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“ONE COUNTRY TWO SYSTEMS” AS BEDROCK OF HONG KONG’S CONTINUED SUCCESS: FICTION OR REALITY?

HORACE YEUNG*
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Abstract: Despite the handover of sovereignty over Hong Kong from the United Kingdom to China in 1997, the principles of “one country two systems” reaffirmed the autonomy of Hong Kong in a number of respects. In accordance with the Sino-British Joint Declaration and Basic Law of Hong Kong, the city is able to enjoy a high degree of autonomy over the systems and policies practiced locally, including social and economic systems, as well as the executive, legislative and judicial systems. Additionally, with its image as a robust financial market largely thanks to the institutions inherited from its colonial era, Hong Kong is able to attract a number of financial activities from China and has firmly established itself as a leading international financial center. Nonetheless, there have been concerns that the advantages of Hong Kong started to fade after its reunification with China. This Article seeks to analyze how Hong Kong’s capitalist system shields the city from the socialist system of China under the principles of “one country two systems,” allowing the city to maintain its position as a premier financial center. It explores the regulatory gap between Hong Kong and China, illustrating that Hong Kong’s strength stems from the operation of a strong company and financial law regime independent of the legal regime in China.

INTRODUCTION

*“Hong Kong will be administered by people in Hong Kong. The administrators will be elected by the people there.”*¹

—Deng Xiaoping

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¹ La Ka-Kuen, *The Legend of Deng Xiaoping*, S. CHINA MORNING POST (Aug. 22, 2014), <http://www.scmp.com/infographics/article/1578965/legend-deng-xiaoping>, archived at <http://perma.cc/8562-PFWU>.

The relationship between Hong Kong and China is unique in having the “one country two systems” principles, widely understood to be pioneered by Deng Xiaoping, the paramount leader of China and architect of *Gaige Kaifang*. This twin-strategy of reform and opening up ensured the present economic success of China. The “one country two systems” principles were subsequently transposed into the Sino-British Joint Declaration and Basic Law of Hong Kong which entailed the following key promises: first, the Hong Kong Special Administrative Region (SAR) government shall be composed of local inhabitants; second, the legislature, to whom the executive authorities shall be accountable, shall be constituted by elections; third, judicial power, which shall be exercised independently, shall be vested in the SAR courts and these courts shall possess the power of final adjudication; fourth, the rights and freedoms of inhabitants shall be protected such that every person shall have the right to freedom of speech, of the press, of assembly, and of religious belief, as well as the right to judicial remedies, the right to confidential legal advice, and the right to challenge in court the actions of the executive branch of government; and lastly, the social and economic systems in Hong Kong and the lifestyle of inhabitants shall remain unchanged for at least fifty years.²

This Article contends that Hong Kong’s status as a quasi-state has been the cornerstone of its success. The investigation will be divided into six parts. The next part will give an overview of Hong Kong’s history and how it rose to prominence as Asia’s leading financial center. Part II will explain how the “one country two systems” principles should be understood in the context of this paper. Parts III and IV will compare the general evolution and specific aspects of the corporate and financial law regimes of Hong Kong and China to reveal a potential regulatory gap between the two jurisdictions. Part V examines the recent political tension in Hong Kong between pro-democracy and pro-Beijing groups, discussing whether a divided Hong Kong, will affect the continued success of the city due to constitutional uncertainty. The final part will conclude that Hong Kong’s strength has come from the operation of a strong company and financial law regime independent of the legal regime on mainland China.

I. A BRIEF HISTORY OF HONG KONG & ITS SUCCESS

A. Humble Beginnings & Breakthrough

On December 19, 1984, British and Chinese officials released a Joint Declaration stating that Hong Kong would become the Hong Kong Special

² See John Head, *Selling Hong Kong to China: What Happened to the Right of Self-Determination?*, 46 U. KAN. L. REV. 283, 294 (1998).

Administrative Region (SAR) of the People's Republic of China on July 1, 1997.³ Today, Hong Kong is one of the most affluent areas in the region, with a gross domestic product (GDP) per capita of \$52,700 in 2013, the fifteenth highest in the world.⁴ The rise of Hong Kong to its present status is a miracle because when it was colonized by the British Empire in 1842, it was merely a small fishing village.

Despite these humble beginnings, Hong Kong developed a strong foundation in financial instruments issuance and dealing “within the British system, particularly company and contractual law and financial practices.”⁵ Trading in Hong Kong in company shares can be traced back to about 1860.⁶ Indeed, one of the largest banks in the world, HSBC, first opened its doors for business in Hong Kong in March 1865 aiming to finance the growing trade between Europe, India, and China.⁷ In 1891, the Association of Stockbrokers in Hong Kong was formed, marking more than one hundred years of development for its stock exchange.⁸

Since the 1980s, Hong Kong's economy has become increasingly service-oriented. Nowadays, the service industry accounts for more than 90 percent of Hong Kong's GDP.⁹ Before the growth of its financial services sector, international trade had long been a defining characteristic of the Hong Kong economy. Beginning in the 1950s, exports of domestically produced light industrial products served as the engine of growth for nearly three decades.¹⁰ Since the late 1970s, many Hong Kong manufacturers have relocated their labor-intensive production processes to China to take advantage of the low production costs available there.¹¹ GDP contribution from manufacturing shrank from 13 percent in 1992, to 4 percent in 2002, and then plummeted to

³ *See id.*

⁴ *The World Factbook: Hong Kong*, CIA, <https://www.cia.gov/library/publications/the-world-factbook/geos/hk.html>, archived at <https://perma.cc/7T35-ZXE9>. For comparison, the GDP per capita of the United States was \$52,800 in the same year. *The World Factbook: United States*, CIA, <https://www.cia.gov/library/publications/the-world-factbook/geos/us.html>, archived at <https://perma.cc/56E3-N4KR>.

⁵ SEC. & FUTURES COMMISSION, SECURITIES REGULATION IN HONG KONG 3 (2002), available at <https://www.sfc.hk/web/doc/EN/speeches/public/others/speechbook/fullversion.pdf>, archived at <https://perma.cc/9FL8-XYBK>.

⁶ *See id.*

⁷ *See HSBC's History*, HSBC, <http://www.hsbc.com/about-hsbc/company-history/hsbc-history> (last visited Mar. 31, 2015), archived at <http://perma.cc/2MNC-8HVR>.

⁸ SEC. & FUTURES COMMISSION, *supra* note 5, at 3–4.

⁹ *See* H.K. INFO. SERV. DEP'T, GOVERNMENT YEARBOOK 2013, at 37 (2014), available at <http://www.yearbook.gov.hk/2013/en/pdf/E03.pdf>, archived at <http://perma.cc/WJH8-8VCM>.

¹⁰ *Hong Kong as a Trading Hub: Entrepôt and Beyond*, H.K. TRADE & DEV. COUNCIL (Apr. 1, 2007), <http://economists-pick-research.hktdc.com/business-news/article/Economic-Forum/Hong-Kong-as-a-Trading-Hub-Entrep-ocirc-t-and-Beyond/ef/en/1/1X000000/1X0034J5.htm>, archived at <http://perma.cc/6ZMK-PWJC>.

¹¹ *Id.*

less than 2 percent in 2012.¹² As the foregoing statistics show, Hong Kong has transformed from a sleepy fishing village into a vibrant service-oriented economy.

The breakthrough for Hong Kong's stock market was the opening of the Far East Stock Exchange on December 17, 1969.¹³ In the 1970s, Hong Kong's securities market became firmly established and then flourished.¹⁴ By early 1973, the Hang Seng Index, which is the free float-adjusted market capitalization-weighted stock market index in Hong Kong, reached a record high of 1,775 points, which has since been eclipsed many times.¹⁵ The subsequent collapse of this speculative boom in 1974 led the government to regulate the rapidly expanding market to meet investor protection and financial stability concerns.¹⁶ Since then, Hong Kong has been on the march again, though there was a worldwide stock market crash in 1987 from which Hong Kong was not immune.¹⁷ Since the 1990s, the number of initial public offerings (IPOs) in Hong Kong has increased significantly due to the influx of Chinese companies on to the exchange.¹⁸

At present, Hong Kong is undoubtedly an international financial market. For example, Time Magazine coined the term "Nylonkong" to describe the extent to which New York, London and Hong Kong are linked by a shared economic culture, and how they have created a financial network that has come to be both an example and an explanation of globalization.¹⁹ The Financial Times went so far as to replace New York and London with Shanghai, coining a new term "Shangkong," following a shift in financial gravity to Asia.²⁰ According to the Global Financial Centres Index (GFCI), Hong Kong has consistently remained in the top three financial centers since 2007, behind only London and New York. With a total market capitalization of about 24 trillion HKD at the end of 2013, Hong Kong's stock market ranked sixth in the world and second in Asia.²¹

The ability of the bourse to attract new listings should particularly be noted. From 2009 to 2011, Hong Kong's stock market led the world in raising

¹² See H.K. INFO. SERV. DEP'T, *supra* note 9, at 37.

¹³ SEC. & FUTURES COMMISSION, *supra* note 5, at 3.

¹⁴ RANALD C. MICHIE, *THE GLOBAL SECURITIES MARKET* 267 (2006).

¹⁵ See SEC. & FUTURES COMMISSION, *supra* note 5, at 8.

¹⁶ MICHIE, *supra* note 14, at 267.

¹⁷ SEC. & FUTURES COMMISSION, *supra* note 5, at 27.

¹⁸ See Horace Yeung & Xiao Huang, *Law and Finance: What Matters? Hong Kong as a Test Case*, 3 *ASIAN J. L. & ECON.* 1, 7 (2012).

¹⁹ See Michael Elliott, *A Tale of Three Cities*, TIME (Jan. 17, 2008) <http://content.time.com/time/magazine/article/0,9171,1704398,00.html>, archived at <http://perma.cc/Y3L9-8GXJ>.

²⁰ Jeffrey Garten, *Amid Economic Rubble, Shangkong Will Rise*, FIN. TIMES (May 11, 2009) <http://www.ft.com/cms/s/0/dfbd55ea-3d8c-11de-a85e-00144feabdc0.html#axzz3TqEhT2W4>, archived at <http://perma.cc/HZ3T-BNJQ>.

²¹ See H.K. INFO. SERV. DEP'T, *supra* note 9, at 58.

funds through IPOs.²² Despite a drop in performance thereafter, in 2013 the city remained second worldwide in terms of attracting IPO funds.²³

B. Hong Kong's Economic Relationship with China

Under British rule, Hong Kong's economy prospered. In contrast, since the Communist Party came to power in 1949, Chinese society has been largely closed off from the outside world and economic development has been significantly hindered. Hong Kong has played a pivotal role throughout China's various stages of development, ranging from a supplier of vital supplies, a trade middleman, and finally a financial center.²⁴ When the Communist Party of China came to power in 1949, it inherited a poor agrarian society consisting mainly of millions of small-scale self-sufficient farming households. China imported most of the strategic supplies from Hong Kong during the Korean War, amid a trade embargo by the United Nations.²⁵

Following the calamity of the Great Leap Forward strategy and the Cultural Revolution, the state advocated a fundamental re-orientation of China's development strategy and marked a new era of economic reform and open-door policy.²⁶ The open-door policy is a vital part of China's new development strategy of intensive growth and the motivational force for reform. The commitment to the open-door policy forced China to modify a rigid economic system to facilitate economic interactions with world markets. The role of Hong Kong in this process has been pivotal and can be summarized into four main functions: financier, trading partner, middleman, and facilitator.²⁷

Hong Kong is the predominant source of foreign finance in China. Hong Kong has provided China with a number of different loans: first direct lending; second, loan syndication; and finally, lending from Hong Kong banks to non-bank customers in China.²⁸ The combined shares of direct loans and syndicated loans from Hong Kong ranged from one-third to two-thirds of China's commercial loans in the period between 1984 to 1987.²⁹ After 1990, Hong Kong added a new aspect to its financing in China by providing a fundraising platform for Chinese companies.

