China and the Rise of Law-Proof Insiders

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Abstract

Alibaba, the e-commerce giant that completed a record-breaking IPO in the United States in 2014 and in mid-2020 was valued at over $500 billion, is one of hundreds of China-based U.S.-listed firms whose controlling insiders are largely "law-proof": the corporate and securities laws governing these firms are effectively unenforceable because the firms' insiders, records, and assets are in China. Legal remedies thus cannot reliably prevent diversion of most of these firms' value.

Our analysis casts doubt on the claim that foreign firms list in the United States to bond insiders to tough securities regulation. In fact, for China-based firms not also listed in China, a U.S. listing has the opposite effect: it effectively insulates insiders from any securities law. Yet U.S. securities regulation not only allows these firms to list, but also requires less disclosure from them than from domestic firms. The system, we show, is biased against American entrepreneurs and likely harms American investors. We suggest ways to reduce this bias and better protect U.S. investors. More generally, our analysis makes clear that one cannot understand corporate governance arrangements without taking into account enforceability.

Keywords: China, Corporate Governance, Securities Law, Corporate Law, Enforcement, Cross-Listing, Bonding

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"Law without enforcement is just… advice." *Attributed to Abraham Lincoln*

INTRODUCTION

Alibaba Group Holding Limited (Alibaba), which in 2014 conducted a record-breaking initial public offering (IPO) on the New York Stock Exchange[1] and in mid-2020 was valued at over $500 billion,[2] is based in China[3] but is subject to U.S. securities law and to Cayman Islands corporate law.[4] It is one of hundreds of U.S.-listed firms that are based in China but subject only to the securities and corporate laws of other jurisdictions.[5] We show

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[1] *See* Lucinda Shen, *These Are the 9 Biggest IPOs of All Time*, FORTUNE (Apr. 26, 2019), http://fortune.com/2019/04/26/biggest-ipos-history-uber/.

[2] *See* Matt Krantz, *Are Your Chinese Stocks on the U.S. Hit List?* INV. B. DAILY (May 27, 2020), https://www.investors.com/etfs-and-funds/sectors/baba-stock-own-biggest-chinese-stocks-hit-list/.

[3] We use the term "China" to refer to Mainland China, excluding Hong Kong and Macau, two "special administrative regions" with separate legal regimes. *See infra* Part III.B.

[4] *See* Jesse M. Fried & Ehud Kamar, *Alibaba: A Case Study of Synthetic Control*, __ HARV. BUS. L. REV. (forthcoming 2021) [hereinafter Fried & Kamar, *Alibaba*] (describing how lead founder Jack Ma effectively controls Alibaba via a set of contractual, employment, and commercial arrangements).

[5] In October 2020, the U.S. government identified several hundred Chinese companies listed on U.S. exchanges with a total market capitalization of $2.2 trillion. *See* U.S.-CHINA ECON. & SECURITY REV. COMM., CHINESE COMPANIES LISTED ON MAJOR U.S. STOCK EXCHANGES 1 (Oct. 2, 2020), https://www.uscc.gov/sites/default/files/2020-10/Chinese_Companies_on_US_Stock_Exchanges_10-2020.pdf. China-based firms trading in the United States generally fall into one of three categories: firms that entered the U.S. stock exchanges through reverse mergers and thereby become domiciled in a U.S. state, typically Delaware or Nevada (*see infra* Part II.B.); firms that conducted an IPO on a U.S. exchange, which are typically domiciled in a tax haven like the Cayman Islands or BVI (such as Alibaba, *see supra* note x); and Chinese state-owned enterprises (SOEs), whose primary listing and domicile is in China. *Cf.* Lauren Yu-Hsin Lin & Curtis J. Milhaupt, *Part Building or Noisy Signaling? The Contours of Political Conformity in Chinese Corporate Governance*, ECGI Law Working Paper No. 493/2020 (July 14, 2020), https://ssrn.com/abstract=3510342 (describing Chinese SOEs and their relationship with the state). We focus on the first two categories of firms, which are neither listed nor domiciled in China. A January 2019 Bloomberg search indicated that there were approximately 220 firms in the first category and 160 in the second. The total market capitalization of these firms currently exceeds $1.2 trillion. *See also* Joseph V. Carcello et al., *When Bonding Fails: Audit Firm Oversight of US-Listed Chinese Companies* 3 (Working Paper, 2014) https://ssrn.com/abstract=2419152 (reporting that most China-based firms listed in the United States are not also listed in China).

that this arrangement renders their insiders law-proof.[6] As a result, the law cannot prevent or deter them from expropriating substantial value from U.S. investors.[7]

The main problem is that almost every person or thing required to enforce the law—the insiders, the insiders' assets, the firms' records, and the firms' assets—is behind China's "Great Legal Wall" and out of reach both for private plaintiffs and for public prosecutors in the United States. China cannot be expected to extradite defendants, enforce foreign judgments, allow foreigners to file claims in its courts, or even permit litigation-critical information to be shared with foreign authorities or plaintiffs' lawyers.[8] Enforcement is even harder when, as is typically the case for large Chinese technology companies like Alibaba, the firm domiciles in the Cayman Islands rather than in the United States.[9] The problem is not merely hypothetical. China-based insiders of China-based firms have expropriated billions of dollars from U.S. investors,[10] making clear both the imperviousness of the Great Legal Wall of China and insiders' willingness to exploit it.

Our analysis has implications for understanding the motivation and effect of cross-border listing. A popular view is that a firm lists its securities in a foreign country to bond itself and its insiders to that country's tough disclosure and enforcement regime and thereby

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[6] Some of these firms, including Alibaba, are also listed in Hong Kong. *See* Fried & Kamar, *Alibaba*, *supra* note x, at ___. *Cf.* Paul Gillis, *Testimony Before the U.S.-China Economic and Security Commission, Chinese Investment in the United States: Impacts and Issues for Policymakers* 1 (Jan. 26, 2017) [hereinafter Gillis, *Testimony]*, https://www.uscc.gov/sites/default/files/Gillis_USCC%20Hearing%20Testimony012617.pdf (reporting that most listed China-based firms not trading on Mainland exchanges, such as Shanghai and Shenzhen, trade in Hong Kong or in the United States). However, the Chinese legal regime that makes China-based insiders law-proof with respect to the United States (*see infra* Part II) also makes them law-proof with respect to all shareholders and regulators outside China, including those in Hong Kong. *See infra* Part III.B. In 2019, China's Securities Law was revised to provide extraterritorial jurisdiction to firms that are neither listed nor domiciled in China, but it is unclear whether or how this provision will be applied.

[7] One reason China-based firms list in the United States is to more easily raise capital from American retail investors. *See* Robert Bartlett et al., *The Myth of* Morrison*: Securities Fraud Litigation against Foreign Issuers* 8 (Institute for Law and Economics Research Paper No. 18–34, 2018), https://ssrn.com/abstract=3283527. *Cf.* John Ammer et al., *Why Do U.S. Cross-Listings Matter?* (Working Paper, 2008), https://www.federalreserve.gov/pubs/ifdp/2008/930/ifdp930.pdf (finding that U.S. investors sharply increase their holdings in a foreign company after it cross-lists, roughly doubling them). Retail investors may invest directly in individual foreign-based U.S.-listed firms via platforms such as Robinhood or ETFs such as Renaissance IPO, which contains a substantial number of China-based firms that recently went public in the Unites States. *See* RENAISSANCE IPO ETF, https://www.renaissancecapital.com/IPO-Investing/US-IPO-ETF-Holdings (last visited Nov. 30, 2020).

