

Second Securities Law Colloquium:
The Problems of Chinese Companies on US Securities Exchanges

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***International Regulatory Competition: Hong Kong's Strategic
Role in the Game Between China and the US***

Fanpeng (Frank) MENG

PhD Candidate

Faculty of Law, the Chinese University of Hong Kong

mengfanpeng@cuhk.edu.hk

REVERSE MERGER

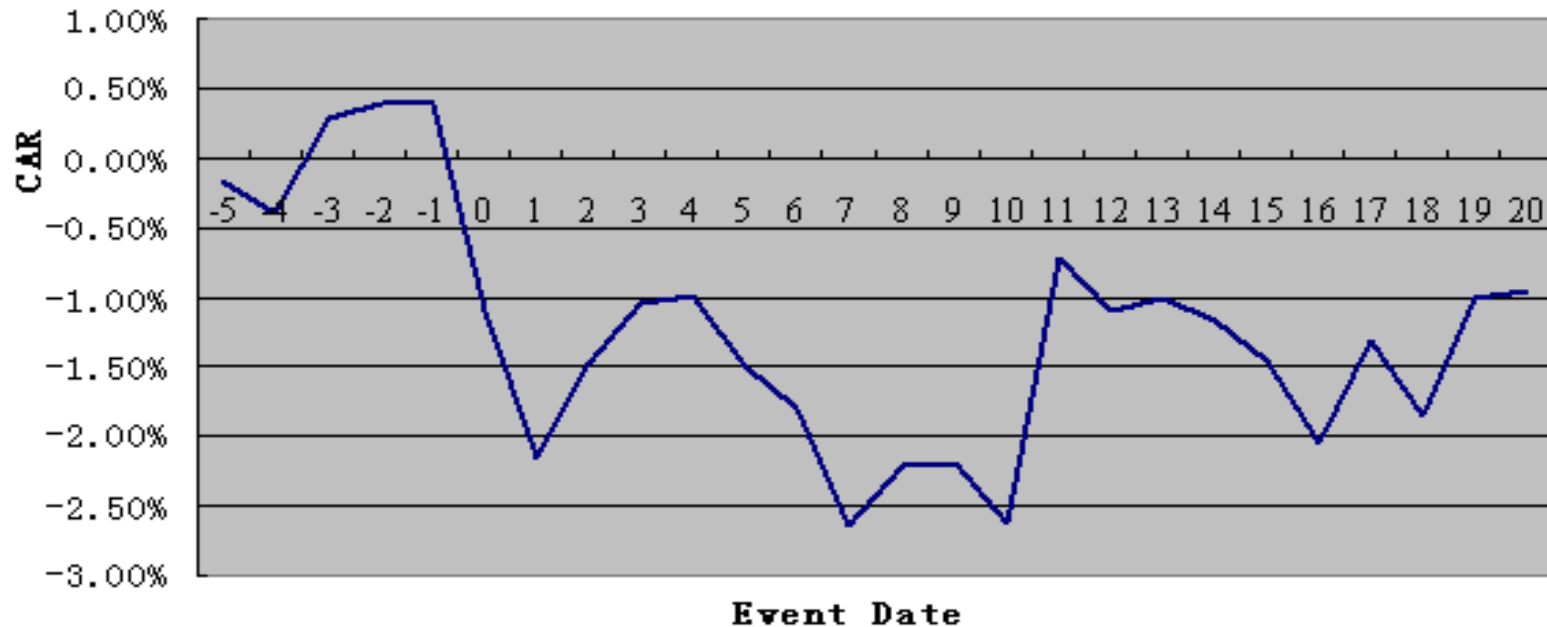
- Backdoor Listing: a private company buys a public shell company that no longer operates, and issue shares through the shell company.
- Hong Kong used to be a popular location for reverse mergers, but not for the last decade.
- Hong Kong: Rule 14.06(6) defines “Reverse Takeover” as:
“An acquisition or a series of acquisitions of assets by an issuer which, in the opinion of the Exchange, constitutes, or is part of a transaction or arrangement or series of transactions or arrangements which constitute, an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new applicants set out in Chapter 8 of the Exchange Listing Rules.”
- This does not mean there is no governance problem in Hong Kong.