²² H.K. INFO. SERV. DEP'T, GOVERNMENT YEARBOOK 2011, at 73 (2012), available at <http://www.yearbook.gov.hk/2011/en/pdf/E04.pdf>, archived at <http://perma.cc/4NGG-J585>.

²³ See H.K. INFO. SERV. DEP'T, *supra* note 9, at 58–59.

²⁴ YUN-WING SUNG, THE CHINA-HONG KONG CONNECTION: THE KEY TO CHINA'S OPEN-DOOR POLICY 5–6, 16–17, 26 (1991).

²⁵ See *id.* at 5.

²⁶ See *id.* at 6.

²⁷ *Id.* at 16–17.

²⁸ See *id.*

²⁹ *Id.* at 95–97.

In July 1993, Tsingtao Brewery, which produces the famous Chinese Tsingtao beer, became the first Chinese company ever to be listed on the Hong Kong Stock Exchange (HKEx).³⁰ The Hong Kong stock market used to be dependent on the property sector, but now has a more diversified structure because of the increasing importance of Chinese companies from a variety of sectors.³¹ For example, the property sector accounted for 31 percent of total market capitalization at the end of 1996, but by 2004, this sector only accounted for 11 percent.³² In contrast, Chinese companies now have an overwhelmingly important presence on the stock exchange. At the end of 2013, out of 1,643 public companies listed on the HKEx, 797 of them were from China.³³ The importance of Chinese companies reached its peak between 2007–2008 when they accounted for over half of the HKEx's total market capitalization, but this number declined to around 40 percent as of mid-2014. The trend came as a result of HKEx's attempt to diversify the sources of issuers. Until late 2006, the HKEx would only accept listing applications from companies incorporated in a few jurisdictions such as Hong Kong, China, the Cayman Islands, and Bermuda.³⁴ As of this moment, there are twenty-one acceptable overseas jurisdictions.³⁵

It is undeniable that the influx of Chinese companies has been the catalyst for Hong Kong to evolve into an international finance center. Fueled by global investors' desire to have a share of China's impressive economic growth, the presence of overseas institutional investors in Hong Kong has increased dramatically. Local retail investors were the major contributors to the Hong Kong market in the 1990s and were responsible for the largest proportion of market turnover value among all types of investors until 2000.³⁶ Since 2000, local retail investors have ceded their dominant position to overseas institutional investors. Measured by turnover value, the largest group of overseas participants is investors from the United States, followed by inves-

³⁰ See Yeung & Huang, *supra* note 18, at 20.

³¹ Joseph Lee & Joanna Poon, *The Listing of Mainland Companies on HKEx and the Implications for Hong Kong*, SEC. & FUTURES COMMISSION 1 (Sept. 2004), <http://www.sfc.hk/web/doc/EN/research/research/rs%20paper%2017.pdf>, archived at <http://perma.cc/Q4LS-KKP8>.

³² *Id.* at 2.

³³ See H.K. INFO. SERV. DEP'T, *supra* note 9, at 58–59.

³⁴ Horace Yeung & Xiao Huang, *Regulatory Cooperation Between Securities Commissions: A Reflection from Hong Kong*, 1 CHINESE J. COMP. L. 112, 153 (2013).

³⁵ *List of Acceptable Overseas Jurisdictions*, HKEX, http://www.hkex.com.hk/eng/rulesreg/listrules/listsptop/listoc/list_of_aoj.htm (last updated July 14, 2014), archived at <http://perma.cc/97GM-2K8L>.

³⁶ Essie Tsoi, *Understanding Investors in the Hong Kong Listed Securities and Derivatives Markets*, SEC. & FUTURES COMMISSION 3 (July 2004) <http://www.sfc.hk/web/doc/EN/research/research/extpaper05%20%28eng%29.pdf>, archived at <http://perma.cc/T52E-Y7UK>.

tors from the United Kingdom.³⁷ Investors from the rest of Europe have also expanded their participation.³⁸

With so many foreign participants, the regulatory authorities in Hong Kong are committed to maintaining a stringent regulatory standard, since Hong Kong is now heavily financial services-oriented. Because market-oriented companies seeking demutualization dominate the Exchange, transactions risk losing revenue if they fail to compete. This drive for profit arguably carries the risk of increasing the scope and intensity of conflict.³⁹ Furthermore, the Exchange may have less incentive to commit resources for self-enforcement or to take enforcement action against its customers or users who are a source of income.⁴⁰ Questions have been raised on inherent conflicts of interest for the Exchanges' dual roles as market operators and regulators.⁴¹ Hong Kong's continued success may hinge on whether it can maintain its image as a sound and robust financial market.

II. HONG KONG'S ECONOMIC, FINANCIAL & REGULATORY SYSTEM AS PART OF CHINA

In 1982, Deng Xiaoping first applied the idea of "one country two systems" to Hong Kong, as originally proposed by Ye Jianying, Chairman of the Standing Committee of the National People's Congress to facilitate the peaceful national reunification of China and Taiwan:

To maintain Hong Kong's prosperity basically depends upon our proposals that China will adopt the policies that are fit for Hong Kong after she resumes the exercise of sovereignty over Hong Kong. Hong Kong's current political and economic systems and even most of its laws can remain unchanged. Certainly, some should be revised and reformed. Hong Kong will still maintain its

³⁷ *Id.* at 15.

³⁸ *Id.*

³⁹ See Reena Aggarwal, *Demutualization and Corporate Governance of Stock Exchanges*, 15 J. APPLIED CORP. FIN. 105, 106 (2002); Andreas Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2543–44 (2006). *But see* Ruben Lee, *The Future of Securities Exchanges*, WHARTON FIN. INST. CTR. 15 (Feb. 26, 2002), <http://www.oxfordfinancegroup.com/media/10341/lee%20future%20securities%20exchanges%202002.pdf>, archived at <http://perma.cc/WP9L-EG9Q> (stating that alternatively, many exchanges have claimed that demutualization would give them an added incentive to maintain high regulatory standards which can attract more business, thereby increasing revenues).

⁴⁰ See Aggarwal, *supra* note 39, at 109.

⁴¹ See *id.*; Fleckner, *supra* note 39, at 2543.

capitalist system. Many present systems that are suitable should remain unchanged.⁴²

On December 19, 1984, Chinese Premier Zhao Ziyang and British Prime Minister Margaret Thatcher, on behalf of their respective governments, signed the Sino-British Joint Declaration, which reflected the basic principles and policies of “one country two systems.”⁴³ The Joint Declaration mandated that the United Kingdom relinquish Hong Kong to Chinese sovereignty on July 1, 1997, and obligated China to establish the territory as a “Special Administrative Region” (SAR).⁴⁴ As such, the territory would “enjoy a high degree of autonomy, except in foreign and defense affairs which are the responsibilities of the Central People’s Government.”⁴⁵

Most importantly, the Joint Declaration formed the foundation of the Basic Law of Hong Kong, which is known as the “mini-constitution.” On the one hand, Hong Kong’s long history as an Asian financial center strengthened its credentials. On the other hand, the Basic Law also played a role in maintaining Hong Kong’s position by expressly stating that the socialist system and policies in China must not be practiced in Hong Kong and the established capitalist system must remain unchanged for 50 years after the handover.⁴⁶

The principles of “one country two systems” have reaffirmed the independence of Hong Kong in a number of respects. In principle, Chinese laws and policies are not applied in Hong Kong.⁴⁷ Article 8 of the Basic Law stipulates that:

The laws previously in force in Hong Kong, that is, the common law, rules of equity, ordinances, subordinate legislation and customary law shall be maintained, except for any that contravene this Law, and subject to any amendment by the legislature of the Hong Kong Special Administrative Region.⁴⁸

This Article contends that there is a potential “regulatory gap” between the corporate and financial law systems of Hong Kong and China, and argues

⁴² BASIC LAW PROMOTION STEERING COMMITTEE, THE BASIC LAW AND HONG KONG: 15TH ANNIVERSARY OF UNIFICATION WITH THE MOTHERLAND 10 (2012), available at http://www.basiclaw.gov.hk/en/publications/book/15anniversary_reunification_ch1_1.pdf, archived at <http://perma.cc/TYS3-ERMB>.

⁴³ See *id.* at 13.

⁴⁴ Joint Declaration on the Question of Hong Kong § 3(2), China-U.K., Dec. 19, 1984, 1399 U.N.T.S. 33; BASIC LAW PROMOTION STEERING COMMITTEE, *supra* note 42, at 13.

⁴⁵ See Joint Declaration on the Question of Hong Kong, *supra* note 44, § 3(2).

⁴⁶ XIANGGANG JIBEN FA art. 5 (H.K.); XIANFA art. 6 (2004) (China) (stating that the basis of the socialist economic system of the People’s Republic of China is socialist public ownership of the means of production).

⁴⁷ See XIANGGANG JIBEN FA art. 18, Annex III (H.K.).

⁴⁸ See *id.* art. 8.

that Hong Kong's advantage has largely come from the operation of a regulatory regime independent of the one in China. The legal framework of both systems will be compared in the next two parts.

III. THE GENERAL LEGAL FRAMEWORK OF THE TWO JURISDICTIONS

The interrelationship between law and financial development are at the core of law and finance studies.⁴⁹ Rafael La Porta and colleagues have examined legal rules addressing the protection of corporate shareholders and creditors, the origin of these rules, and the quality of their enforcement in forty-nine countries.⁵⁰ They have alleged that the legal environment, including both legal rules and their enforcement, matters for the size and extent of a country's capital market.⁵¹ A good legal environment protects the potential financiers against expropriation by entrepreneurs.⁵² As a result, investors are willing to surrender funds in exchange for securities, thereby expanding the scope of capital markets.⁵³ The advantage of good regulation is also confirmed by the bonding hypothesis proposed by John Coffee.⁵⁴ According to this theory, instead of going for a lower cost and less demanding regulatory structure, companies tend to choose an internationally renowned market, generally with higher entry and ongoing requirements.⁵⁵ They comply voluntarily with a high level of disclosure and corporate governance standards.⁵⁶ In this way, a company may potentially benefit from an increase in its share price and the ability to raise capital at a lower cost.⁵⁷

A. Hong Kong

Fundamentally, Hong Kong's regulatory system is stronger than China's. The development of Hong Kong's corporate and financial law regime has a close connection with its historical status as a British colony.⁵⁸ The genesis of

⁴⁹ Mathias Siems, *Legal Origins: Reconciling Law & Finance and Comparative Law*, 52 MCGILL L. J. 55, 57 (2007).

⁵⁰ See Rafael La Porta et al., *Legal Determinants of External Finance* 52 J. FIN. 1131, 1131–32 (1997). *But see* Daniel Berkowitz et al., *Economic Development, Legality and the Transplant Effect*, 47 EUR. ECON. REV. 165, 166–67 (2003); John Armour et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, 6 J. EMPIRICAL LEGAL STUD. 343, 344 (2009).

⁵¹ La Porta et al., *supra* note 52, at 1132.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ See John C. Coffee, *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1780–83 (2002).

⁵⁵ *See id.*

⁵⁶ *See id.*

⁵⁷ *See id.* at 1783.