[8] *See infra* Part II.A.

[9] *See infra* Part III.

[10] *See infra* Part II.B.

raise capital at a lower cost.[11] Our analysis suggests that listing in a foreign country can have the opposite effect and purpose: insiders may list their firms solely outside their home jurisdiction to raise enforcement obstacles and make themselves legally unreachable. We further show that a firm can erect even higher barriers to enforcement by domiciling in a jurisdiction like the Cayman Islands that is home to neither the firm's insiders nor the firm's investors. More generally, our work suggests that one must know the extent to which corporate-governance rules are enforceable to evaluate their effect.

Our analysis has implications also for U.S. securities regulation. We show that U.S. securities regulation oddly favors Chinese entrepreneurs taking firms public over American entrepreneurs.[12] First, while American entrepreneurs cannot lower enforcement risk by, say, capping personal liability or eliminating certain enforcement mechanisms, Chinese entrepreneurs can do so by ensuring that key insiders and their assets, and the firm's assets and records, remain in China. Second, while American entrepreneurs' firms are domestic issuers subject to standard disclosure requirements, China-based and other foreign entrepreneurs can choose whether their firms will be treated as domestic issuers or as foreign private issuers required to disclose much less.

Whether this biased system harms American investors depends on the validity of a key premise underlying U.S. securities regulation: that investors cannot adequately price variations in enforcement and disclosure at the IPO. If this premise is correct, the system not only disadvantages American entrepreneurs but also likely harms American investors buying stock in China-based law-proof firms. The solution then is to level the playing field up: the law should require China-based firms and other non-U.S.-based firms to demonstrate that their insiders are not law-proof as a condition for listing in the United States, and it should subject these firms to the same disclosure requirements as U.S.-based firms. Conversely, even if the premise is incorrect and the bias in the law does not harm American investors, the system still disadvantages American entrepreneurs, as they cannot choose the level of enforcement and disclosure optimal for their firms. In this case, U.S. securities regulation should allow any firm to choose its level of disclosure and enforcement at the IPO, and limit the law's role to enforcing this choice. Either way, the law needs fixing.

Before proceeding, we wish to make two points. First, we do not claim that all or most China-based insiders will expropriate investors. These insiders may be constrained by ethical beliefs, a need to preserve their reputation,[13] or a desire to travel or conduct business

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[11] *See infra* Part IV.

[12] *See infra* Part V.

[13] Or, at least to preserve their reputation in the United States. Massive expropriation of U.S. investors may not harm China-based insiders' reputations at home, as Chinese residents often do not pay attention to legal action in the United States against China-based insiders, even if such information is not blocked by Chinese censors. *Cf.* Yawen Li, *The Shell Game: Reverse Merger Companies and the Regulatory Efforts to Curb Reverse Merger Frauds*, 15 N.Y.U. J.L. & BUS. 153, 175 ("Because of the informational barrier created by

in the United States or other countries that will enforce U.S. judgments or effect extradition. Some insiders might wish to protect assets outside of China that are not easily moveable and are vulnerable to seizure. In addition, while so far China has turned a blind eye to massive expropriation of U.S. investors by Chinese residents,[14] it may wish to prevent expropriation in the future, especially at a highly visible firm.[15] Finally, China-based firms that go public in the United States sometimes employ legally-reachable non-Chinese nationals as directors or officers.[16] As long as they remain in their positions, their China-based colleagues may refrain from wrongdoing to avoid jeopardizing them.[17] Any of these constraints might provide some assurance to U.S. investors. But they are likely no substitute for the types of legal protection available to investors in U.S.-based, U.S.-listed firms. And when it comes to those forms of legal protection, there is little for U.S. investors in China-based firms to rely on.

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distance, language and culture, such companies' poor performance in the U.S. stock market or even legal actions against them in the United States often do not reach domestic investors").

[14] China has never prosecuted Chinese nationals for acts related to foreign-listed, China-based companies, even when there were clear violations of Chinese criminal law. *See* Gillis, *supra* note x, at 9.

[15] *See* Tamar Groswald Ozery, *Illiberal Governance and the Rise of Corporations: An Oxymoron or China's Greatest Triumph?,* 42(4) U. PA J. INT'L L. __ (forthcoming 2021) (explaining how the Chinese Communist Party's pervasive control over Chinese firms gives it sufficient carrots and sticks to induce most Chinese nationals to act according to its wishes, signaling commitment to growth and potentially providing protection to domestic and foreign investors in China-based foreign-listed firms). *Cf.* Tamar Groswald Ozery, *The Politicization of Corporate Governance—A Viable Alternative*, AM. J. COMP. L. __ (forthcoming 2021) (explaining how politicized corporate governance in China provides functional substitutes for traditional corporate governance mechanisms).

[16] For example, Alibaba's President (Michael Evans) and several members of its board are non-Chinese nationals. *See* Alibaba Grp. Holding Ltd., Annual Report (Form 20–F), at 170 (2020) [hereinafter Alibaba Form 20–F (2020)]. Of course, these people could be replaced by Jack Ma and other Chinese nationals who ultimately control Alibaba. *See* Fried & Kamar, *Alibaba*, *supra* note x.

[17] In some cases, non-Chinese nationals have been sacrificed to facilitate misappropriation. *See* SEC v. Subaye, Inc., No. 13 CIV. 3114 PKC, 2014 WL 5374957, *1 (S.D.N.Y. Oct. 16, 2014), https://www.westlaw.com/Document/Ie07dad005aff11e4a795ac035416da91/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0. *See* Securities and Exchange Commission v. Subaye, Inc., Civil Action No. 13 CIV 3114 (S.D.N.Y.), Litigation Release No. 23116, Oct. 21, 2014, https://www.sec.gov/litigation/litreleases/2014/lr23116.htm (describing how China-based insiders of Subaye could not be reached for fraud, but that was not the case for U.S.-based CFO Tom Crane who was ordered to pay a civil penalty of $150,000 and barred from serving as an officer or director of a public company for ten years). Another example was the Canadian CFO of Longtop, who was extradited to the United States, tried, and forced to pay a fine in connection with an expropriation by Longtop's law-proof China-based controller. *See infra* note x.

Second, our goal is not to criticize the Chinese legal system, which China as a sovereign nation is free to shape as it wishes. Rather, our purpose is to criticize the U.S. legal system, and in particular the incoherence of U.S. securities regulation.[18] If American entrepreneurs listed U.S.-based firms only in China and became law-proof in China as a result, while Chinese entrepreneurs were fully subject to China's corporate and securities laws, we would criticize the incoherence of Chinese securities regulation.

