or becoming subject to a large debt or a default on same, suffering a large loss (e.g., exceeding 10% company NAV) or a significant change in business conditions, e.g., a change in company management or replacement of board members. It may include a decision to reduce registered capital, merge, dissolve, or file bankruptcy, or to file a large litigation or cancel an important shareholder resolution.

Securities Law Article 76 provides that a person who has *illegally* obtained material non-public information has an insider’s duty and is, thus, prohibited from trading on the basis of that information.<sup>50</sup> A person *illegally* obtains inside information if the inside information is obtained where, for example, theft, cheating, tapping, spying, or bribery is involved, where close relatives of primary insiders, or people with other types of close relationships with primary insiders or from people who have contact with primary insiders during sensitive periods. Under Securities Law Article 202, administrative liability can be imposed with the following consequences:

[The inside trader] shall be ordered to dispose of the illegally obtained securities according to law, his illegal gains shall be confiscated and, in addition, he shall be imposed a fine of not less than the amount of but not more than five times the illegal gains, or a fine of not more than the value of the securities illegally purchased or sold.

If an insider trading case is serious enough to constitute a crime, criminal liability, under Criminal Law, Article 180 provides that insider traders:

shall be sentenced to not more than five years in prison or criminal detention, provided the circumstances are serious. They shall be fined, additionally or exclusively, a sum not less than 100 per cent and not more than 500 per cent as high as their illegal proceeds. If the circumstances are especially serious, they shall be sentenced to not less than five years and not more than 10 years in prison.

In addition, they shall be fined a sum not less than 100 per cent and not more than 500 per cent as high as their illegal proceeds.

“Serious circumstances” and “very serious circumstances” are defined terms for Criminal Law Article 180 purposes.<sup>51</sup> In 2007, the CSRC largely restructured its insider trading framework through its “Insider Trading Guidance Provisions (“2007 Guidance”), Article 12:

Article 12. Securities trading activity that conforms to the following conditions shall constitute insider trading: (1) the person undertaking the behavior is an insider; (2) the information involved is inside information; and (3) the subject person buys or sells related securities during the price sensitive period of the inside information, or suggests that other persons buy or sell related securities, or [publicly] reveals the [inside] information.

Article 12 of the 2007 Guidance introduces a new term – “insider” – which did not appear in the 2006 Securities Law. The definition of “insider” was expanded in the 2007 Guidance Articles 6(2)-(5) to include the securities issuer or listed company, the controlling shareholder of the issuer or listed company and their directors, supervisory board members and senior management, any party involved in a listed company’s merger, acquisition or reorganization and their relevant personnel, people who gain inside information in the performance their work, the partners and spouses of natural persons included in Article 74(i)-(vi) of the 2006 PRC Securities Law, parents or children or other relatives of natural persons in the above-mentioned categories who come into possession of inside information, those who employ illegal methods such as “trickery,” as well as eavesdropping, coaxing, monitoring, and secret trading to gain inside information and those gaining inside information through “other channels.”

The 2007 Guidance provides insiders may be “legal” as well as natural persons,<sup>52</sup> and makes trading in *possession* of inside information (during a price sensitive period) a basis for insider liability, which but for the requirement of intentional/reckless conduct, is akin to a strict liability standard for a class of persons who would not have been liable under the 2006 Securities Law.<sup>53</sup> On June 1, 2012, CSRC issued a Judicial Interpretation on Insider Trading Law in Criminal Cases was issued which reversed the normal burden of proof in insider trading criminal prosecutions (“the 2012 Interpretation”).<sup>54</sup> Under the 2012 Interpretation, Article 1, insiders listed in the 2006 Securities Law Article 74, e.g., directors and senior managers, are *presumed* to possess inside information, and that presumption exists for close relatives of primary insiders, or persons with other types of close relationships with primary insiders, or even those who have contact with primary insiders during the sensitive periods, if their transactions appear “obviously abnormal.” To determine if a transaction is “obviously abnormal,” the totality of circumstances is considered, including, among other things, when the trading in issue occurred (relative to when the insider information was obtained) and how different the trading in issue was from the defendant’s prior/normal trading. The presumption of insider information possession can be rebutted if defendant shows a lawful reason for having the information.