“LIGHT-HANDED” REGULATORY APPROACH

- The SEHK: SRO, an operator as well as a front-line regulator of the Hong Kong stock market.
- Non-statutory nature of Listing Rules: upon breach of the Listing Rules, the SEHK only has contractual right to launch disciplinary sanctions.
- Practical sanctions: public criticism & public censure
- Rationale: the SEHK is a subsidiary of the HKEx, the HKEx is listed on the SEHK. It has an interest in listing as many companies as possible, while enforcement generates no revenues. Therefore, the purpose to maximize shareholder value conflicts enforcement goals.
- Reputational sanctions: effective regulatory tools in the UK & China

REPUTATIONAL SANCTION

- Share Price Reaction: Sample Size (54 observations, 2001-2009)



- Negative Collateral Effects: N/A
 - China: eg. the company cannot issue new shares or make a private placement for one year, its ability to obtain bank loans may be affected, individuals may be forced to resign from office and disqualified to serve as independent directors for three years.
- Is it still effective outside Hong Kong ?

DUAL FILING SYSTEM

- Section 5 of the Securities and Futures (Stock Market Listing) Rules (SMLR), a listing applicant must:
 - submit a copy of application to the SEHK; then file the same copy of application to the SFC within one business day, or authorize the exchange to file on its behalf.
- Section 6 of the SMLR:
 - the SFC may object to the application if it fails to comply with the requirements of the dual-filing system, or it is false or misleading ... or it is not in the interest of the public ...
 - April 2003 – March 2011: the SFC received 983 applications, commented on 642, and only on three occasions declared its intention to object to the application for deficient disclosure.
- The SFC may exercise its statutory powers to take action against false or misleading disclosure through Section 384 of the SFO which created two disclosure offences:
 - where a person provides false or misleading information in purported compliance with a requirement under the SFO
 - where a person otherwise provides a false or misleading record or document to the SFC ...

Accounting and Auditing Practices

- December 2007:
 - Joint Declaration on the Convergence of China Accounting Standards for Business Enterprises and Hong Kong Financial Reporting Standards
 - Joint Declaration on the Convergence of Mainland Auditing Standards and Hong Kong Accounting Standards
- September 2009:
 - Pilot Work Plan for Accounting Firms' Auditing of H-share Companies: Chinese accounting firms satisfied with certain criteria may apply for providing auditing services to H-share companies.
- December 2010:
 - allow H-share companies to prepare their financial statement using Chinese accounting standards, and
 - Allow Chinese accounting firms approved by the MOF and the CSRC to service H-share companies using Chinese auditing standards.

Statutory Private Enforcement Mechanisms

- SFO:
 - Section 281 and Section 305: market misconduct activities,
 - Section 108: reliance of fraudulent, reckless, or negligent misrepresentation to induce others to invest,
 - Section 391: communication of false or misleading information to the public.
- Companies Ordinance (Cap 32):
 - Section 168BA to Section 168 BK: statutory derivative action.
- Order 15, rule 12 of the Rules of the High Court (Cap 4A):
 - Where numerous persons have the same interest in a proceeding and where the relief request is beneficial to the entire group, an action can be commenced by one or more of them as representatives of the group.
- Class action:
 - 2009 Consultation Paper: an opt-out model of class action.
- No contingency fee and instead fees will “follow the event”

MPAAO

- Regulatory standard:
 - Overseas: equivalent to that of Hong Kong
 - H-share: sufficient level of shareholder protection
- MPAAO: Mandatory Provisions for Articles of Associations for Companies to be Listed Overseas
- Article 163(1): for H-share companies,

If any dispute or claim that concerns the company's business and is based on rights or obligations provided for in the articles of association of the company or in the company law or other relevant laws or administrative regulations arises between a foreign shareholder and the company, a foreign shareholder and a director, a supervisor, the manager or other senior management staff of the company or between a holder of foreign investment shares listed outside the PRC and a holder of domestic investment shares, the parties concerned should submit the dispute or claim to arbitration.

- Article 163(1) :

When a dispute or claim ... is submitted to arbitration, the dispute or claim should be submitted in its entirety, and all persons (being the company, or shareholders, directors, supervisors, managers, or other senior management staff of the company) that have a cause of action due to the same fact or whose participation is necessary for the resolution of the dispute or claim should submit to arbitration.

- Article 163(2): an arbitration claim can be made, at the option of the applicant, to either the China International Economic and Trade Arbitration Commission (CIETAC) or the Hong Kong International Arbitration Centre (HKIAC).

Conclusion

- “Race to the top” vs. “Race to the bottom”: as compared with the US, Hong Kong’s regulatory regime is not characterized by intensive enforcement at the backend.
- Hong Kong’s regulatory regime is well-organized, well-regulated, efficient, and transparent, which attracts issuers as well.
- Along with geographical, cultural, language, and political factors, Hong Kong will continue to be a prime listing venue for Chinese companies.
- Meanwhile, these factors together provide Hong Kong a comparative advantage over other listing venues such as the US.