The remainder of this paper is organized as follows. Part I explains how enforceable securities law and corporate law, along with the threat of imprisonment, monetary damages, and reputational ruin, can deter controlling insiders of a U.S.-listed and domiciled firm based in the United States from massively expropriating public investors. Part II shows how this deterrence all but disappears when the firm remains U.S.-listed and domiciled, but now its assets and records and its insiders and their assets are located in China. Part III explains how changing the firm's domicile from the United States to the Cayman Islands further insulates insiders. Part IV considers implications for the legal-bonding hypothesis for cross-listing. Part V puts forwards implications for U.S. securities regulation. A conclusion follows.

I. HOW ENFORCEABLE LAW PROTECTS PUBLIC INVESTORS IN CONTROLLED FIRMS

This Part explains how enforceable corporate law and securities law can reduce the diversion economic value from public investors. Section A describes the potential types of tunneling in a hypothetical controlled firm trading in the United States. Section B explains how securities law and corporate law play complementary roles in reducing tunneling at this firm, how the government and private investors use these laws, and what it means for insiders to be law-proof.

A. The Risk of Tunneling

Consider a controlling shareholder ("controller") of a listed firm. The controller appoints the directors and the officers (along with the controller, "insiders").

Absent legal constraints, insiders could massively expropriate public investors via tunneling transactions.[19] The tunneling transactions could take place before the end of the firm's life as a public company. Such midstream tunneling transactions could include: value-

[18] We use China-based firms to illustrate the incoherence of U.S. securities regulation because there are hundreds of China-based firms neither listed nor domiciled in China that trade in the United States, with an aggregate market capitalization exceeding $1 trillion (*see supra* note x), and the enforcement challenges associated with China-based firms are well-known (*see infra* Part II). We are unaware of another jurisdiction comparable to China along either dimension.

[19] Managers of widely-held firms may also engage in tunneling, via excessive compensation or otherwise, but shareholders' ability to replace them constrains the magnitude of this tunneling.

shifting asset transactions between the firm and insiders or related parties;[20] value-shifting securities transactions involving insiders, public investors, and the firm;[21] and insiders taking a corporate opportunity from the firm. These forms of value extraction occur, to a greater or lesser degree, in most controlled firms around the world.[22]

At the end of the firm's life as a public company, there could also be endgame tunneling: a freeze-out at a low price determined by the controller. For example, the controller can cause the firm to merge with a shell corporation owned by the controller in consideration for cash.[23] Whatever the deal structure, a freeze-out price below the pre-deal intrinsic value of the stock expropriates public investors.[24]

B. The Role of Enforceable Law in Deterring Controller Tunneling

Corporate law and securities law play complementary roles in deterring controller tunneling. When enforceable, they can make tunneling impossible or too costly to be worthwhile. [25]

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[20] *See generally* Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal*), 16 EUR. BUS. ORG. L. REV. 1 (2015) (describing tunneling transactions).

[21] *See, e.g.,* Jesse M. Fried & Holger Spamann, *Cheap-Stock Tunneling around Preemptive Rights,* 137 J. FIN. ECON. 353 (2020) (explaining how equity issuances by controlled firms can be used to dilute minority shareholders).

[22] *See, e.g.,* Jesse M. Fried, Ehud Kamar & Yishay Yafeh, *The Effect of Minority Veto Rights on Controller Pay Tunneling*, 138 J. FIN. ECON. 777 (2020) (finding evidence of pay tunneling in controlled Israeli firms).

[23] Or the controller can cause a firm to sell all of its assets to the wholly-owned entity for cash, which is then distributed pro rata to all firm shareholders. Alternatively, the controller can cause a firm to undergo a reverse stock split that ensures each public investor is entitled to receive only a fractional share for which cash in lieu of the fractional share can be paid.

[24] Freeze-outs often occur at a slight premium to the market price. However, a controller may seek to depress the pre-freeze-out market price so that even after paying a premium the transaction expropriates public investors. *Cf.* In re Dole Food Co., Inc. Stockholder Litig., CA 8703–VCL, 2015 Del. Ch. LEXIS 223 (Del. Ch. Aug. 27, 2015), https://courts.delaware.gov/opinions/download.aspx?ID=228790 [hereinafter, *Dole Food*] (describing efforts by a controller to drive down the stock price before a take-private).

[25] When investors turn capital over to a controlled firm, they face two other types of risk besides tunneling, neither of which are addressed by investor-protection rules. The first is *business risk*: no matter how faithful and competent is the controller and her hired managers, the firm's business may not succeed due to managerial incompetence, market developments, or regulatory shifts. There is no escaping this risk, which also arises in widely-held firms. The second is *dissipation risk*: a controller may deliberately seek nonpecuniary psychic benefits at the expense of shareholder value. Such dissipation is largely unpreventable: there is usually

1. Corporate Law and Securities Law

Corporate law provides various forms of protection to public investors, but its most fundamental purpose is to prevent tunneling. To this end, corporate law prohibits transactions that benefit the controller at public investors' expense by imposing fiduciary duties on controllers and other insiders, which public investors and their attorneys enforce via private litigation.

Securities law requires listed firms to publicly disclose accurate information about their financial condition and certain insider transactions.[26] This disclosure serves two purposes. First, it provides public investors with information about firm value to facilitate trading in the firm's shares. Second, it alerts public investors to violations of corporate law and thereby enables them to enforce their corporate-law rights. Without disclosure it would be difficult for investors to use these rights against tunneling. Securities law is enforced by public investors and their attorneys as well as by the government.

2. Enforcement Mechanisms

Corporate law and securities law deter violations only if insiders believe they will be subject to punishment for violating these laws. Punishment includes both formal penalties and litigation-related costs.[27] As the likelihood of punishment declines, so does deterrence.[28]

The law provides for two main types of formal penalties: monetary fines and damages, and imprisonment. Financial penalties imposed on the firm hurt insiders only to the extent they own shares.[29] But financial penalties imposed on insiders individually can have real

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no legal constraint on the controller's ability to make value-destroying decisions absent a clear *financial* conflict of interest.

[26] U.S. securities law does not generally prohibit unfair conflict transactions, as long as all disclosure requirements are satisfied, with the exception of certain restrictions on insider trading. *See* Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

[27] Corporate and securities laws can also operate through injunctions against tunneling transactions. But an injunction will not be effective unless the enjoined party can be deterred from violating the injunction. Thus, the law's ability to constrain via injunction, like its ability to constrain via the threat of penalties, ultimately depends on its ability to inflict costs on a potential violator.

[28] *See generally* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

[29] A regulator can also indirectly impose a financial cost on the controller by preventing a controlled firm from engaging in certain types of transactions, or barring the controller individually from certain types of activities in the market.

sting.[30] To the extent an insider cannot protect her assets from seizure, the possibility of financial loss will have a deterrent effect. Insiders can be imprisoned for violating U.S. securities laws,[31] embezzlement,[32] fraud (including wire fraud),[33] perjury in corporate or securities litigation,[34] or contempt of court.[35] To the extent that insiders fear imprisonment, they will be deterred.