⁵⁸ *See* Yeung & Huang, *supra* note 18, at 9.

the current corporate law framework is the *Companies Ordinance (CO) of 1865* that mirrored the *English Companies Act of 1862*, which in turn incorporated both the *Joint Stock Companies Registration and Regulation Act of 1844* and the *Limited Liability Act of 1855*.⁵⁹ Likewise, the *Companies Act of 1908* in the United Kingdom was followed by the *Companies Ordinance of 1911* in Hong Kong. The CO was designated as Chapter (Cap) 32 in 1933. After 1933, no further significant legislative initiative in company law was introduced until 1984, which reflected the *Companies Act of 1948*.⁶⁰ Since then, the law has constantly been revised.⁶¹ Other related rules and regulations include the Listing Rules of the HKEx, as well as the *Code on Corporate Governance Practices* and the *Code on Takeovers and Mergers*. Furthermore, the substantive legal framework in Hong Kong to protect investors and promote market efficiency mirrors the United Kingdom's common law system of investor protection.⁶² For example, both common law and statutory law impose certain duties on company directors.⁶³ Directors owe fiduciary duties, which are based upon showing the utmost good faith.⁶⁴ The new *Companies Ordinance* in Hong Kong was published in August 2012 and entered into force in March 2014.⁶⁵ The new law aims to achieve four main objectives: to enhance corporate governance, ensure better regulations, facilitate business and modernize the law.⁶⁶

Formal regulation of securities law started in 1974 when a market crash attracted government attention and led to the introduction of legislation.⁶⁷ That same year, the *Securities Ordinance* and the *Protection of Investors Ordinance* became effective.⁶⁸ In 1987, when the world's securities markets braced themselves for another crash, the Hong Kong government recognized the need to strengthen its systems and regulatory arrangements to maintain its position as the foremost Asian capital market.⁶⁹ The 1987 crash led to the

⁵⁹ MINKANG GU, UNDERSTANDING CHINESE COMPANY LAW 10 (2006).

⁶⁰ See *Companies (Winding Up and Miscellaneous Provisions) Ordinance*, (2014) Cap. 32, 1 (H.K.); John H. Farrar, *Developing Corporate Governance in Greater China*, 25 U. N. S. WALES L.J. 462, 474 (2002).

⁶¹ See Farrar, *supra* note 60, at 474.

⁶² See Yeung & Huang, *supra* note 18, at 10.

⁶³ See *id.* at 11.

⁶⁴ See *id.*

⁶⁵ *Companies Ordinance Rewrite*, FIN. SERVICES & TREASURY BUREAU H.K., http://www.fstb.gov.hk/fsb/co_rewrite/eng/home/home.htm (last updated Feb. 20, 2014), archived at <http://perma.cc/ZLN7-PTH5>.

⁶⁶ *New Companies Ordinance Overview*, COMPANIES REGISTRY H.K., http://www.cr.gov.hk/en/companies_ordinance/overview.htm (last updated Mar. 3, 2014), archived at <http://perma.cc/HP5B-U7JQ>.

⁶⁷ SEC. & FUTURES COMMISSION, *supra* note 5, at 11.

⁶⁸ *Id.*

⁶⁹ See *id.* at 32.

appointment of the Securities Review Committee.⁷⁰ The *Securities and Futures Commission Ordinance*, which passed its final reading in 1989, marked the beginning of a strong single regulator.⁷¹ In 1991, the *Securities (Disclosure of Interests) Ordinance* and *Securities (Insider Dealing) Ordinance* came into force.⁷² In 2003, the *Securities and Futures Ordinance* (SFO) consolidated and modernized all of the previous ordinances regulating the securities markets in Hong Kong.⁷³ The Securities and Futures Commission (SFC) is recognized under the SFO as an autonomous statutory body and is responsible for regulating the securities and futures markets in Hong Kong.⁷⁴

B. China

Until the Company Law came into effect on July 1, 1994, shareholding companies and the securities market operated in China without either company law or securities law.⁷⁵ Regulation consisted of piecemeal rules issued by different governmental entities. Before 1994, the *Standard Opinion on Limited Liability Companies* and the *Standard Opinion on Companies Limited by Shares* served as interim measures before the promulgation of a comprehensive set of company laws.⁷⁶ Based on previous draft regulations and the two standard opinions, the Company Law passed by the National People's Congress on December 29, 1993, and served two main functions: (i) to establish a modern enterprise system compatible with the social market economy and (ii) to set out the legal basis for regulating different types of companies.⁷⁷ The Company Law has since been slightly amended twice, in 1999 and 2004, and been subject to more radical changes introduced in 2005 and 2013.⁷⁸

Even though both stock exchanges in Shanghai and Shenzhen were established in the early 1990s, the first set of securities laws did not come into

⁷⁰ *Id.*

⁷¹ *See id.* at 55.

⁷² *See* Yeung & Huang, *supra* note 18, at 9.

⁷³ *See id.*

⁷⁴ H.K. INFO. SERV. DEP'T, *supra* note 23, at 91.

⁷⁵ JIANG YU WANG, *COMPANY LAW IN CHINA* 6–7 (2014).

⁷⁶ *See id.*; Le Jiachun, *China's Bond Market*, in *CHINA'S FINANCIAL MARKETS: AN INSIDER'S GUIDE TO HOW THE MARKETS WORK* 158 (Salih N. Neftci & Michelle Yuan Menager-Xu eds., 2007).

⁷⁷ *See* WANG, *supra* note 75, at 6–7.

⁷⁸ *Id.* (explaining that the recent company law amendments removed the requirement for companies to have a minimum level of capitalization and that it is expected to encourage more entrepreneurs to start their own businesses fostering the growth of the individual economic sector.); *see China's Amended Company Law Facilitating More Business*, PRICEWATERHOUSECOOPERS CONSULTANTS (SHENZHEN) (Jan. 2014), http://www.pwccn.com/webmedia/doc/635253180786908970_chinatax_news_jan2014_1.pdf, archived at <http://perma.cc/9VG9-LZBD>.

effect until 1999.⁷⁹ This pattern of development can be attributed to the Chinese tendency to subordinate law to government authority exercising detailed administrative control over economic activities rather than permitting these activities to be defined by law.⁸⁰ Like the Company Law, positive changes in the regulatory framework were made through revisions to the Securities Law in 2005.⁸¹ Shareholders' rights overall were significantly strengthened.⁸² The regulator in China is the China Securities Regulatory Commission (CSRC).

IV. A COMPARISON OF THE SPECIFIC ASPECTS OF THE REGULATION

Jurisdictions regulate publicly held companies in recognition of the vulnerability of public investors. The two major principles are: first, to ensure that the prices of publicly traded securities are reasonably well-informed; and second, to control the quality of publicly traded securities and ensure effective corporate governance arrangements protect public shareholders.⁸³ Accordingly, three legal strategies are employed to protect the interests of investors: the entry strategy, the trusteeship strategy, and the rules and standards strategy.⁸⁴

First, the entry strategy requires mandatory disclosure for new issues of shares, as well as other specific ongoing disclosures for listed companies.⁸⁵ An offer for the sale or subscription of shares must be mandatorily disclosed via a prospectus, which is a document provided to potential investors, and is important because it contains the information they need to decide whether or not to invest.⁸⁶ The additional requirements of ongoing disclosure are also essential to other legal mechanisms used to protect shareholders.⁸⁷ For example, the disclosure of self-dealing transactions between the company and its directors, coupled with the requirement to obtain the shareholders' approval on these transactions, can be critical to controlling the opportunistic behavior of managers.⁸⁸

Second, the trusteeship strategy empowers a disinterested third party to screen companies that wish to enter the stock market.⁸⁹ Stock exchanges, for

⁷⁹ See CHINA SEC. REG. COMMISSION, CHINA CAPITAL MARKETS DEVELOPMENT REPORT, 174, 250 (2008), available at http://www.csrc.gov.cn/pub/csrc_en/Informations/publication/200911/P020091103520222505841.pdf, archived at <http://perma.cc/B6VL-KHNK>.

⁸⁰ Iain MacNeil, *Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies*, 2 J. CORP. L. STUD. 289, 301 (2002).

⁸¹ CHINA SEC. REG. COMMISSION, *supra* note 79, at 174, 250.

⁸² WANG, *supra* note 75, at 6–7.

⁸³ See Gerard Hertig et al., *Issuers and Investor Protection*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 193 (Kraakman et al. eds., 2004).

⁸⁴ *Id.* at 194.

⁸⁵ See *id.* at 195–97.

⁸⁶ See *id.* at 199.

⁸⁷ See *id.* at 204–07.

⁸⁸ See *id.*

⁸⁹ *Id.* at 207.

instance, through their listing review process, can be regarded as the guardian of quality.⁹⁰

Finally, the rules and standards strategy concerns the acceptable characteristics and behavior of listed companies.⁹¹ They are usually employed in conjunction with the previous two strategies. For example, stock exchanges will review listing applications in accordance with certain recognizable standards stated in the listing rules.⁹² Similarly, to ensure the reliability of corporate disclosures, a misrepresentation must be clearly specified and offenders must be held responsible through the use of standards backed by liability.⁹³

The manner in which China and Hong Kong have employed the three major legal strategies is of relevance to this Article and will be examined one by one. Although new company laws were introduced in 2014 in both China and Hong Kong, the discussion here will be made with reference to earlier laws which were largely responsible for the market growth to date.

A. Entry Strategy

The entry strategy concerns both the initial and subsequent disclosures of companies.⁹⁴ The key mechanism of the initial disclosures is a prospectus.⁹⁵ In the case of a listing and the subsequent public offer, it is necessary to consider the filing requirements under both company and securities law as well as under the listing rules. The production of a prospectus generally involves the coordinated efforts of various parties involved in the listing processes as well as subsequent verification by the relevant regulatory authorities. This is an illustration of how the entry strategy and trusteeship strategy can work together.

1. Prospectus

The prospectus drafting involves a spectrum of parties such as company management, staff, underwriters, lawyers, and accountants. In Hong Kong, specific requirements for the information in a prospectus are set out in Chapter 11 and Appendix 1 of the Listing Rules.⁹⁶ Additionally, the requirements

⁹⁰ See *id.* at 208.

⁹¹ *Id.* at 208–09.

⁹² See *id.* at 209–10.

⁹³ See *id.* at 210–12.

⁹⁴ See *id.* at 195–96.

⁹⁵ See *id.* at 199.

⁹⁶ See generally *Chapter 11: Listing Documents*, H.K. EXCHANGES & CLEARING LTD. (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_11.pdf, archived at <https://perma.cc/3AEC-35PF> (outlining the specific requirements for the information provided in a prospectus); *Appendix 1*, H.K. EXCHANGES & CLEARING LTD. (July 11, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/appendix_1.pdf.

stipulated in the Companies Ordinance (CO) must also be taken into account.⁹⁷ All of these requirements under the Listing Rules and the CO, however, are not mutually exclusive and overlap regarding the content required. In general, information about the issuer and its management, the securities for which listing is sought, the issuer's financial position, the intended use of proceeds, its business activities, and a list of its advisers is required.⁹⁸

Following drafting, underwriters perform due diligence to establish the completeness and accuracy of the information contained in the prospectus. Practice Note 21 of the HKEx sets out the steps a sponsor must undertake to fulfill its responsibilities.⁹⁹ Authorization must then be sought from the SFC by providing a copy of the prospectus signed by the directors, with certain specified endorsements thereon. If approved, the SFC will transfer the case to the HKEx. If not, the SFC has the power to require further information from the company and raise an objection to the listing.¹⁰⁰ Grounds for objection can be, for instance, that the prospectus does not provide sufficiently detailed information on the company and its affairs for an investor to make an informed decision or that the application is false or misleading as to a material fact or omission of a material fact.¹⁰¹ The reason can also be as general as that the SFC considers it not in the public interest for the securities to be listed.¹⁰²

The HKEx will also play an active role in raising questions about the contents of the prospectus. This demonstrates how the entry strategy can be employed in conjunction with the trusteeship strategy, which will be discussed later.

By comparison, a comprehensive set of legal procedures for producing a prospectus is a relatively recent advancement in China. The prospectus rule is mainly governed by *Criteria No. 1 on the Content and Format of Information Disclosure by Companies Conducting Public Offer of Securities—Prospectus*, which was significantly revised in 2006.¹⁰³ Prior to that, the CSRC and the

com.hk/eng/rulesreg/listrules/mbrules/vol2.htm, archived at <https://perma.cc/756L-35AJ> (outlining the specific requirements for the information provided in a prospectus).

⁹⁷ See Companies (Winding Up and Miscellaneous Provisions) Ordinance, (2014) Cap. 32, 9–11, § 38 (H.K.).