The 2006 Securities Law contains a provision prioritizing private civil liabilities for securities violations. Securities Law Article 232 states: “If the property of a person, who violates the provisions of this Law and who therefore bears civil liability for damages and is required to pay a fine, is insufficient to pay both the damages and the fine, such person shall first bear the civil liability for damages.” Article 232, however, lacks detailed procedures for civil damages, and Chinese courts, for that reason, have not been enthusiastic about adjudicating such cases. China’s regulators have strengthened insider trading laws and they are strengthening enforcement efforts to assure China markets are fair and perceived to be fair.<sup>55</sup> Private parties have started bringing civil actions, a development which will play a role in deterring those who would abuse positions to gain an unfair trading advantage in China’s securities markets.

### Conclusion

If China seeks to benefit from participation in international capital markets, it must play by rules consistent with those markets, and this requires real transparency and disclosure. There is every indication that China is willing to do this. Modern notions of corporate social responsibility, universally embraced as desirable in developed and undeveloped countries alike, are arguably analogous to the PRC concept of state responsibility to its citizens. China should be encouraged to smooth the rough patches in its evolving legal system, as noted, to accommodate and protect the interests of individual shareholders in China companies.

China's president, Xi Jinping, and the Chinese government, have targeted the fight against party corruption and conflicts of interest, as a major priority. President Xi has made pervasive graft a central theme since becoming president in March of 2013, and he has urged the government to improve channels for people to report on graft while strengthening supervision and transparency.<sup>56</sup> Certainly, in the relative infancy of its remarkable economic boom, China should be encouraged and supported to enhance and refine mechanisms for strengthening corporate governance and financial transparency in its markets.

Western capital markets, including the U.S., should join hands in this effort by contributing rational dialogue and good faith negotiation regarding areas of common interest. Such negotiation and dialogue must not, however, compromise the need for maintenance of international standards regarding transparency and financial disclosure. A balanced global capital market that welcomes China as a solid, contributing, and valued citizen, will ensure the benefit of an integrated, optimal global society.

### Notes:

<sup>1</sup>The phrase "reverse merger" refers to a process where a private company seeking to be listed on U.S. publicly traded stock market, buys control of a public "shell" company and the private company's management assumes control over that shell. If the public shell is SEC-registered, the formerly private acquiring company need not undertake the expensive and time-consuming review with state and federal regulators required to "go public," since this process was completed by the acquired public company. Reverse merger is a way to become publicly traded without jumping through the hoops an initial public offering ("IPO") would otherwise require. Since the negative publicity relating to alleged fraud in certain China companies that entered the U.S. markets through reverse merger ("CRMs"), the SEC has tightened reverse merger requirements.

<sup>2</sup>This is in direct contrast to the large number of China companies that entered the U.S. markets over the past decade. Indeed, numerous mainland China companies were gobbled up by private equity funds during that period of time. Subsequently many of these companies employed private equity "exit" strategies that involved cashing out through U.S. stock offerings. Such exit strategies are largely no longer viable because of market pushback, leaving a number of "stranded" private equity interests in China. Market resistance to China company listings in the U.S. have been matched contemporaneously by regulatory initiatives in China designed to increase scrutiny of China companies that seek to go public in China. Notably, a moratorium by the CSRC against IPOs, beginning in October 2012, has only recently been lifted, albeit subject to stricter guidelines promulgated by the regulators.

<sup>3</sup>Sarbanes-Oxley Act of 2002, Pub. L. No.107-204, 116 Stat.745.

<sup>4</sup>The U.S. Congress enacted the Securities Act of 1933 (the 1933 Act, the Securities Act, the Truth in Securities Act, the Federal Securities Act, or the '33 Act, Pub. L. 73-22, 48 Stat. 74, enacted 1933-05-27, codified at 15 U.S.C. § 77a, the Securities Exchange Act of 1934 (the "Exchange Act") (Pub.L. 73-291, 48 Stat. 881, enacted June 6, 1934, codified at 15 U.S.C. § 78a et seq.) governs secondary trading of securities (stocks, bonds, and debentures). The Exchange Act established the Securities and Exchange Commission (SEC), the agency primarily responsible for enforcement of United States federal securities law.

<sup>5</sup>See Jonathan P. Schmidt, *Inequities in Corporate and Securities Law: Disabling the Exploitation of Chinese Corporation and Charting a Path to International Commercial Accountability*, 14 *San Diego Int'l L. J.* 384 (Spring, 2013).