The enforcement of corporate law and securities law against an insider can also impose considerable collateral costs, even if in the end the insider avoids both jail and financial penalties. A defendant in protracted civil or criminal litigation bears the risk of an adverse outcome until the litigation ends. The defendant also loses time, energy, and money in the process. Being named as a defendant can create reputational harm, even if the

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[30] In the United States, controllers and their affiliated directors have had to pay financial damages in certain going-private cases, either following an adverse judgment or via pre-judgment settlement in the shadow of such a judgment. *See, e.g.*, *Dole Food*, *supra* note x.

[31] Any willful violation of the substantive provisions of the securities law, including registration and fraud provisions, is a criminal offense. *See* 15 U.S.C. § 78ff. However, insiders cannot be imprisoned for violations of judge-made or statutory corporate law, willful or otherwise, at least in the United States and the Cayman Islands.

[32] *See, e.g.*, 11 Del. C. § 841(b) ("a person is guilty of theft if the person, in any capacity, legally receives, takes, exercises control over or obtains property of another which is the subject of theft, and fraudulently converts same to the person's own use"); depending on the value of the stolen property, imprisonment may be for a term of not less than two and up to 25 years, *see* 11 Del. C. § 4205(b)). *See also* Nev. Rev. Stat. Ann. § 205.300 ("any agent… of any person, corporation, association or partnership . . . who uses or appropriates the money, property or effects… is guilty of embezzlement and shall be punished in the manner prescribed by law for the stealing or larceny of property of the kind and name of the money, goods, property or effects so taken, converted, stolen, used or appropriated").

[33] *See* 18 U.S.C. § 1343.

[34] *See* 18 U.S.C. §§ 401–403; FED. R. CRIM. P. 42. *See also* CHARLES DOYLE, CONG. RSCH. SERV., RL34303, OBSTRUCTION OF JUSTICE: AN OVERVIEW OF SOME OF THE FEDERAL STATUTES THAT PROHIBIT INTERFERENCE WITH JUDICIAL, EXECUTIVE, OR LEGISLATIVE ACTIVITIES (Apr. 17, 2014), https://fas.org/sgp/crs/misc/RL34303.pdf.

[35] *See id.* at 30. While imprisonment is uncommon, a number of U.S. insiders have been jailed for criminal violations in connection with their governance of firms. *See Timeline: A History of Insider Trading,* N.Y. TIMES (Dec. 6, 2016), https://www.nytimes.com/interactive/2016/12/06/business/dealbook/insider-trading-timeline.html (reporting that Enron's CEOs Jeffrey Skilling and Kenneth Lay were both sentenced to prison for their participation in the Enron accounting fraud, although Lay died before entering jail); *7 of the Biggest Corporate Scandals*, CNN MONEY (Oct. 14, 2015), https://money.cnn.com/gallery/news/2015/10/14/biggest-corporate-scandals/2.html (reporting that WorldCom's CEO Bernard Ebbers went to prison on fraud and conspiracy charges).

defendant is later cleared. Embarrassing information might come to light in the litigation, generating additional reputational costs.[36]

However, the prospect of these costs increases the deterrent power of corporate law and securities law only if insiders expect enforcement. And the prospect of reputational costs will have a deterrent effect only if the insider cares about her reputation among those following media accounts of the case.

Our point here should be uncontroversial: the deterrent effect of formal penalties for violating corporate law and securities law and litigation-related costs depends on enforcement.[37] To be sure, ethical or reputational considerations may motivate insiders to follow these laws even if the likelihood of enforcement is low. But in most cases these extralegal considerations will not suffice. If they did, we would not need laws and sanctions for breaking them.

3. Enforceable Corporate Law and Securities Law Deter Tunneling

To understand the deterrent power of enforceable corporate and securities laws, suppose that our hypothetical controlled firm is domiciled in Delaware and listed on the NYSE, and thus a domestic issuer under U.S. securities law. Suppose that the firm's only asset is a wholly-owned operating subsidiary located in the United States. The insiders, including the controller, are U.S. residents.

Suppose the controller considers engaging in a tunneling transaction that would reduce the value of public investors' equity by 50%, and asks her lawyer to spell out the consequences. The lawyer will say that private attorneys representing shareholders would vigorously pursue class actions and derivative claims under Delaware law against the insiders for breach of fiduciary duties. The insiders could be forced to turn over firm documents in discovery, submit to depositions, and testify under oath. At trial, they would have to prove that the tunneling transaction was entirely fair. They presumably could not do so, and thus would be hit by large damages that could require them to return all of their ill-gotten gains and perhaps more. A settlement is possible, but settlement terms would tend to reflect what

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[36] For the argument that corporate law in the United States affects managerial behavior mainly through the threat of adverse reputational effects, see generally Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); Roy Shapira, *A Reputational Theory of Corporate Law*, 26 STAN. L. & POL'Y REV. 1 (2015); Roy Shapira, *Mandatory Arbitration and the Market for Reputation*, 99 B.U. L. REV. 873 (2019) (arguing that litigation facilitates reputational deterrence by uncovering new pieces of information, as well as changing the framing, credibility, and salience of existing pieces of information).

[37] *Cf.* Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207 (2009) (finding that stronger public enforcement of the securities laws, as measured by regulator resources, improves market functioning).

plaintiffs could obtain at trial. The controller would also bear litigation-related costs, such as a damaged reputation.

To reduce plaintiffs' prospects for recovery, the insiders might withhold information required by U.S. securities law or mislead investors. However, private attorneys representing shareholders, perhaps joined by U.S. authorities, would sue the insiders for violations of securities law. These suits could lead to fines or even imprisonment, limiting the insiders' willingness to mislead.

The insiders could not thwart legal proceedings by not responding to complaints, committing perjury, or refusing to pay damages. Contempt of court and perjury would result in fines and imprisonment, and failure to pay would lead to enforceable judgment liens on their personal assets. Understanding these consequences, the controller would likely be deterred from pursuing the tunneling transaction.

In this example, the controller is deterred because she and other insiders are legally reachable. But suppose that the firm's assets, insiders, and insiders' assets were in a jurisdiction that refuses extradition requests, does not enforce U.S. judgments, and does not allow the collection of information. In such a case, the insiders would be law-proof and deterrence would fail. As Part II will show, this is the situation of the hundreds of China-based firms that are listed in the United States, and neither domiciled nor listed in China.

II. THE EFFECT OF LOCATING INSIDERS, RECORDS, AND FIRM ASSETS IN CHINA

This Part explains that locating individuals, information, and assets in China puts them beyond the reach of U.S. authorities and private investors seeking to enforce U.S. securities law or U.S. state (or any non-China) corporate law. Section A explains that Chinese rules make it difficult to extradite China-based insiders, seize assets, or obtain information about tunneling transactions involving the firm. Section B recounts how these obstacles led to massive expropriation of U.S. investors in dozens of China-based firms that became U.S.-listed and legally domiciled through reverse mergers. Section C describes the continuing vulnerability of U.S investors in China-based, U.S.-listed firms that are neither listed nor domiciled in China. Section D returns to our tunneling example.