⁹⁸ *Id.*

⁹⁹ *Practice Note 21 to the Rules Governing the Listing of Securities*, H.K. EXCHANGES & CLEARING LTD. (July 11, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/pn_21.pdf, archived at <https://perma.cc/U94Y-8PTZ> [hereinafter *Practice Note 21*].

¹⁰⁰ Securities and Futures (Stock Market Listing) Rules, (2003) Cap. 571V, 2–3, § 6 (H.K.). Under SMLR rule 6(4), the HKEx is prohibited from listing any company to which the SFC has lodged an objection. *Id.*

¹⁰¹ *Id.* §§ 3C, 6.

¹⁰² *Id.* § 6.

¹⁰³ Criterion No. 1 on the Content and Format of Information Disclosure by Companies Conducting Public Offer of Securities—Prospectus (May 18, 2006) [hereinafter *Criterion No. 1*]; HORACE YEUNG & FLORA XIAO HUANG, CHINESE COMPANIES AND THE HONG KONG STOCK MARKET 111 (2014).

company were the two major entities involved. A sponsorship system for stock issuance, which will be discussed in the trusteeship strategy section, was not put into place in China until 2003.¹⁰⁴ The company applying for the initial public offer of shares and listing within China must produce a prospectus to the CSRC.¹⁰⁵ All the information disclosed by the issuer in the prospectus and its abstract must be true, accurate, and complete. Any omission of matters or any relevant subsequent events after the submission of the draft prospectus must be explained to the CSRC.¹⁰⁶

The prospectus rule specifies the required information that must be included in a prospectus.¹⁰⁷ Although the truthfulness, accuracy, and completeness of the prospectus is the primary responsibility of management, the sponsors, lawyers, and accountants involved in the listing process are required to examine and verify the prospectus and declare that they have duly performed their duties.¹⁰⁸ By placing more reliance on market intermediaries and lessening the burden on the CSRC, this accountability mechanism has clearly been a new initiative in China.

Both Hong Kong and China will hold the responsible parties liable in cases of misstatement or material omission. In Hong Kong, a statement included in a prospectus is deemed to be untrue if it is misleading in the form and context in which it is included.¹⁰⁹ This also includes a material omission from the prospectus.¹¹⁰ An untrue statement can give rise to a range of potential liabilities involving administrative, civil, and criminal sanctions. The Listing Rules provide that each of the directors of the company is required to accept responsibility for the information contained in the listing document and include in the listing document a statement to that effect.¹¹¹ Failure to comply with the prospectus requirements can render the company and any responsible entities liable for a fine.¹¹² Under the CO, civil liability is imposed on certain categories of persons to pay compensation to investors, who applied for the securities on the faith of the prospectus and suffered loss because of the untrue or misleading statement in the prospectus.¹¹³ Furthermore, under the

¹⁰⁴ YEUNG & HUANG, *supra* note 103, at 113.

¹⁰⁵ Criterion No. 1, art. 2.

¹⁰⁶ *Id.* art. 7; YEUNG & HUANG, *supra* note 103, at 111.

¹⁰⁷ YEUNG & HUANG, *supra* note 103, at 111.

¹⁰⁸ Criterion No. 1, arts. 121–24.

¹⁰⁹ Companies (Winding Up and Miscellaneous Provisions) Ordinance, (2014) Cap. 32, 18–19, § 41A, (H.K.).

¹¹⁰ *Id.* §§ 41A(2), 343(2)(A).

¹¹¹ *Chapter 11: Listing Documents*, *supra* note 96, at 11.12.

¹¹² Companies (Winding Up and Miscellaneous Provisions) Ordinance, (2014) Cap. 32, 9–11, § 38, (H.K.).

¹¹³ *Id.* § 40. The following people are potentially liable: (1) every director of the company at the time of the issue of the prospectus; (2) a promoter of the company (being any person who is a party to the preparation of the prospectus); (3) every person who has authorized the issue of the

SFO, a person who makes a fraudulent, reckless, or negligent misrepresentation in a prospectus can be liable to pay compensation where a person has invested in reliance on such misrepresentation and suffers a pecuniary loss as a result.¹¹⁴ Criminal liability can also be imposed on any person who authorizes the issuance of a prospectus containing an untrue statement or a material omission.¹¹⁵ The intent to defraud by the deliberate or reckless making of a false statement of a material fact can even constitute fraud.¹¹⁶

Similarly, China operates a system comprising administrative, civil, and criminal sanctions. The Securities Law of China states that the information disclosed by any issuer and listed company must be true, accurate, and complete, and must not contain any false record, misleading statement, or major omission.¹¹⁷ Unfortunately, how the provision should be enforced was not clarified until 2003. The *Several Provisions of the Supreme People's Court on Hearing Civil Compensation Cases Arising from False Statement on the Securities Market* provided a precise definition.¹¹⁸ False statements are statements made by wrongdoers in information disclosure or announcements through the media, which influence investors to make a wrong estimation and result in significant detriment to their investment.¹¹⁹ In contrast, a material omission is the failure to disclose, either wholly or partially, the required information by one with the duty to act.¹²⁰ The Securities Law clearly states the

prospectus. *See id.* Possible defenses include, but are not limited to: (1) the prospectus was issued without their consent; or (2) they had reasonable grounds to believe and did believe that the statement was true. *See id.*

¹¹⁴ Securities and Futures Ordinance, (2012) Cap. 571, 55–56, § 108, (H.K.). Liability may also arise out of contract or tort law. *See id.* As a general principle, all those involved in the preparation and issue of material used in connection with the offering may be liable for negligence if they fail to exercise due care in the preparation of the material and investors relying on the material suffer losses. *See id.*

¹¹⁵ Companies (Winding Up and Miscellaneous Provisions) Ordinance, (2014) Cap. 32, 18, 143, § 40A, (H.K.) (stating that such a person will be liable to imprisonment of up to three years and a fine of up to 700,000 HKD); *see also* Securities and Futures Ordinance, (2012) Cap. 571, 54–55, § 107, (H.K.) (stating that under the ordinance, a person, who makes a fraudulent or reckless misrepresentation in a prospectus, may be liable to imprisonment of up to seven years and a fine of up to 1 million HKD).

¹¹⁶ Theft Ordinance, (1997) Cap. 210, 5–6, § 16A (H.K.).

¹¹⁷ Zhōnghuá rénmín gònghéguó zhèngquán fǎ (2014 xiūzhèng)(中华人民共和国证券法(2014修正)) [Securities Law of the People's Republic of China (2014 Amendment)] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 31, 2014, effective Aug. 31, 2014), art. 63 (China).

¹¹⁸ Zuì gāo gāo rén rén mín fǎyuàn guānyú shěnlǐ zhèngquán shìchǎng yīn xūjiǎ chénshù yīnfā de mínshì péicháng ànjàn de ruògān guīdìng (最高 人民法院关于审理证券市场因虚假陈述引发的民事赔偿案件的若干规定) [Several Provisions of the Supreme People's Court on Hearing Civil Compensation Cases Arising from False Statement on the Securities Market] (promulgated by the Supreme People's Court of the People's Republic of China, Jan. 9, 2003), art. 17 (China).

¹¹⁹ *See id.*

¹²⁰ *See id.*

possible administrative penalties for the offense.¹²¹ Meanwhile, the potential joint civil liabilities of the issuer, management personnel of the issuer, sponsors, and underwriters are mentioned in Article 69 of the Securities Law.¹²² For offenses involving criminal elements, the offenders can face imprisonment for up to five years.¹²³

2. Ongoing Disclosures

As for their ongoing disclosure obligations, listed companies are generally required to disclose their financial and operating conditions to the public.¹²⁴ In Hong Kong, apart from the regulation of prospectuses, listed companies are required under the CO to maintain proper accounting records, prepare them in a specified form, ensure that they present a true and fair view of the state of affairs of the company, and present them to their members.¹²⁵ This form of information disclosure is generally in the format of annual reports and accounts as well as interim reports.¹²⁶ Specific content requirements for annual reports and accounts are set out in Appendix 16 of the Listing Rules.¹²⁷ The Listing Rules also contain a number of provisions obligating companies to keep shareholders and the wider market informed.¹²⁸ Certain transactions, whether proposed or undertaken by a company, must be dis-

¹²¹ Securities Law of the People's Republic of China (2014 Amendment), art. 193. (stating that issuers, listed companies or other persons liable for disclosure which contains fraudulent information, misleading information or major omission will be ordered to make correction and be subject to a warning and a fine ranging from 300,000 to 600,000 RMB. The person-in-charge and other personnel who are directly accountable will be subject to a warning and a fine ranging from 30,000 to 300,000 RMB.)

¹²² *See id.* art. 69.

¹²³ Zhōnghuá rénmin gònghéguó xíngfǎ (中华人民共和国刑法) [The Criminal Law of the People's Republic of China] (revised by the Standing Comm. Nat'l People's Cong., Mar. 17, 1997), art. 160 (China). The Criminal Law especially applies in information disclosure cases where the amount involved is large, the consequences are serious, or if there are other serious circumstances as stipulated in the law. *See id.*

¹²⁴ *Chapter 13: Continuing Obligations*, H.K. EXCHANGES & CLEARING LTD. 13.03 (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_13.pdf, archived at <https://perma.cc/T4NQ-DR76>.

¹²⁵ Companies (Winding Up and Miscellaneous Provisions) Ordinance, (2014) Cap. 32, 96, § 274 (H.K.).

¹²⁶ *Chapter 13: Continuing Obligations*, *supra* note 124, at 13.20.

¹²⁷ *Appendix 16*, H.K. EXCHANGES & CLEARING LTD. (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/appendix_16.pdf, archived at <https://perma.cc/6H82-ANFA>.

¹²⁸ *Chapter 13: Continuing Obligations*, *supra* note 124, at 13.03, 13.05, 13.09 (stating that there are two general principles: first, price sensitive information should be disclosed immediately; and second, any information which is necessary to enable the market to appraise the position of the company, or which might affect market activity or assist establish a false market should be disclosed as soon as reasonably practicable).

closed to shareholders and potentially may require their prior approval.¹²⁹ This is an example of how mandatory disclosure can work alongside other legal strategies, such as the decision rights of a shareholder. Such transactions can fall into two categories: notifiable transactions and connected transactions.¹³⁰ The former generally concerns the magnitude of a transition in which quantitative tests are applied to determine the nature and level of disclosure required.¹³¹ Examples of a notifiable transaction are substantial acquisitions and disposals.¹³² Connected transactions refer to those that involve persons closely connected with the company, who are prohibited from abusing their positions with the company.¹³³ Examples of a connected person include any director, chief executive, or substantial shareholder as defined in the Listing Rules.¹³⁴ For every disclosable transaction, the company is required to notify the HKEx and make an announcement in a local newspaper.¹³⁵ In some cases, shareholders' approval is essential before the transaction can proceed.¹³⁶ Broadly speaking, a company must report, make announcements, and seek the approval of shareholders unless a waiver is sought from the HKEx for a connected transaction.¹³⁷

By contrast, the problem associated with ongoing disclosures in China is that state-owned listed companies are exempt from disclosing certain transactions. The information disclosure system in China is based on the Securities Law, Company Law, listing rules, and other relevant supplementary regulatory documents such as the *Administrative Measures on Information Disclosure of Listed Companies*.¹³⁸ Companies must establish their own financial and

¹²⁹ See *id.* at 13.36.

¹³⁰ See *Chapter 14: Notifiable Transactions*, H.K. EXCHANGES & CLEARING LTD. (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_14.pdf, archived at <https://perma.cc/2V9X-H56K>; *Chapter 14A: Connected Transactions*, H.K. EXCHANGES & CLEARING LTD. (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_14a.pdf, archived at <https://perma.cc/K9PQ-FSMR>.

¹³¹ See *Chapter 14: Notifiable Transactions*, *supra* note 130, at 14.06.

¹³² *Id.* at 14.01.