<sup>6</sup>Short-sellers claim to undertake investigations of China companies. They publish their "findings" on blogs which drive the price of the stock downward. Short-sellers make money when the price declines and have been accused of market manipulation through the dissemination of unfounded negative information.

<sup>7</sup>Charles M.C. Lee, Kevin K. Li, & Ran Zhang (2013), *Shell Games: Are China Reverse Merger Firms Inherently Toxic?* ("Shell Games"), *Current Draft: September 11, 2013*.

<sup>8</sup>*Id.* at 3.

<sup>9</sup>In the U.S., an initial public offering ("IPO") takes place when shares of stock in a company are sold for the first time to the general public on a stock exchange. Most companies going public use the services of an investment banker, which may act as an underwriter, and costs are higher than a reverse merger.

<sup>10</sup>See *Shell Games*, *supra* n.7, at 4.

<sup>11</sup>*Id.* at 6.

<sup>12</sup>The phrase "Big Four" refers to the China-based affiliates of the international accounting firms, Deloitte & Touche, Ernst & Young, KPMG and Price Waterhouse Coopers. In China they are known as Deloitte & Touche Tohmatsu, Ernst & Young Hua Ming, KPMG Huaxhen and Price Waterhouse Coopers Zhong Tian.

<sup>13</sup>In a separate lawsuit, the SEC subpoenaed workpapers of Deloitte & Touche Tohmatsu in a federal court action dealing with Long Top Financial Technologies, which was a Deloitte client accused of accounting fraud. See *In the Matter of Long Top Fin. Tech. Ltd.*, SEC Administrative Proceeding No.3-14622.

<sup>14</sup>The Public Accounting Oversight Board ("PCAOB") is a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to supervise audits of public companies and protect the interests of investors.

<sup>15</sup>15 USC §7216(a)(1).

<sup>16</sup>PCAOB Rule 1001(p)(ii) and SEC Release No. 34-48180, among others.

<sup>17</sup>See generally Sigrid, Ursula, Jernudd, *China, State Secrets, and the Case of Xue Feng: The Implication for International Trade*, 12 *Chi. J. Int'l L.* 309 (2011).

<sup>18</sup>The Initial Decision Release No. 553, United States of America before the Securities and Exchange Commission, *In the Matter of BDO China Dahua, et. al.*, Jan. 22, 2014.

<sup>19</sup>See Joseph D. Piotroski and T.J. Wong, Institutions and Information Environment of Chinese Listed Firms, prepared for the NBER project "Capitalizing China" (October 2011) (herein after "Piotroski").

<sup>20</sup>See Chapter 3, § 3 of the Securities Law of the People's Republic of China (as amended August 29, 2004) and Chapter VI of the Rules Governing the Listing of Stocks on the Shanghai Stock Exchange.

<sup>21</sup>See generally Piotroski and Wong, *supra* n. 20.

<sup>22</sup>*Id.*

<sup>23</sup>Eighty-nine of these China SOES are listed in the 2013 Fortune Global 500 list of the world's largest corporations, giving China the second largest country representation in that list. The number of China companies on the Fortune Global list has increased at the annual rate of approximately 20% since 2005. Source: World 500 Largest Corporations in 2013; the Chinese Are Rising, Forbes, July, 2013. <http://www.forbes.com/sites/panosmourdukoutas/2013/07/17/worlds-500-largest-corporations-in-2013-the-chinese-are-rising/>

<sup>24</sup>Li-Wen, Curtis J. Milhaupt, We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, 65 Stanford L. Rev. 700 (April, 2013).

<sup>25</sup>Gu Weixia, Securities Arbitration in China: a Better Alternative to Retail Shareholder Protection, 33 Nw. J. Int'l L. & Bus. 283, 288 (Winter, 2013).

<sup>26</sup>*Id.* at 291-92.

<sup>27</sup>*Id.* 292.

<sup>28</sup>*Id.* at 293-94.

<sup>29</sup>*Id.* at 293-96.

<sup>30</sup>Judges, in China, often come from non-legal careers and lack legal training prior to bench assignment. Coupled with limited experience with securities regulation and securities law complexities, judges may feel they lack competence to properly adjudicate securities fraud cases even when plaintiffs bring them. *Id.* at 297.