A. The Great Legal Wall of China

Chinese law shields China-based insiders from extradition, blocks the seizure of their personal assets in China, and prevents depositions and the sharing of litigation-critical documents. In short, China surrounds its residents and firms by a "Great Legal Wall" that is impossible to scale for U.S. authorities or investors suing in U.S. courts.[38]

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[38] For ease of exposition, we assume litigation originates in the United States, which is where U.S. authorities will sue and attorneys can be expected to bring class-action corporate or securities suits and corporate derivative suits. Unsurprisingly, Chinese courts have not been considered a viable option for resolving disputes

This Great Legal Wall consists of laws and courts that apply them with an eye toward following the wishes of the Chinese Communist Party.[39] As Part II.B below discusses, dozens of fraud cases involving Chinese reverse-merger firms demonstrate that the Chinese legal system has little interest in exposing Chinese defendants to the reach of U.S. authorities or investors. We assume that this will continue to be true, although we do not know how the Chinese legal system will handle any given case.

1. No Extradition

U.S. authorities enforce U.S. securities laws in part through criminal sanctions, including imprisonment.[40] Imprisonment is also the punishment for perjury or contempt of court in civil and criminal securities cases and in corporate cases.[41] Arrest warrants have been issued against insiders of China-based, U.S.-listed firms for such infractions.[42]

However, China does not have an extradition treaty with the United States.[43] To our knowledge, no Chinese national has ever been extradited to the United States for violation of U.S. securities law or U.S. judicial orders in corporate matters.[44] As long as insiders remain

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that arise outside of China between Chinese nationals and foreigners. *See* Dan Harris, *Disputes with Chinese Companies*, HARRIS BRICKEN (Sept. 5, 2018), https://harrisbricken.com/blog/disputes-with-chinese-companies (noting that Chinese courts are unlikely to accept jurisdiction in such cases, will prohibit nearly all discovery while basing rulings almost exclusively on documentary evidence (not testimony), and rarely issue large damage awards). If the firm is (like Alibaba) domiciled in the Cayman Islands and listed in Hong Kong, some investor litigation could commence in either jurisdiction. However, as we explain in Part III, public investors are highly unlikely to bring cases in the Cayman Islands or Hong Kong due to various procedural hurdles. And, if they did, they would run into the exact same barriers in China as if they had commenced litigation in the United States.

[39] Chinese judges are told that they should serve the interests of the Chinese Communist Party and not see themselves as independent of it. *See* Lucy Hornby, *China's Top Judge Denounces Judicial Independence*, FIN. TIMES (Jan. 17, 2017), https://www.ft.com/content/60dddd46-dc74-11e6-9d7c-be108f1c1dce.

[40] *See supra* Part I.B.

[41] *See id.*

[42] For example, in *Deutsch v. ZST Digital Networks Inc.*, C.A. 8014 (Del. Ch. Jan. 7, 2019), the Delaware Court of Chancery issued an arrest warrant for two Chinese executives who for several years had not complied with court orders in a shareholder suit. *See* Vince Sullivan, *Chancery Issues Arrest Warrants for Chinese Tech Execs*, LAW360 (Jan. 7, 2019), https://www.law360.com/articles/1115940/chancery-issues-arrest-warrants-for-chinese-tech-execs. The ZST saga is discussed in more detail *infra* note x.

[43] *See, e.g.,* Rogers v. State, 40 So. 3d 888 (Fla. Dist. Ct. App. 5 Dist. 2010) (noting that the Department of Justice, Office of International Affairs produced information to the court and confirmed that "there was no extradition treaty between China and the United States").

[44] *Cf.* Alexandra Stevenson & Matthew Goldstein, *Bounty Hunter Tracks Chinese Companies That Dupe Investors*, N.Y. TIMES (Mar. 15, 2016), https://www.nytimes.com/2016/03/16/business/dealbook/bounty-

in China, they cannot be taken to the United States for trial and possible imprisonment. They are now likely safe also in Hong Kong. Although the United States had an extradition treaty with Hong Kong,[45] it was suspended in August 2020.[46] Even before the treaty was suspended, China had successfully pressured Hong Kong not to extradite a fugitive to the United States pursuant to the treaty.[47]

To be sure, the insiders could not travel the United States or to other countries with effective extradition treaties with the United States. In extreme cases, this could be a hardship.[48] But as China grows more powerful, the number of countries willing to extradite Chinese nationals to the United States can be expected to shrink.[49] In any event, insiders'

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hunter-tracks-chinese-companies-that-dupe-investors.html (reporting that a Nevada state court had found an executive of Sino Clean Energy, REN Baowen, in criminal contempt and ordered his arrest for failing to comply with earlier court orders). As of summer 2020, there is no record of REN being detained or extradited to the United States.

[45] *See* Agreement with Hong Kong for the Surrender of Fugitive Offenders, Dec. 20, 1996, U.S.–H.K., S. Treaty Doc. No. 105–3, https://www.congress.gov/treaty-document/105th-congress/3/document-text?overview=closed.

[46] *See* The President's Executive Order on Hong Kong Normalization, Exec. Order No. 13,936, 85 Fed. Reg. 43,413 (Jul. 14, 2020), https://www.govinfo.gov/content/pkg/FR-2020-07-17/pdf/2020-15646.pdf. The suspension occurred as a part of a broader U.S. response to Beijing's imposition of the National Security Law in Hong Kong. *See* Press Statement, Morgan Ortagus, Spokesperson, U.S. Department of State, Suspension or Termination of Three Bilateral Agreements With Hong Kong (Aug. 19, 2020), https://www.state.gov/suspension-or-termination-of-three-bilateral-agreements-with-hong-kong/. The United States was one of several nations that suspended the agreement, in addition to Canada, New Zealand, Australia, Britain, Finland, and Ireland; France decided not to ratify a pending extradition agreement. *See Ireland suspends extradition treaty with Hong Kong*, Reuters (Oct. 23, 2020), https://www.reuters.com/article/uk-hongkong-security-ireland/ireland-suspends-extradition-treaty-with-hong-kong-idUKKBN2781XA; Shannon Tiezzi, *US Becomes Latest Country to Suspend Extradition Treaty with Hong Kong*, Diplomat (Aug. 20, 2020), https://thediplomat.com/2020/08/us-becomes-latest-country-to-suspend-extradition-treaty-with-hong-kong/.

[47] *See* Venus Wu, *China Leaned on Hong Kong Not to Hand Fugitive to U.S., State Department Says,* REUTERS (May 30, 2018), https://www.reuters.com/article/us-hongkong-extradition/china- leaned-on-hong-kong-not-to-hand-fugitive-to-u-s-state-department-says-idUSKCN1IV1HV.

[48] For example, Kobi Alexander, an Israeli national who was CEO of Delaware-domiciled, U.S.-listed Comverse, fled to Namibia to avoid extradition when charged with criminal violations of U.S. securities law in connection with option backdating. Several years later, he turned himself in and was tried and sentenced in the United States because he had effectively been prevented from visiting family in Israel, which has an effective extradition treaty with the United States. *See* Shlomo Maital, *An Israeli Businessman's Journey from Hi-Tech Visionary to Convicted Felon,* JERUSALEM POST (Apr. 28, 2017), https://www.jpost.com/Jerusalem-Report/The-high-cost-of-flight-485423.