¹³³ See *Chapter 14A: Connected Transactions*, *supra* note 130, at 14A.07.

¹³⁴ *Id.*

¹³⁵ *Id.* at 14A.03.

¹³⁶ *Chapter 14: Notifiable Transactions*, *supra* note 130, at 14.44, 14.18, 14.46, 14.54 (stating that in general, shareholders may approve a transaction by a majority vote in a general meeting and that shareholders and their associates who have a material interest in a notifiable or connected transaction should abstain from voting).

¹³⁷ *Chapter 14A: Connected Transactions*, *supra* note 130, at 14A.03, 14A.73.

¹³⁸ Shàngshì gōngsī xīnxī pīlù guǎnlǐ bànfǎ (上市公司信息披露管理办法) [Administrative Measures for the Disclosure of Information for Listed Companies] (promulgated by China Securities Regulatory Comm'n, Jan. 30, 2007) (China); Zhōnghuá rénmín gònghéguó gōngsī fǎ (2013 xiūzhèng) (中華人民共和國公司法(2013 修正)) [The Company Law of the People's Republic of China] (issued by the Standing Comm. of the People's National Cong., Dec. 28, 2013, effective Mar. 1, 2014), arts. 164, 165 (China); Zhōnghuá rénmín gònghéguó zhèngquán fǎ (2014 xiūzhèng) (中华人民共和国证券法(2014 修正)) [Securities Law of the People's Republic of China]

accounting systems and prepare reports at the end of each accounting year.¹³⁹ Listed companies must also submit their annual/interim reports and accounts to the CSRC and stock exchanges, which should consist of certain elements required by the law.¹⁴⁰ Furthermore, ad hoc reports must be disclosed in a timely manner when the share price of the company might be substantially affected by certain significant matters such as decisions on major investments and asset acquisitions, decisions on reductions in capital, mergers, involvement in a lawsuit, or applications for bankruptcy.¹⁴¹ Objective tests based on the value of a transaction are used to assess the materiality of a transaction.¹⁴² For connected transactions, disclosure must be made according to the principle of importance, which stipulates the quantitative standards.¹⁴³ Those notifiable and connected transactions that triggered the disclosure obligation might require approval at the shareholders' general meeting. When deciding on these transactions, the connected shareholders must avoid voting.¹⁴⁴ Specific exemptions for disclosure and approval, however, can be sought from the stock exchanges and shareholders when the transactions involve daily operating activities.¹⁴⁵ A general exemption is granted to state-owned listed companies.¹⁴⁶ If a listed company and any connected parties are both under the control of the same state-owned asset administrative institution, they will not be deemed to have a connected relationship.¹⁴⁷ This can have a broad effect because all SOEs, apart from financial institutions, are controlled by the

(2014 Amendment)] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 31, 2014, effective Aug. 31, 2014), arts. 58–66 (China).

¹³⁹ The Company Law of the People's Republic of China, arts. 164, 165.

¹⁴⁰ Securities Law of the People's Republic of China (2014 Amendment), art. 11; Administrative Measures for the Disclosure of Information for Listed Companies, arts. 21, 22 (including the elements of: (1) company profile; (2) financial accounting report and business report; (3) profile of management and their shareholders; and others).

¹⁴¹ Securities Law of the People's Republic of China (2014 Amendment), art. 67; Administrative Measures for the Disclosure of Information for Listed Companies, art. 30.

¹⁴² See, e.g., The Company Law of the People's Republic of China, art. 121 (stating that where a listed company is to acquire or sell major assets which exceed thirty percent of the total value of its assets, a resolution of the shareholders' general meeting shall be passed by a two-thirds majority of shareholders who are present at the meeting with voting rights).

¹⁴³ See *Rules Governing the Listing of Stocks on the Shanghai Exchange*, SHANGHAI STOCK EXCHANGE 10.2.5, http://english.sse.com.cn/home/public/c/en_sserule20090408.pdf (last visited Mar. 31, 2015), archived at <http://perma.cc/9J3V-ADWE>. Transactions with connected individual persons that have a monetary value above 300,000 RMB and those with connected legal persons above 3 million RMB shall be disclosed. *Id.* at 10.2.3, 10.2.4. A connected person is one who has a relationship with the enterprise that is directly or indirectly controlled by the interests of the company. The Company Law of the People's Republic of China, art. 217(4).

¹⁴⁴ *Rules Governing the Listing of Stocks on the Shanghai Exchange*, *supra* note 143, at 10.2.2.

¹⁴⁵ *Id.* at 10.2.15.

¹⁴⁶ *Id.* at 10.1.4.

¹⁴⁷ *Id.*

state-owned Assets Supervision and Administration Commission of the State Council.

In summary, two major problems exist in the Chinese market, which are absent in Hong Kong, because of the dominance of SOEs and the inexperience of regulators. First, SOEs are exempt from disclosing certain connected transactions.¹⁴⁸ This can be a potential hazard to investors' interests and it is simply not fair to other listed non-SOEs. Second, China could have absorbed the experience of other developed markets to introduce a number of well-drafted rules. The authorities, however, remain unsure about how to implement and enforce these rules. As a result, new rules have continuously been issued to explain the old rules, as exemplified by the *Several Provisions of the Supreme People's Court on Hearing Civil Compensation Cases Arising from False Statement on the Securities Market*. It will take time for the Chinese authorities to master a steep learning curve.

B. Trusteeship Strategy

This section will move on to discuss how the trusteeship legal strategy has been adopted by China and Hong Kong. China is a beginner in this area because powers and responsibilities have long been concentrated in the hands of the CSRC. In general, issuers are required to go through a screening process before they become listed. The interests of the investing public are the foremost priority when screening listing applications. An application can be refused if the listing might jeopardize investor interests. The party in charge of this process can differ. In China, the CSRC is still the primary authority in practice to approve listings, although the new Securities Law suggests otherwise.¹⁴⁹ Even the CSRC itself has criticized its current system as "prone to too much administrative control" because of the possible political interference from other state entities.¹⁵⁰

¹⁴⁸ *Id.*

¹⁴⁹ See *Zhōnghuá rénmin gònghéguó zhèngquàn fǎ* (中华人民共和国证券法) [Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective Aug. 8, 2004) art. 43 (China); *Zhōnghuá rénmin gònghéguó zhèngquàn fǎ* (2005 xiūdìng) (中华人民共和国证券法 (2005 修訂)) [Securities Law of the People's Republic of China, 2005 Revision] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jun. 29, 2013) art. 48 (China). Under Article 43 of the Securities Law of 1998, an applicant applying for listing must submit its application to the CSRC. See Securities Law of the People's Republic of China, art. 48. The term "CSRC" was replaced by "stock exchange" in art. 48 of the Securities Law of 2005. Securities Law of the People's Republic of China, 2005 Revision, art. 48. This amendment in theory should be a strong sign of reducing the state's involvement in the regulation of stock market. See *id.* But see ALICE DE JONGE, CORPORATE GOVERNANCE AND CHINA'S H-SHARE MARKET 60–61 (2008) (arguing that the listing of companies in China has been and is still largely politically driven).

¹⁵⁰ CHINA SEC. REG. COMMISSION, *supra* note 79, at 250.

In Hong Kong, the SFC has delegated the duty to approve listings to the HKEx. The Listing Committee and the Listing Division of the HKEx undertake the listing review and approval process. The composition of the Listing Committee is specified in the Listing Rules.¹⁵¹ It first grants or refuses approval to list before the process may progress to the Listing Division for review.¹⁵² The Listing Division is responsible for all day-to-day listing matters including the interpretation, administration, and enforcement of the Listing Rules.¹⁵³

Similarly, an initial public offering in China requires CSRC approval.¹⁵⁴ The listing process starts with an application to the CSRC. After gaining the approval of the CSRC, the issuer can subsequently submit the documents to the relevant exchange for review, although this raises two potential concerns.¹⁵⁵ First, it is commonly believed that becoming listed is difficult unless the issuer has certain political connections, which was particularly true in the era of the quota system, discussed below. Second, potential conflicts of interest exist because the CSRC favors some large SOEs.

In line with its socialist market economy, China has tried to maintain tight control over its financial markets. This control has seriously restricted access to capital for many companies. In the early days of the Chinese stock market, the CSRC imposed a quota on the maximum number of shares that could be issued each year.¹⁵⁶ The CSRC intended these quotas to curb potentially excessive investment demand in a premature market, where participants had not developed an understanding of the market rules or their rights and obligations.¹⁵⁷ Provincial governments and industry supervising bodies were assigned quotas and they would recommend companies for listing within them. The CSRC would then provide the final approval on public offerings.¹⁵⁸

Eventually, this quota system was replaced when the *Interim Regulations on the Public Offering Review Committee of the CSRC* entered into effect.¹⁵⁹ The creation of the Public Offering Review Committee has been an

¹⁵¹ See Chapter 2: Introduction, H.K. EXCHANGES & CLEARING LTD. 2A.17 (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_2.pdf, archived at <https://perma.cc/JX6J-53ZY>.

¹⁵² See *id.* at 2A.05.

¹⁵³ See *id.* at 2A.02.

¹⁵⁴ Zhōnghuá rénmin gònghéguó zhèngquàn fǎ (2014 xiūzhèng)(中华人民共和国证券法(2014修正)) [Securities Law of the People's Republic of China (2014 Amendment)] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 31, 2014, effective Aug. 31, 2014), art. 10 (China).

¹⁵⁵ *Rules Governing the Listing of Stocks on the Shanghai Exchange*, *supra* note 143, at 5.1.2.

¹⁵⁶ CHINA SEC. REG. COMMISSION, *supra* note 79, at 165.

¹⁵⁷ *Id.* at 165–66.

¹⁵⁸ *Id.*

¹⁵⁹ See CHINA KNOWLEDGE PRESS, FINANCIAL SERVICES IN CHINA 188 (2005).

integral part of the new IPO approval system. It votes independently on listing applications and offers review opinions.¹⁶⁰ The Public Offering Review Committee, which is composed of mainly external members, attempts to offer a more objective view of the fitness of a company seeking to be listed. Moreover, potential conflicts of interest are eliminated by shifting reliance during the screening process away from the CSRC towards other third parties. Subsequently, the CSRC makes the final decision on whether or not to approve the application in accordance with relevant conditions.¹⁶¹ Ultimately, the stock exchange will also make a decision upon receipt of all the required documents from the issuer following CSRC approval based on the voting of its Listing Committee.¹⁶²

In 2003, the CSRC issued the *Interim Measures for the Stock Issuance and Listing Sponsorship System*, marking the beginning of the sponsor system.¹⁶³ This became a statutory requirement with the 2005 amendments to the Securities Law.¹⁶⁴ The qualifications and duties of sponsors are stipulated in the *Measures for the Administration of the Sponsor System for the Offering and Listing of Securities*.¹⁶⁵ Any parties who want to become a sponsor must register with the CSRC.¹⁶⁶ In the listing process, a sponsor must act in good faith and with due diligence to conduct a full investigation of the issuer.¹⁶⁷ In the course of the due diligence investigation, the sponsor must carefully examine the contents of the issuer's application documents and prospectus. In China, the sponsor also takes up the role of compliance adviser.¹⁶⁸ Once the issuer's securities are listed, the sponsor must guide the issuer on an ongoing basis in performing obligations such as operation compliance and information disclosure.¹⁶⁹

¹⁶⁰ Liu Lisheng, *An Overview of China's Financial Markets*, in CHINA'S FINANCIAL MARKETS, *supra* note 76, at 7.

¹⁶¹ *See id.*

¹⁶² *Rules Governing the Listing of Stocks on the Shanghai Exchange*, *supra* note 143, at 5.1.6, 5.1.7.

¹⁶³ Zhèngquàn fāxíng shàngshì bǎojiàn zhìdù zhàn xíng bànfǎ (证券发行上市保荐制度暂行办法) [Interim Measures for the Stock Issuance and Listing Sponsorship System] (promulgated by the China Securities Regulatory Comm'n, Dec. 28, 2003, effective Feb. 1, 2004) (China).