<sup>31</sup>*Id.* at 297-98 (discussing study prepared by Benjamin L. Liebman & Curtis J. Milhaupt, Reputational Sanctions in China's Securities Market, 108 Colum. L. Rev. 929, 943 (2008)).

<sup>32</sup>See 33 Nw. J. Int'l L. & Bus. at 298.

<sup>33</sup>*Id.*

<sup>34</sup>See Roberta S. Karmel, Is the Independent Director Model Broken?, 37 Seattle U. L. Rev. 775, 806-07, text at n. 199 (2014) (hereinafter "Karmel") (citing *inter alia* Kan Zhang, Corporate Governance in China: How Does the State Influence Its Own Enterprises?, 9 B.Y.U. Int'l L. & Mgmt. Rev. 111, 1115 (2013) and Code of Corporate Governance for Listed Companies in China (issued by the Chinese

Securities Regulatory Commission, ch.2(3), ch.3(5), effective Jan. 7, 2007), reviewed March 25, downloaded [http://www.csrc.gov.cn/pub/csrc\\_en/newsfacts/release/200708/t20070810\\_69223.htm](http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69223.htm)).

<sup>35</sup>See Karmel, at 806-07 (text at note 200, citing and quoting Code of Corporate Governance for Listed Companies in China (issued by the Chinese Securities Regulatory Commission, ch.2(3), ch.3(5), effective Jan. 7, 2007), available at [http://www.csrc.gov.cn/pub/csrc\\_en/newsfacts/release/200708/t20070810\\_69223.htm](http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69223.htm)).

<sup>36</sup>See Karmel, at 807 (text at n. 205).

<sup>37</sup>*Id.*, at 808 (text at n. 209).

<sup>38</sup>*Id.*, at 808-09 (text at n. 213-14).

<sup>39</sup>*Id.*, at 808-09 (text at n. 207-18).

<sup>40</sup>See *infra* Part I, Section C.

<sup>41</sup>See Nicholas Calcina Howson, "Quack Corporate Governance" As Traditional Chinese Medicine – The Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle against Party's State Political Economic Power, 37 *Seattle U. L. Rev.* 667, 681, text at n. 32 (2014) ("Howson") (citing "Guanyu Guifan Shangshi Gongsi Yu Guanlianfang Zijin Wanglai Ji Shangshi Gongsi Duiwai Danbao Ruogan Wenti De Tongzhi [Notice Regarding Several Issues Relating to the Regulation of Listed Company-Related Party Funds Flows and Listed Company External Guarantees], Aug. 28, 2003, zhengjianhui [2003] 56, CSRC Laws and Regulations, at 981-83.").

<sup>42</sup>See Howson, *supra*, n.42, 37 *Seattle U. L. Rev.* at 681, n. 33.

<sup>43</sup>*Id.* (text at ns. 34-35).

<sup>44</sup>*Id.* (text at n. 36).

<sup>45</sup>*Id.* at 681-82, text at ns. 37-40.

<sup>46</sup>See generally Hui Huang, *The Regulation of Insider Trading in China: Law and Enforcement* (2014) (and slides), reviewed April 9, 2014, downloaded [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2378842](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2378842); Nicholas C. Howson, *Enforcement Without Foundation? Insider Trading and China's Administrative Law Crisis*, 60 *The American Journal of Comparative Law*, 955 (2012) (insider trading "is an acknowledged fact of the Chinese domestic capital markets") (hereinafter "Enforcement"); Greg Tzu Jan Yang, *Insider Trading in China: Compared with Cases in the United States*, Contemporary Asian Studies Series (2012), reviewed April 3, 2014, downloaded <http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1212&context=mscas>.

<sup>47</sup>The 2006 Securities Law was promulgated in October, 2005, but was not effective until January, 2006 and is, therefore, referred to herein as the "2006 Securities Law."

<sup>48</sup>Article 73 states: "It is prohibited for those with knowledge of securities trading [related] inside information or those who have illegally procured inside information to use inside information in undertaking securities trading activities."