[49] Consider the experience of Canada, which arrested for extradition to the United States the CFO of Huawei on suspicion of violating U.S. criminal laws. *See* Daisuke Wakabayashi, *Huawei C.F.O. Is Arrested in Canada for Extradition to the U.S.,* N.Y. TIMES (Dec. 5, 2018). Following the arrest, China sought to pressure Canada to release the CFO by, for example, detaining two Canadian nationals on various charges and sentencing

knowledge that they can avoid extradition by staying in China reduces the deterrent effect of U.S. courts.

2. No Enforcement of U.S. Judgments

Neither U.S. investors nor U.S. authorities seeking to enforce U.S. judgments can seize assets in China.

(a) U.S. Investors

U.S. investors asserting corporate claims or securities claims in the United States cannot recover from insider assets or firm assets located in China. China does not have an enforcement treaty with the United States.[50] Attempts to enforce a foreign judgment that has not been recognized by a Chinese court can be punished as violation of Chinese judicial sovereignty.[51]

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a third, who had already been arrested for drug smuggling, to death. *See* Chris Buckley & Catherine Porter, *Canadian Sentenced to Death in China for Drug Smuggling Will Appeal,* N.Y. TIMES (Jan. 19, 2019), https://www.nytimes.com/2019/01/22/us/politics/meng-wanzhou-extradition.html. As of November 2020, this extradition attempt has not been resolved. *See, e.g.*, Tessa Vikander & Moira Warburton, *Canada Border Officials' Testimony to Resume in Huawei CFO's U.S. Extradition Case*, REUTERS (Nov. 17, 2020), https://www.reuters.com/article/uk-usa-huawei-tech-canada/canada-border-officials-testimony-to-resume-in-huawei-cfos-u-s-extradition-case-idUKKBN27X18V. Given Canada's experience, other countries understandably might be reluctant to extradite Chinese nationals to the United States.

[50] *See* Song Jianli, *Recognition and Enforcement of Foreign Judgments in China: Challenges and Developments*, CHINA INT'L COMM. CT. (Aug. 30, 2018), http://cicc.court.gov.cn/html/1/219/199/203/1048.html#_ftnref23. Even were there such a treaty, a U.S. judgment would not be enforced if it were considered to "violate the basic principles of the laws of China and the sovereignty, security, and public interest of China." Zhonghua Renmin Gongheguo Minshi Susongfa (中华人民共和国民事诉讼法) [Civil Procedure Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., June 27, 2017, effective July 1, 2017) [hereinafter China Civil Procedure Law], art. 282, http://cicc.court.gov.cn/html/1/219/199/200/644.html; King Fung (Dicky) Tsang, *Chinese Bilateral Judgment Enforcement Treaties*, 40 LOY. L.A. INT'L & COMP. L. REV. 1, 4 (2017).

The Convention on Choice of Court Agreements, *concluded* June 30, 2005, 44 I.L.M. 1294 [hereinafter Hague Convention], https://www.hcch.net/en/instruments/conventions/full-text/?cid=98, signed by China in 2017, does not avail either. While the Convention enables a party with a court judgment in one signatory country to enforce the judgment in another, the Convention has not been ratified by either the United States or China. More importantly, the Convention applies only if the parties' contract "...designates, for the purpose of deciding disputes which have arisen or may arise in connection with a particular legal relationship, the courts of one Contracting State or one or more specific courts of one Contracting State to the exclusion of the jurisdiction of any other courts." *See* Hague Convention, art. 3(a). Because U.S. investors and U.S. authorities will not have entered into such a contract with the China-based firm and its insiders, even a fully-ratified Convention would not help.

[51] *See* White Paper, *China's Derivatives Market and Judicial Trends*, ISDA / KING & WOOD

To be sure, a Chinese court can still choose to enforce a U.S. judgment.[52] Two courts have chosen to do so, although only one of the cases involved a U.S. plaintiff and a Chinese defendant (the other case involved a Chinese plaintiff seeking to enforce a U.S. default judgment against Chinese defendants).[53] But these decisions have no precedential value in China.[54] In any event, because China generally does not enforce U.S. judgments,[55] China-based insiders can be expected to ignore foreign judgments obtained by U.S. investors.[56]

(b) U.S. Authorities

U.S. authorities can bring securities claims against a China-based firm and its China-based insiders and obtain judgments. But these judgments are unlikely to be enforced in China, even though U.S. authorities have enforcement tools not available to investors.

The United States and China have agreed to mutual legal assistance in criminal matters, including in forfeiture proceedings.[57] But China can refuse assistance on a number

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MALLESONS, 19 (2018), https://www.isda.org/a/9pREE/Chinese-Derivatives-Market-and-Legal-Trends.pdf (reporting a case in which KPMG was fined for receiving the assets of a Chinese company according to a BVI court's judgment that had been recognized by Chinese courts, thereby demonstrating that "that a foreign bankruptcy or similar order must be first recognized by a Chinese court before the administrator or receiver may exercise its powers against the relevant assets in China).

[52] A foreign judgment from a country with which China does not have a bilateral treaty can be enforced if there is reciprocity between China and the foreign government in question, and the foreign judgment does not violate the basic principles of the laws of China and the sovereignty, security, and public interest of China. *See* Tsang, *supra* note x, at 4.

[53] *See* Craig I. Celniker, *et al., Client Memorandum: PRC Court Recognizes a U.S. Court Judgment for First Time Based on Principle of Reciprocity*, MORRISON & FOERSTER (Sept. 11, 2017), https://www.mofo.com/resources/publications/170908-prc-court-principle-reciprocity.html; Qing Di & Karen King, *Trending Toward Reciprocity: Enforcement of US Judgments in China*, CHINA B. REV. (Sept. 6, 2019), https://www.chinabusinessreview.com/trending-toward-reciprocity-enforcement-of-us-judgments-in-china/; Terence Wong & Ya'nan Zhao, *The Current Status of Enforcing U.S. Judgments in China*, WINSTON & STRAWN, LLP (July 30, 2019), https://www.winston.com/en/thought-leadership/the-current-status-of-enforcing-us-judgments-in-china.html.

[54] *See* Celniker, *supra* note x, at __.

[55] *See* Donald Clarke, *The Bonding Effect in Chinese Cross-Listed Companies: Is It Real?, in* ENFORCEMENT OF CORPORATE AND SECURITIES LAW: CHINA AND THE WORLD 88, 94 (Robin Hui Huang & Nicholas Calcina Howson eds., 2017).

[56] *See* Dan Harris, *China Enforces United States Judgment: This Changes Pretty Much Nothing*, CHINA L. BLOG (Sept. 5, 2017), https://www.chinalawblog.com/2017/09/china-enforces-united-states-judgment-this-changes-pretty-much-nothing.html.