¹⁶⁴ Zhōnghuá rénmín gònghéguó zhèngquàn fǎ (2014 xiūzhèng) (中华人民共和国证券法 (2014 修正)) [Securities Law of the People's Republic of China (2014 Amendment)] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 31, 2014, effective Aug. 31, 2014), art. 11 (China).

¹⁶⁵ Zhèngquàn fā háng shàngshì bǎojiàn yèwù guǎnlǐ bànfǎ (证券发行上市保荐业务管理办法) [Measures for the Administration of the Sponsor System for the Offering and Listing of Securities] (promulgated by the China Securities Regulatory Comm'n, Oct. 17, 2008, effective Dec. 1, 2008) (China).

¹⁶⁶ *See id.* art. 17.

¹⁶⁷ *Id.* art. 24.

¹⁶⁸ *Id.* arts. 23, 36.

¹⁶⁹ *Id.*

A sponsor is also required in Hong Kong.¹⁷⁰ Every company seeking a listing in Hong Kong must appoint a sponsor, which can be a corporation or an authorized financial institution, licensed or registered to advise on corporate finance matters.¹⁷¹ Under the Listing Rules, the sponsor must be acceptable to the HKEx, meaning the sponsor must be impartial and independent.¹⁷² The sponsor must declare its impartiality and independence to the HKEx.¹⁷³ The sponsor's role as watchdog is recognized by the Listing Rules.¹⁷⁴ It must ensure that all information provided to the exchange during the listing process is true and complete.¹⁷⁵ As part of the listing process, a due diligence exercise is performed, which involves a review of documentation and interviews of management, staff, and anyone deemed relevant.¹⁷⁶ It also comprises of a physical inspection of assets.¹⁷⁷ Various matters must be properly assessed, such as business feasibility, financial literacy, corporate governance experience, and competence of the directors.¹⁷⁸ The Listing Rules also expressly address the role of compliance advisers.¹⁷⁹ The function of the compliance adviser is to assist the newly listed issuer through the early stages of its life as a listed company, monitoring announcements, transactions, and activities, in particular, which might lead to regulatory consequences.¹⁸⁰

As noted earlier, Hong Kong has a much longer history in finance than mainland China; therefore, Hong Kong possesses a critical mass of expertise in financial services and related professional sectors. Meanwhile, China still requires some time to get up to speed. Since the inception of the sponsor system in China, 67 securities companies and 609 professionals have successfully registered.¹⁸¹ Unfortunately, the integrity of these sponsors remains questionable. For example, in 1997–2000, there were around 100 securities companies in China, and more than half of them were involved in the embezzlement of client funds.¹⁸² This might be a huge problem. As Gerard Hertig and colleagues have suggested, the vestigial characteristics of the trusteeship

¹⁷⁰ See Chapter 3A: Sponsors and Compliance Advisors, H.K. EXCHANGES & CLEARING LTD. 3A.02 (July 7, 2014) https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_3a.pdf, archived at <https://perma.cc/V6JP-TY6Y>.

¹⁷¹ See *id.*

¹⁷² See *id.* at 3A.06, 3A.07.

¹⁷³ See *id.*

¹⁷⁴ See *id.*

¹⁷⁵ *Id.* at 3A.11.

¹⁷⁶ See *id.* at 3A.11(2); *Practice Note 21*, *supra* note 99, at 13(b).

¹⁷⁷ *Practice Note 21*, *supra* note 99, at 13(e).

¹⁷⁸ *Id.* at 11(b).

¹⁷⁹ See Chapter 3A: Sponsors and Compliance Advisors, *supra* note 170, at 3A.19.

¹⁸⁰ See *id.* at 3A.23.

¹⁸¹ CHINA KNOWLEDGE PRESS, *supra* note 159, at 283.

¹⁸² *Id.* at 284.

strategy in major jurisdictions speak of the maturity of the public markets.¹⁸³ Whether the Chinese market possesses such maturity is doubtful. Still, it is certain that the Chinese market has become more liberal than ever before since the quota system was abolished.

C. Rules and Standards Strategies

As mentioned before, listing applications are screened by the competent authorities. Screening criteria are based on objective and observable standards. These can include, but are not limited to, the incorporation requirement, the profit, capitalization or revenue test, and the minimum public float. Other ongoing requirements will also be discussed.

1. Initial Obligations

A basic requirement for listing is that an issuer must be duly incorporated or otherwise validly established according to the relevant laws of its place of incorporation.¹⁸⁴ This directly affects what jurisdiction will govern the affairs of a company from its formation to dissolution. The first step a company has to take in a listing is to set itself up as a public company. In Hong Kong, an issuer incorporated locally must not be a private company.¹⁸⁵ Companies that are incorporated overseas can list on the HKEx, but they are subject to the provisions of Part XII of the CO and Listing Rule 19, or 19A for Chinese companies.¹⁸⁶

In China, according to the *Administrative Measures for the Initial Public Offering and Listing of Stocks* (IPO Measures), the issuer must be a joint stock company limited by shares.¹⁸⁷ In theory, the laws in China do not ex-

¹⁸³ Hertig et al., *supra* note 83, at 208.

¹⁸⁴ *Chapter 8: Qualifications for Listing*, H.K. EXCHANGES & CLEARING LTD. 8.02 (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_8.pdf, archived at <https://perma.cc/CVT2-7649>.

¹⁸⁵ *See id.* at 8.03.

¹⁸⁶ Companies (Winding up and Miscellaneous Provisions) Ordinance, (2014) Cap. 32, § 342; *Chapter 19: Overseas Issuers*, H.K. EXCHANGES & CLEARING LTD. (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_19.pdf, archived at <https://perma.cc/26VL-HXCC>; *Chapter 19A: Issuers Incorporated in the People's Republic of China*, H.K. EXCHANGES & CLEARING LTD. (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_19a.pdf, archived at <https://perma.cc/TK2F-BPSZ>.

¹⁸⁷ Shǒucì gōngkāi fāxíng gǔpiào bìng shàngshì guǎnlǐ bànfǎ (首次公开发行股票并上市管理办法) [Administrative Measures for the Initial Public Offering and Listing of Stocks] (issued by China Securities Regulatory Comm., May 17, 2006), art. 8 (China); Zhōnghuá rénmín gònghéguó gōngsī fǎ (2013 xiūzhèng) (中華人民共和國公司法(2013修正)) [The Company Law of the People's Republic of China] (issued by the Standing Comm. of the People's National Cong., Dec. 28, 2013, effective Mar. 1, 2014), arts. 24, 72 (China). A company limited by liability, unlike a joint stock company limited by shares, must be invested in and established by not more than fifty shareholders. *See* The Company Law of the People's Republic of China, art. 24, 72. Art. 72 states

pressly prohibit foreign companies from issuing and listing shares in China.¹⁸⁸ In practice, however, the prevailing view is that the issuer must be a company limited by shares that has been incorporated in China in accordance with the Company Law.¹⁸⁹ At present, it is unlikely that the CSRC will approve a foreign company for listing. This is consistent with the pervading image of the Chinese market that it is still relatively closed whereas Hong Kong's growth has relied on international trade and finance for over 100 years.

Furthermore, the basic commercial rationale for raising capital requires investors to be sufficiently interested in the company. The first thing for any company and for the stock exchange to consider is whether the company is qualified for listing. This will ensure the *ex ante* quality of publicly traded securities (for *ex post* quality, appropriate standards for listed companies come into play). In Hong Kong, the requirements are outlined in Chapter 8 of the Listing Rules.¹⁹⁰ The HKEx considers the suitability of the company and its business for listing. The company will need to satisfy one of three quantitative tests: the profit test, the market capitalization test, or the revenue test.¹⁹¹ Broadly speaking, this means that the company must have an adequate trading record of at least three financial years.¹⁹² Also, there should be a sufficient amount of profit attributable to shareholders in the most recent years.¹⁹³ Regarding market capitalization, the company should have at least 2 billion HKD at the time of listing.¹⁹⁴ Furthermore, it must have a turnover of at least 500 million HKD for the most recently audited financial year.¹⁹⁵ Lower admission requirements are in place for the Growth Enterprise Market (GEM), which this Article does not discuss.

Similarly, in China an issuer must have been continuously operating for at least three years since its establishment, unless otherwise approved by the

that the shareholders may only transfer all or part of the company's equity among themselves. *Id.* art. 72. A shareholder wishing to transfer his or her equity to a party other than another shareholder requires consent of a majority of the other shareholders. *Id.*

¹⁸⁸ See Administrative Measures for the Initial Public Offering and Listing of Stocks, art. 8.

¹⁸⁹ CHENGWEI LIU, CHINESE COMPANY AND SECURITIES LAW 327 (2008). *But see China's Stock Markets to Let in Foreign Firms*, BBC (July 11, 2001) <http://news.bbc.co.uk/1/hi/business/1433474.stm>, archived at <http://perma.cc/4YFX-Y37S>; see also *China Opens the Door to Foreign Listings*, INT'L BUS. TIMES (Sept. 10, 2009), <http://www.ibtimes.com/china-opens-door-foreign-listings-328453>, archived at <http://perma.cc/8LTE-JGUU>.

¹⁹⁰ See Chapter 8: *Qualifications for Listing*, *supra* note 184, at 8.01.

¹⁹¹ *Id.* at 8.05(1)–(3).

¹⁹² *Id.* at 8.05(1)(a).

¹⁹³ *Id.* at 8.05(1).

¹⁹⁴ *Id.* at 8.05(2)(d).

¹⁹⁵ *Id.* at 8.05(2)(e).

State Council.¹⁹⁶ With other requirements, the Chinese market is more accommodating to smaller companies than Hong Kong's Main Board. The capital, profit and revenue requirements are: (1) 30 million RMB immediately prior to the IPO; (2) positive earnings each year and over 30 million RMB in aggregate in the three-year track record; and (3) over 300 million RMB in aggregate in the three-year track record respectively.¹⁹⁷ In addition, the company should have good standing and operation compliance. To be considered as in good standing, the ownership of shares and key assets in the company must be clean and clear, without any major disputes over them.¹⁹⁸ To be considered as in operation compliance, the company must not have committed any material violations of laws.¹⁹⁹ The CSRC is particularly concerned that the issuer must be independent from its controlling shareholders or *de facto* controlling parties. For instance, the management and organizational structure of the issuer must be independent.²⁰⁰ By contrast, the HKEx does not have such an independence requirement. As a side note, China did not have a junior exchange like the GEM in Hong Kong until a new growth market was established in 2009.²⁰¹

An adequate market and public interest in the business of the company can also be, to a certain extent, reflected by the public shareholding of a company. In Hong Kong, this requirement normally means at least 25 percent of the company's total issued capital must be held by the public at all times.²⁰² This is also an ongoing requirement and shortfalls in the public float will have consequences for the company.²⁰³ In the case of larger companies, the

¹⁹⁶ Shōuci gōngkāi fāxíng gūpiào bìng shàngshì guǎnlǐ bànfǎ (首次公开发行股票并上市管理办法) [Administrative Measures for the Initial Public Offering and Listing of Stocks] (issued by China Securities Regulatory Comm., May 17, 2006), art. 9 (China).

¹⁹⁷ *Id.* art. 33.

¹⁹⁸ *Id.* arts. 10, 13.

¹⁹⁹ *See id.* art. 11, (stating that the production and business operation of an issuer must comply with the relevant provisions of the laws, administrative regulations and its article of association, and shall comply to the State's industrial policy); *see also* Zhōnghuá rénmín gònghéguó zhèngquàn fǎ (中华人民共和国证券法) [Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective Aug. 8, 2004) art. 50 (China) (stating that the financial accounting documents of the issuer in the past three years must not contain any fraudulent entries).