<sup>49</sup> Article 74 states: "Persons with knowledge of securities trading [related] inside information include (i) directors, supervisory board members, and senior managers of the issuer; (ii) 5% or more shareholders of the company and its/their directors, supervisory board members and senior managers, and the actual controlling shareholders of the company and its/their directors, supervisory board members and senior managers; (iii) directors, supervisory board members and senior manager of companies controlled by the issuer; (iv) people whose executive or staff position in the company provides access to inside information; (v) Securities Regulatory Organ [CSRS] staff and others who pursuant to their legally stipulated duties administer or regulate securities issuance and trading; (vi) relevant securities sponsors, underwriters, securities exchange personnel securities registration and settlement personnel, and securities service institution personnel; and (vii) other persons, stipulated in regulation by the State Council Securities Regulatory Organ [the CSRC]."

<sup>50</sup> Article 76 states "Persons possessing inside information relating to securities trading and persons obtaining inside information unlawfully shall not, prior to the publication of such inside information, purchase or sell the securities of the company concerned, or disclose such information, or suggest other persons trade in such securities.

Where, with respect to the acquisition of the shares of a listed company by a natural person, a legal person or other organization that holds 5% or more of the shares of the company individually or jointly with others through agreements or other arrangements, there are other provisions under this law, such other provisions shall govern.

Where insider trading causes losses to investors, the traders shall be held liable for the losses pursuant to law."

<sup>51</sup> "Serious circumstances" include cases where (1) the accumulative trading amount of securities is more than 500,000 yuan; (2) the accumulative amount of used margin for futures trading is more than 300,000 yuan; (3) the accumulative amount of profits gained or losses avoided is more than 150,000 yuan; (4) insider trading is conducted or insider information is leaked more than three times; or (5) any other serious circumstance. "Very serious circumstances" include (1) the accumulative trading amount of securities is more than 2,500,000 yuan; (2) the accumulative amount of used margin for futures trading is more than 1,500,000 yuan; (3) the accumulative amount of profits gained or losses avoided is more than 750,000 yuan; or (4) any other very serious circumstance.

<sup>52</sup> Enforcement, 60 Am. J. Comp. L. at 970.

<sup>53</sup> *Id.* at 970-71. Criminal conviction for insider trading requires proof of either intentional or reckless conduct, whereas non-criminal (administrative) liability may be based on negligence and can subject a defendant to administrative penalties. The prosecutor or administrative plaintiff must demonstrate scienter, i.e., that the insider knew or should have known the information about the issue would be deemed "inside information" when trading occurred.

<sup>54</sup> See generally Legal Guidelines on Insider Trading Set for June Launch, Caijing.com, reviewed April 10, 2014, downloaded, <http://english.caijing.com.cn/2012-06-05/111876698.html> (new guidelines clarify definition of insider trading in several laws and regulations, e.g., Securities Law, Criminal Law and the Regulation on Administration of Futures Trading, identifying what is not considered insider trading and

identifying sensitive periods for obtaining insider information -- China insider trading tends to have the "characteristics of high secrecy and wide social impact," making it difficult for regulators to enforce -- CSRS has been cracking down on such trading since 2009 but due to difficulties identifying the crime and gathering evidence, cases going to trial are far fewer than the number of cases).

<sup>55</sup>See generally Hui Huang, *The Regulation of Insider Trading in China: Law and Enforcement* (2014), reviewed April 2, 2014, downloaded [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2378842](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2378842). ("According to CSRC statistics, from early 2008 to the end of 2011, the CSRC gained clues to 426 cases of insider trading, but only initiated investigations on 153 cases. Due to the difficulties in applying the law, few insider trading cases end up going to trial. As of the end of 2011, Chinese courts tried a total of 22 criminal cases involving insider trading and disclosure of secret data, including one in 2007, one in 2008, 4 in 2009, 5 in 2010 and 11 in 2011.").

<sup>56</sup>According to Andrew Wedeman, a political science professor at Georgia State University and the author of "Double Paradox: Rapid Growth and Rising Corruption in China," This is the most sustained drive against high-level corruption since the advent of economic reforms in the early 1980s. Source: Shari Oster, *President Xi's Anticorruption Campaign Biggest since Mao*, Bloomberg, March 4, 2014, reviewed April 9, 2014, downloaded <http://www.bloomberg.com/news/2014-03-03/china-s-xi-broadens-graft-crackdown-to-boost-influence.html>