[57] *See* Agreement on Mutual Legal Assistance in Criminal Matters, June 19, 2000, U.S.-China, https://2009-2017.state.gov/s/l/treaty/tias/2000/126767.htm [hereinafter Agreement on Mutual Legal

of grounds, including that the requested assistance would "prejudice the sovereignty, security, public order, important public policy, or other essential interests of China."[58] Unsurprisingly, such refusal is routine.[59] To our knowledge, U.S. authorities have never used this agreement successfully.

In addition, the U.S. government may be permitted to seize funds in foreign bank accounts by seizing an equivalent amount from the foreign bank's correspondent or interbank account in the United States.[60] However, an overseas defendant can avoid seizure by withdrawing money from bank accounts in her name. To our knowledge, this provision has never been used against a China-based defendant.

3. No Information

To enforce securities law and corporate law, U.S. investors and U.S. authorities must gather information on potential violations. The Great Legal Wall of China impedes this information gathering, imposing another stumbling block on the path to enforcement.

(a) U.S. Investors

U.S. investors will have difficulty obtaining information from China-based defendants in litigation because service of process is slow or impossible, depositions are prohibited, state secrecy laws and related laws prohibit the sharing of key documents, and discovery of other documents is limited.

Slow or no service of process. In U.S. civil litigation, the plaintiff obtains information via deposition and document discovery after the defendant has been served the complaint and given an opportunity to answer. When the defendant is U.S.-based, service of process is generally quick and depositions and document discovery can begin.[61] By contrast, when the

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Assistance].

[58] *See id*.

[59] *See* John Hill, *DC Circ. Won't Let 3 Chinese Banks Duck US Subpoenas*, LAW360 (August 6, 2019), https://www.law360.com/articles/1185604/dc-circ-won-t-let-3-chinese-banks-duck-us-subpoenas (reporting that the U.S. Department of Justice did not bother to use this agreement to get records from Chinese banks in connection with an investigation into evasion of North Korean sanctions because cooperation from China under this agreement has been "poor").

[60] *See* U.S. Dep't of Just., Asset Forfeiture Pol'y Manual, 134 (2019), https://www.justice.gov/criminal-afmls/file/839521/download.

[61] In certain types of cases, discovery may be delayed. For example, in cases brought under the Private Securities Litigation Reform Act (PLSRA), there is an automatic stay of discovery during the pendency of motions to dismiss that can delay discovery for months. *See* 15 U.S.C. § 78u-4(b)(3)(B).

defendant is China-based, service can take months or years. In some cases, the Chinese bureaucracy simply refuses to cooperate.[62]

No depositions. Even if service of process in China succeeds, U.S. investor-plaintiffs seeking information will run into a brick wall. China prohibits any depositions of its citizens on its soil whether in person or by telephone.[63] So U.S. investors' attorneys cannot question China-based insiders under oath in China. Without depositions, U.S. investors must rely on documentary evidence. But, as we will now explain, this too will be elusive.

State secrets law and related laws. China-based defendants can claim that they are prohibited from turning over documentary evidence by a wide array of rules designed to keep information out of foreign hands.

China's State Secrets Protection Law and its related regulations criminalize the disclosure of information that relates to Chinese national security and other potentially sensitive interests.[64] State secrets are broadly defined to include matters involving state security and national interests (or matters whose divulging is likely to prejudice those interests), including matters of national economic and social development, science and technology, and the investigation of criminal offences.[65] The law contains a catchall

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[62] *See* Aaron Lukken, *How to Serve Process in China…Important Updates*, HAGUE L. BLOG (May 14, 2018), https://www.haguelawblog.com/2018/05/serve-process-china-important-updates/. Service against a U.S.-listed firm will be relatively simple, since stock exchange rules will require that the firm have a local agent for that purpose. For a firm domiciled in the Cayman Islands, substituted service can be effected against its officers and directors. *See* GCR Order 11, rule 1(1)(ff); Daiwa Capital Markets Europe Limited v. Al Sanea, Grand Court of Cayman, Cause No. 22, 2019 (paragraphs 18–21).

[63] *See* Harris, *supra* note __.

[64] Zhonghua Renmin Gongheguo Baoshou Guojia Mimifa (中华人民共和国保守国家秘密法) [State Secrets Protection Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Sept. 5, 1988, amended Apr. 29, 2010, effective Oct. 1, 2010), https://www.cecc.gov/resources/legal-provisions/law-on-the-protection-of-state-secrets-cecc-partial-translation-and, [hereinafter State Secrets Protection Law]. *See generally* Raymond Siu Yeung Chan & John Kong Shan Ho, *Could Complying with China's Secrecy Laws Be an Excuse for Auditors not to Provide their Working Papers of Auditing Chinese Companies? Recent Cases in the United States and Hong Kong*, 26 KING'S L. J. 99 (2015); Robin Hui Huang, *The US-China Audit Oversight Dispute: Causes, Solutions, and Implications for Hong Kong* 13 (Working Paper, 2020); Robin Hui Huang, "一国两制" 背景下的香港与内地证券监管合作体制：历史演变与前景展望 (The Prospect and Evolution of the Securities Regulatory Cooperative Regime between Hong Kong and Mainland China under the 'One Country, Two Systems' Arrangement)" (2017) 5 *Bijiaofa Yanjiu 比较法研究 [Journal of Comparative Law]* 12, 19–21.

[65] *See* David Moncure, *The Conflict Between United States Discovery Rules and the Laws of China: The Risks Have Become Realities*, 16 SEDONA CONF. J. 283, 291–96 (2015), https://thesedonaconference.org/sites/default/files/publications/The%20Conflict%20Between%20US%20Discovery%20Rules%20and%20the%20Laws%20of%20China.16TSCJ283.pdf (describing the State Secrets Protection Law and its broad scope).

provision that punishes individuals for sharing information that they "should have known" concerned national security and the national interest, even if it is not marked as classified.[66] Material can be retroactively classified as a state secret after litigation commences.[67] Punishment can include imprisonment in excess of ten years.[68] The law applies to commercial enterprises,[69] and has been used to justify refusals to turn documents in for U.S. securities-law cases.[70]

Relatedly, China's Archives Law and related regulations classify firms' financial and audit information, including foreign-listed China-based firms, as archive documents that require government authorization to be delivered outside China or to foreigners or foreign organizations inside China.[71] Archive documents are broadly defined to include accounting books, financial reports, and bank statements.[72] Thus, virtually any export of financial

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[66] *See* Huang, *supra* note x, at 13.

[67] *See id.* at 14.

[68] *See id.*

[69] *See* State Secrets Protection Law, art. 3.

[70] *See infra* note x (Longtop). *See also* William D. Duhnke, Pub. Co. Acct. Oversight Bd., *Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China* (Dec. 7, 2018), https://pcaobus.org/News/Speech/Pages/statement-vital-role-audit-quality-regulatory-access-audit-information-internationally.aspx ("China's state security laws are invoked at times to limit U.S. regulators' ability to oversee the financial reporting of U.S.-listed, China-based companies. In particular, Chinese laws governing the protection of state secrets and national security have been invoked to limit foreign access to China-based business books and records and audit work papers").