²⁰⁰ Administrative Measures for the Initial Public Offering and Listing of Stocks, arts. 16, 18 (stating that the issuer's senior management personnel shall not receive salaries from the issuer's controlling person or the affiliates controlled by such a controlling person and that the functions of business operation and management of the issuer shall not mix up with its controlling shareholder, *de facto* controller or the affiliates.).

²⁰¹ Robin Kwong, *New Chinese Bourse Set to Lure Domestic Flotations*, FIN. TIMES CHINESE (June 30, 2009), <http://www.ftchinese.com/story/001027281/en>, archived at <http://perma.cc/8GFL-R36J>.

²⁰² *See Chapter 8: Qualifications for Listing, supra* note 184, at 8.08(1)(a); *Chapter 13: Continuing Obligations, supra* note 124, at 13.32–13.35.

²⁰³ *Chapter 13: Continuing Obligations, supra* note 124, at 13.32.

HKEx has the discretion to adjust the minimum percentage requirement to as low as 15 percent.²⁰⁴ In China, the issuer must offer at least 25 percent of its total share capital to the public, although an issuer with a total share capital of more than 400 million RMB can only make a 10 percent public offering.²⁰⁵ Additionally, an IPO in China has socialist characteristics, for example, the requirement that 10 percent shares of a state-owned company must be transferred to the National Council for Social Security Fund when the company goes public.²⁰⁶ This makes the State Fund the largest institutional investor in China.

Another distinct feature that separates China's stock market from other financial markets is the "maximum public float," which guarantees the presence of at least one controlling shareholder.²⁰⁷ This creates the potential for majority-minority conflicts. The creation of State Shares and Legal Person Shares, which both carry significant constraints on tradability, was a special mechanism introduced by the government to prevent the loss of state control, especially when former SOEs went public.²⁰⁸ Before 2005, when the non-tradable share reform was introduced, almost two-thirds of most companies' shares had been persistently and tightly locked in the hands of the state and other state entities.²⁰⁹ By the end of 2008, the percentage dropped to around 48 percent.²¹⁰ Although many Hong Kong companies also have blockholders, which are generally wealthy families, the market is still capable of facilitating the emergence of world-renowned companies with dispersed ownership, such as HSBC.²¹¹

As demonstrated by the aforementioned, the criteria for entering the Chinese market are evidently lower than those for Hong Kong. Unlike Hong Kong, which has a two-tier market, the Chinese market needed to strike a balance between either including a wider spectrum of companies or allowing only a selection of elite companies. Although the Chinese market is still dominated by state-owned companies, the establishment of a new board illustrated

²⁰⁴ See Chapter 8: *Qualifications for Listing*, *supra* note 184, at 8.08(1)(d).

²⁰⁵ Zhōnghuá rénmin gònghéguó zhèngquàn fǎ (2014 xiūzhèng) (中华人民共和国证券法 (2014 修正)) [Securities Law of the People's Republic of China (2014 Amendment)] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 31, 2014, effective Aug. 31, 2014), art. 50 (China).

²⁰⁶ *State Shares to Be Transferred to NCSSF*, CAIJING MAG. (June 19, 2009), <http://misc.caijing.com.cn/templates/inc/webcontent.jsp?id=110187081&time=2009-06-19&cl=100&page=all>, archived at <http://perma.cc/UDG2-SEMC>. The new requirement is retroactive. *Id.* It is estimated that 131 state-owned companies, which had gone public since June 2006, would be affected. *Id.*

²⁰⁷ Horace Yeung, *Non-Tradable Share Reform in China: A Review of Progress*, COMP. RES. L. & POL. ECON. 4 (Research Paper No. 48/2009, 2009).

²⁰⁸ *Id.*

²⁰⁹ *Id.* at 1, 7.

²¹⁰ See *id.* at 17.

²¹¹ See *id.* at 21.

the state's efforts to reinstate the fund-raising function of the stock market for smaller private companies. At the same time, there will be more company choices for investors, depending on their own risk preference.

2. Ongoing Requirements

Other than some initial obligations to ensure the quality of issuers, ongoing requirements are essential to keep the listed companies and their managers in check. The HKEx grants listings subject to those conditions it deems necessary for the protection of the investor or the maintenance of an orderly market.²¹² It can suspend dealings in any securities or cancel the listing of any securities as it sees fit.²¹³ For example, an unexplained or unusual change in the price or volume of trading typically results in suspension. Additionally, when the company is in material breach of its obligations under the Listing Rules, the HKEx will consider suspending dealings in its shares.²¹⁴ Dealing can also be suspended at the request of the company, which often occurs when the company is about to make a major announcement.²¹⁵ Ultimately, cancellation can be imposed on the company by the HKEx pursuant to the Listing Rules where a company is no longer suitable to remain listed.²¹⁶ This can occur when the company has persistently breached the Listing Rules requirements.

One of the distinguishing features of the Chinese system is the implementation of a special treatment (ST) mechanism.²¹⁷ The exchanges assign special treatment to certain shares by putting "ST" before the company name when the exchanges observe financial or other abnormalities that could lead the company to risk.²¹⁸ This designation first serves as a warning to investors and to the company of the risk of listing termination.²¹⁹ Both exchanges implement daily price range limits on share trading, namely 10 percent for normal shares and 5 percent for ST shares.²²⁰ The limits are to prevent big swings in share prices to keep the market stable and protect the interests of retail investors. Although vigorous price fluctuations can lead to a temporary

²¹² *Chapter 6: Trading Halt, Suspension, Cancellation and Withdrawal of Listing*, H.K. EXCHANGES & CLEARING LTD. 6.01 (July 7, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_6.pdf, archived at <https://perma.cc/Q6YH-C796>.

²¹³ *See id.*

²¹⁴ *See id.*

²¹⁵ *See id.* at 6.02, 6.04.

²¹⁶ *See id.* at 6.01; Securities and Futures (Stock Market Listing) Rules, (2003) Cap. 571V, 2–3 (H.K.)

²¹⁷ *Rules Governing the Listing of Stocks on the Shanghai Exchange*, *supra* note 143, at 13.1.1.

²¹⁸ *Id.* at 13.1.1, 13.1.3.

²¹⁹ *Id.* at 13.1.2.

²²⁰ *Id.* at 13.1.4.

suspension of trading, some circumstances can cause the suspension or permanent cancellation of listing.²²¹ Termination circumstances include: consistent losses for the past three consecutive years; material financial report misstatements; risks of bankruptcy; failure to meet the listing requirements; and, involvement in illegal conduct.²²² Despite the number of circumstances that could lead to termination, the introduction of “ST” as a buffer has greatly reduced the risk of delisting.

In addition to surveillance and monitoring by the stock exchanges, the listed companies must follow a number of corporate governance requirements. The corporate governance framework in Hong Kong is derived primarily from four sources: common law and equity; statutory legislation;²²³ constitutional documents of the company; and soft laws. These four categories are not mutually exclusive of one another. For example, statutory requirements in many respects bear a strong relationship to the directors’ fiduciary duties and their common law duty of care, skills, and diligence. Similarly, the Listing Rules are not legally binding, but require the statutory backing by virtue of the SMLR.²²⁴ Although the CO and the company constitutional documents provide the basic skeletal structure of a company, such as that a public company must have at least two directors, the Listing Rules have been the major driver of a wider program for improving the standards of corporate governance in Hong Kong. The most significant development was the adoption of the Code on Corporate Governance into the Listing Rules. The Code largely follows the United Kingdom’s Combined Code and its “comply or explain” principle.²²⁵

²²¹ Zhōnghuá rénmin gònghéguó zhèngquàn fǎ (2014 xiūzhèng) (中华人民共和国证券法 (2014 修正)) [Securities Law of the People’s Republic of China (2014 Amendment)] (promulgated by the Standing Comm. Nat’l People’s Cong., Aug. 31, 2014, effective Aug. 31, 2014), arts. 55, 56 (China); *Rules Governing the Listing of Stocks on the Shanghai Exchange*, *supra* note 145 at 14.1.1, 14.3.1.

²²² Securities Law of the People’s Republic of China (2014 Amendment), art. 56; *Rules Governing the Listing of Stocks on the Shanghai Exchange*, *supra* note 145, at 14.3.1.

²²³ See, e.g., Companies (Winding up and Miscellaneous Provisions) Ordinance, (1933) Cap. 32; Securities and Futures Ordinance, (2003), Cap. 571.

²²⁴ Securities and Futures (Stock Market Listing) Rules, (2003) Cap. 571V. Rule 3(a) provides that a company applying for listing on the HKEx is required to comply with the rules and requirements of the HKEx. *Id.*

²²⁵ See FIN. REPORTING COUNCIL, UK CORPORATE GOVERNANCE CODE 4 (2014), available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.aspx>, archived at <https://perma.cc/F3SP-KRHM>; Appendix 14, H.K. EXCHANGES & CLEARING LTD. (July 11, 2014), <https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/vol2.htm>, archived at <https://perma.cc/65NW-234M> (requiring that a company report on whether it has complied with the provisions and explain deviations from the provisions in the Code); see also Chapter 3: *Authorised Representatives, Directors, Board Committees and Company Secretary*, H.K. EXCHANGES & CLEARING LTD. 3.21, 3.25 (July 11, 2014), https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_3.pdf, archived at <https://perma.cc/2LFC-GCE6> (requiring a listed company to have audit and remuneration committees in place for greater regulatory effect).

According to a corporate governance report in 2005 by CLSA, a French investment group, and the Asian Corporate Governance Association, Hong Kong and Singapore remained on top in terms of the quality of corporate governance among Asian countries, whereas China ranked at the bottom, alongside the Philippines and Indonesia.²²⁶ China ranked particularly low on its implementation of rules and regulations as well as accounting and auditing standards.²²⁷ Enforcement remains the greatest concern in China.

In China, regulatory requirements regarding corporate governance are reflected in the *Code of Corporate Governance for Listed Companies* issued in January 2002, which was developed in accordance with the OECD Principles of Corporate Governance.²²⁸ The principal difference between the Chinese framework and the Hong Kong framework is that China has not adopted a “comply or explain” principle. A listed company is required to take the contents specified in the Code into account when formulating or revising its articles of association and detailed management rules.²²⁹ The Code is the objective standard of measurement for the CSRC and the stock exchanges to judge whether a listed company has a favorable governance structure. It outlines the fundamental principles of the standards of conduct that should be followed by the management and requires listed companies to protect the interests of minority shareholders.²³⁰ The CSRC has issued certain rules to implement the provisions in the Code. For instance, the *Rules for General Meeting of Shareholders of Listed Companies* and the revised *Guidance of Articles of Association of Listed Companies* were issued in 2006.²³¹ Pursuant to the Code and the *Guidance Opinions on the Establishment of an Independent Director System in Listed Companies*, independent directors must account for at least one-third of the membership of a company’s board of directors and should include at least one professional accountant.²³² Compensation, audit, and nomination committees are required to be chaired by an independent director and at least 50 percent of the committees must be constituted by independent directors.²³³

²²⁶ *CLSA and ACGA’s 2005 CG Report Finds Singapore and Hong Kong Remain Top 2 Respective Winners with Minimal Difference Now Between the Two*, CLSA (Nov. 22, 2005) https://www.clsa.com/about-clsa/media-centre/2005-media-releases/20051122_en.php, archived at <https://perma.cc/WV84-32CN>.

²²⁷ *See id.*

²²⁸ *See Code of Corporate Governance for Listed Companies in China*, CHINA SEC. REG. COMMITTEE (Jan. 7, 2001), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69223.html, archived at <http://perma.cc/78N9-7VLJ>.

²²⁹ *See id.*

²³⁰ *See id.*

²³¹ *Corporate Governance of Listed Companies in China*, OECD 34–35 (2011), <http://www.oecd.org/daf/ca/48444985.pdf>, archived at <http://perma.cc/LQF8-5CY4>.

²³² Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (issued by China Sec. Reg. Comm’n, Aug. 6, 2001), ¶ (3) (China).

²³³ *Id.* ¶ V(4).

Furthermore, a supervisory board must be established according to the Company Law.²³⁴ This is regarded as a mechanism to safeguard the lawful rights and interests of the company and its shareholders.²³⁵

It is worth noting that the improvement of Chinese listed companies in corporate governance is mainly compelled by pressure from monitoring authorities. According to a 2006 survey of the top 100 listed Chinese companies by the Chinese Academy of Social Science, improvement in corporate governance was mainly driven by the higher standards of mandatory regulations such as information disclosure and transparency, whereas in self-disciplined areas such as the responsibilities of the board of directors and roles of stakeholders, the governance standards remained low.²³⁶

V. RECENT POLITICAL INSTABILITY IN HONG KONG

The political explanation for the growth of western securities markets has been that if a society's institutions do not promote shareholder value, then ownership separation, which can influence the depth of a market, ought to be narrower than elsewhere.²³⁷ Political stability is obviously a concern to all investors. Recently, the tension between pro-Beijing and pro-democracy groups over how the promise of universal suffrage would be delivered to the special administrative region has unsettled Hong Kong.²³⁸ John Tsang, Hong Kong's financial secretary, remarked in August 2014 that the uncertain political situation might lead to "a perfect financial storm."²³⁹ Occupy Central is a plan initiated by the pro-democracy group to mobilize more than 10,000 people to block streets in Central, the financial district of Hong Kong, if the government fails to deliver a satisfactory political reform proposal for the election of the Chief Executive in 2017.²⁴⁰ John Tsang's remark mirrors an April 2014 study from UBS, an investment bank, which claimed that a prolonged

²³⁴ Zhōnghuá rénmín gònghéguó gōngsī fǎ (2013 xiūzhèng) (中華人民共和國公司法 (2013 修正)) [The Company Law of the People's Republic of China] (issued by the Standing Comm. of the People's National Cong., Dec. 28, 2013, effective Mar. 1, 2014), art. 117 (China)

²³⁵ *Code of Corporate Governance for Listed Companies in China*, *supra* note 232.

²³⁶ Lu Ton et al., *Corporate Governance Assessment on the Top 100 Chinese Listed Companies*, INST. WORLD ECON. & POL. CHINESE ACAD. SOC. SCI. 6–7, http://www.eaber.org/sites/default/files/documents/IWEP_LuTong_2006.pdf, archived at <https://perma.cc/64WQ-JSMF?type=pdf>.

²³⁷ MARK ROE, *CORPORATE GOVERNANCE: POLITICAL AND LEGAL PERSPECTIVES* 199 (Edward Elgar ed., 2005).

²³⁸ See Julie Zhu & Mark Wembridge, *Hong Kong Pro-China Rally Draws Fake Crowd Allegations*, FIN. TIMES (Aug. 18, 2014), <http://www.ft.com/intl/cms/s/0/09a2679c-2685-11e4-8bb5-00144feabdc0.html#axzz3VjdpTK3K>, archived at <http://perma.cc/ENA6-EW82>.

²³⁹ *Id.* (internal citations omitted).

²⁴⁰ Jeffie Lam & Peggy Sito, *Occupy Central to Hit Hongkong Land, Wharf Holdings Hardest*, UBS SAYS, S. CHINA MORNING POST (Apr. 1, 2014), <http://www.scmp.com/news/hong-kong/article/1462791/occupy-central-hit-hongkong-land-wharf-holdings-hardest-ubs>, archived at <http://perma.cc/H8QW-7WTF>.

political incident in Hong Kong could cause stock market volatility and warned that it might take a long time for the city to regain the confidence of foreign investors and travelers.²⁴¹

Despite Articles 45 and 68 of the Basic Law expressly stating that the ultimate aim is the selection of the Chief Executive and election of all the members of the Legislative Council by universal suffrage upon nomination, discussions on the models, roadmap, and timetable for implementing universal suffrage in Hong Kong have been attracting a great deal of discussion.²⁴² On the one hand, the pro-democracy camp, represented by Occupy Central with Love and Peace (OCLP), believes the government should adopt an open-minded attitude towards civil nomination.²⁴³ On the other hand, the pro-Beijing camp, represented by Silent Majority for Hong Kong (SMHK), opposes OCLP and fights for “democracy without chaos.”²⁴⁴ To eliminate confusion surrounding the constitutional development in Hong Kong, both the Hong Kong SAR government and the Central Government of China have taken action. In December 2013, the Hong Kong authorities issued the *Consultation Document on the Methods for Selecting the Chief Executive in 2017 and for Forming the Legislative Council in 2016* to formally commence a five-month public consultation to collect views from various sectors of the community on major issues and related questions on the two electoral methods.²⁴⁵ Subsequently, in June 2014, the State Council in China issued a white paper on the practice of the “one country, two systems” policy in Hong Kong.²⁴⁶

The Hong Kong Bar Association was particularly anxious about two points in the State Council white paper. First, the Association believes that respect for the rule of law means more than “doing things according to law.”²⁴⁷ Proper self-restraint in the exercise of power and judicial independ-

²⁴¹ See *id.*

²⁴² See XIANGGANG JIBEN FA arts. 45, 68 (H.K.); Zhu & Wembridge, *supra* note 242.

²⁴³ OCLP, <http://oclp.hk> (last visited Mar. 28, 2015), archived at <http://perma.cc/K89M-BEN7>.

²⁴⁴ *Our Stance*, SILENT MAJORITY FOR H.K., http://www.silentmajority.hk/?page_id=824&lang=en (last visited Mar. 13, 2015), archived at <http://perma.cc/549Z-R66L>.

²⁴⁵ *Methods for Selecting the Chief Executive in 2017 and Forming the Legislative Council in 2016*, METHOD FOR SELECTING THE CHIEF EXECUTIVE BY UNIVERSAL SUFFRAGE 1.18, 5.01–5.12 (Dec. 2013), <http://www.legco.gov.hk/yr13-14/english/panels/ca/papers/ca1209-cdoc20131204-e.pdf>, archived at <https://perma.cc/8Q3F-U6BR?type=pdf>.

²⁴⁶ *Full Text: Chinese State Council White Paper on ‘One Country, Two Systems’ Policy in Hong Kong*, S. CHINA MORNING POST (June 10, 2014), <http://www.scmp.com/news/hong-kong/article/1529167/full-text-practice-one-country-two-systems-policy-hong-kong-special>, archived at <http://perma.cc/H8WZ-PV6P>.

²⁴⁷ *White Paper on the Practice of “One Country, Two Systems” Policy in the Hong Kong Special Administrative Region: Response of the Hong Kong Bar Association*, H.K. BAR ASS’N ¶ 4 (June 11, 2014), http://www.hkba.org/whatsnew/misc/White_Paper_Response_eng.pdf, archived at <http://perma.cc/46RX-3W4Y> (internal citations omitted).

ence are also important.²⁴⁸ Furthermore, the Association criticizes the State Council for categorizing judges and judicial officers as part of “Hong Kong’s administrators,” claiming such a stance sends the wrong message to the people that “Courts here are part of the machinery of the Government and sing in unison with it.”²⁴⁹ Similarly, the Law Society of Hong Kong responded to the State Council white paper by reiterating “unambiguously that the rule of law and judicial independence are essential for maintaining the principle of ‘One Country, Two Systems,’ as well as the stability and prosperity of Hong Kong.”²⁵⁰

Despite the currently divided society, several prominent authorities are optimistic about the principles of “one country, two systems” and a high degree of autonomy for Hong Kong. Andrew Li Kwok-nang, a former chief justice of the Court of Final Appeal, said he “remain[s] confident that, with constant vigilance, the rule of law with an independent judiciary will continue to thrive in the coming years.”²⁵¹ The former chief justice, however, recognized the inherent tensions and grey areas in the “one country, two systems” principles. Additionally, William Hague, former Foreign Secretary of the United Kingdom, also commented, “Hong Kong’s unique constitutional framework has worked well . . . [and it is] vital for the future prosperity and security of Hong Kong.”²⁵²

CONCLUSION

Hong Kong represents an international finance center built on the foundation of Anglo-American law and finance. A strong corporate and financial law regime is the bedrock of success for Hong Kong. China might have adopted some even more stringent standards and regulations than Hong Kong, for example, the corporate governance arrangements are not based on a “comply or explain” principle and the special treatment system that is in place to alert investors to some potentially risky companies.²⁵³ One distinguishing

²⁴⁸ See *id.*

²⁴⁹ See *id.* ¶ 7 (internal citations omitted).

²⁵⁰ *Submission on the White Paper on the Practice of “One Country, Two Systems” Policy in the Hong Kong Special Administrative Region*, L. SOC’Y H.K. 2 (June 25, 2014), http://www.hklawsoc.org.hk/pub_e/news/submissions/20140625.pdf, archived at <http://perma.cc/6Y2P-VZKG>.

²⁵¹ Andrew Li, *Under Rule of Law, an Independent Judiciary Answers to No Political Masters*, S. CHINA MORNING POST (Aug. 15, 2014), <http://www.scmp.com/comment/insight-opinion/article/1573656/under-rule-law-independent-judiciary-answers-no-political>, archived at <http://perma.cc/V6R4-FY5D>.

²⁵² *Six Monthly Reports on Hong Kong: January to June 2014*, FOREIGN & COMMONWEALTH OFF. 3 (July 10, 2014), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/328978/HONG_KONG_Six_Monthly_Report_Final_Version2.pdf, archived at <https://perma.cc/5ZZG-TCXS>.

²⁵³ See Code of Corporate Governance for Listed Companies in China (issued by China Sec. & Reg. Comm’n, Jan. 7, 2001, effective Jan. 7, 2001) (China); *Rules Governing the Listing of*

difference between the Chinese and Hong Kong systems is, however, that the CSRC is responsible for admitting securities to the listing and has a wide discretion in making this decision, whereas the SFC is not directly involved in listing because it has delegated this duty to the HKEx.²⁵⁴ Although the quota system has been abolished and the new Securities Law has given the Chinese stock exchanges more authority in the listing process, the companies to be publicly listed are still, to a large extent, selected by the state through control by the CSRC.

The Chinese government's strict administrative control over the market has led to the undesirable effect of producing losers instead of winners. With scarce listing quotas in the past, many companies have adopted extreme measures such as false accounting and bribery to obtain the opportunity to list. Hong Kong's strength over the Chinese market has been evidenced by its ability to attract a large number of Chinese listings and, according to the CSRC, Chinese companies have been able to learn the management methods, accounting systems, laws, and regulations in a well-established market in the process.²⁵⁵

Despite the recent constitutional reform debate, the principles of "one country, two systems" and the high degree of autonomy for Hong Kong, as enshrined in the Joint Declaration and Basic Law of Hong Kong, continues to receive respect from across the political spectrum. Nonetheless, the need for constructive dialogues and a consensus regarding how the constitutional package will ultimately look persists. A priority should be the preservation of the "one country, two systems" principles, as they are "vital for the future prosperity and security of Hong Kong."²⁵⁶

Stocks on the Shanghai Exchange, SHANGHAI STOCK EXCHANGE 13.1.1, 13.1.3, http://english.sse.com.cn/home/public/c/en_sserule20090408.pdf (last visited Mar. 31, 2015), archived at <http://perma.cc/9J3V-ADWE>.

²⁵⁴ Iain Macneil & Alex Lau, *International Corporate Regulation: Listing Rules and Overseas Companies* 50 INT'L & COMP. L. Q. 787, 797 (2001).

²⁵⁵ Edward Chen & Winnie Poon, *The Role of Hong Kong Capital Markets in Financing Chinese Mainland Enterprises*, NOMURA FOUNDATION 16 (Mar. 7–8, 2002), http://www.nomurafoundation.or.jp/app_list/hdd/20020307-08_EKY_Chen_-_Winnie_Poon.pdf, archived at <http://perma.cc/94NE-MKZ2>.

²⁵⁶ *Six Monthly Reports on Hong Kong: January to June 2014*, *supra* note 252, at 3.