[71] *See* Guanyu Jiaqiang Zai Jingwai Fahang Zhengquan yu Shangshi Xiangguan Baomi he Dang'an Guanli Gongzuo de Guiding (关于加强在境外发行证券与上市相关保密和档案管理工作的规定) [Regulations on Strengthening Secrecy and Archive Administration Work for Issuing Securities and Listing Overseas] (promulgated by the China Securities Regulatory Commission, State Secrets Bureau, State Archive Bureau, issued Oct. 20, 2009, effective Oct. 20, 2009) CSRC Notice [2009] No. 29, http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/wz/jnss/201012/t20101231_189694.html [hereinafter Regulation 29]. Regulation 29 is based on the State Secrets Protection Law and the Archives Law, as well as China's Securities Law, and prohibits disclosing information that may be classified as state secrets (any document, material, or other property involving state secrets) to any securities company, securities service agency, or overseas regulatory institution without prior government approval. *See* Moncure, *supra* note x, at 297.

The Accounting Archives Management Measures, which were promulgated under the Archives Law and China's Accounting Law, also prohibit entities from moving their "accounting archives" (including financial reports and bank statements) outside China. *See* Chan and Ho, *supra* note x, at 105-106; Jerry C. Ling, *Commentaries: Traps for the Unwary in Disputes Involving China*, JONESDAY (Aug. 2012), https://www.jonesday.com/en/insights/2012/08/traps-for-the-unwary-in-disputes-involving-china#_ednref8.

[72] The Accounting Archives Management Measures indicates that archives include all financial

documents and data could violate the law.[73] Like the State Secrets Law, the Archives has been used to justify a refusal to turn over corporate documents, including audit papers of overseas-listed firms.[74]

Finally, information not shielded by these two statutes and related regulations can be subject to other statutes limiting the transfer of information pertaining to China-based businesses. For example, a Chinese public accountancy statute generally prohibits accountants from disclosing information relating to a Chinese company.[75] And Article 177 of the Chinese Securities Law, as revised in 2020, provides that no entity or individual in China may provide documents and information relating to securities to overseas regulators without the approval of the relevant Chinese securities regulator and various government officials.[76]

Other limits on discovery. U.S. shareholders face additional obstacles to discovery. First, China prohibits foreign litigants from obtaining evidence in China by any means other than the relatively slow Hague Convention or diplomatic channels.[77] Second, China does not

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records, bank account information, and accounting-related documents. *See* Kuaiji Dang'an Guanli Banfa (会计档案管理办法) [Accounting Archives Management Measures] (promulgated by the Ministry of Finance, Bureau of State Archives, Dec. 11, 2015, effective Jan. 1, 2016), art. 6, https://www.saac.gov.cn/news/2015-12/15/content_124188.htm. Contracts with Chinese government entities are also considered accounting archives. *See* Zhonghua Renmin Gongheguo Dang'an Fa (中华人民共和国档案法) [Archives Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Sept. 5, 1987, revised June 20, 2020, effective Jan. 1, 2021) [hereinafter the Chinese Archives Law], arts. 2, 22, 25, https://baijiahao.baidu.com/s?id=1672319340554475558&wfr=spider&for=pc (contracts with the central or a local government, as well as information relating to the creation of the contracts, are "government archives" and may not be exported from China). The Archives Law was revised in June 2020, effective January 1, 2021, but the changes are minor.

[73] *See* Chan and Ho, *supra* note x, at 105–06 ("Given the broad definition of accounting archives and the prohibition on exporting both the original archives and duplicates, there is a high risk that any export of financial documents and data could violate the law").

[74] *See infra* Part III.C.2; Chan and Ho, *supra* note x, at 109–10.

[75] *See* Zhonghua Renmin Gongheguo Zhuce Kuaijishifa (中华人民共和国注册会计师法) [Law of the People's Republic of China on Certified Public Accountants] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 31, 1993, effective Jan. 1, 1994, as amended August 31, 2014), art.19, http://www.cicpa.org.cn/introcicpa/laws/201210/t20121021_35703.html.

[76] *See* Zhonghua Renmin Gongheguo Zhengquanfa (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. 28, 2019, effective Mar. 1, 2020), art. 177, http://www.csrc.gov.cn/tianjin/tjfzyd/tjjflfg/tjgjfl/201912/t20191231_368792.htm; *see also* Public Statement, U.S. Securities and Exchange Commission, *The PCAOB's Inability to Inspect Audit Work Papers in China Continues* (Apr. 21, 2020), https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting.

[77] *See* PRC Civil Procedure Law, art. 263 (stating that except when provided for through international

allow pretrial discovery and is slow and often unwilling to provide other types of information.[78]

(b) U.S. Authorities

U.S. authorities have more information-gathering tools than U.S. investors, but these tools are of little use, and the authorities therefore run into the same problems as investors.[79]

As noted above, the United States and China have agreed to provide mutual legal assistance in criminal matters.[80] This assistance includes serving documents, executing requests for inquiry, and freezing and seizing evidence.[81] But China can refuse assistance on a number of grounds, including that the requested assistance would "prejudice the sovereignty, security, public order, important public policy or other essential interests of China."[82] And China has in fact done so.[83]

The United States and China have also signed the Enhanced Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange

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treaty like the Hague Convention, or diplomatic channels, "no foreign organization or individual may, without the consent of the competent authorities of the People's Republic of China, serve documents or make investigations and collect evidence within the territory of the People's Republic of China"); U.S. Dep't of State, *China Judicial Assistance Information* (May 1, 2019), https://travel.state.gov/content/travel/en/legal/Judicial-Assistance-Country-Information/China.html ("Under its Declarations and Reservations to the Hague Evidence Convention and subsequent diplomatic communications, China has indicated that taking depositions. . . and obtaining other evidence in China for use in foreign courts may, as a general matter, only be accomplished through requests to its Central Authority under the Hague Evidence Convention"); Sun Woo (Gabriel) Kim, *Deposing Witnesses in China*, ANDERSON & ANDERSON LLP (Apr. 9, 2018), http://www.anallp.com/index.php/index/article/aid/255.html ("Despite the fact that these formal, official vehicles for obtaining discovery exist, according to U.S. officials, in more than 30 years under the Consular Convention and 13 years under the Hague Convention, China has only granted permission for taking such a deposition on one occasion. In fact, those who participate in unauthorized depositions can result in serious sanctions ranging from arrest, detention, or deportation").

[78] *See* Harris, *supra* note __.

[79] *See* Press Release, U.S. Securities and Exchange Commission, SEC Charges Deloitte & Touche in Shanghai with Violating U.S. Securities Laws in Refusal to Produce Documents, Press Release No. 2012–87 (May 9, 2012), https://www.sec.gov/news/press-release/2012-2012-87htm.

[80] *See* Agreement on Mutual Legal Assistance, *supra* note x.

[81] *See id.* at __.

[82] *See* Agreement on Mutual Legal Assistance, *supra* note __, art. 3.

[83] *See supra* Part II.A.2.(b).

of Information.[84] This agreement "encourages and enables cooperation between securities regulators through exchanging information to combat securities and derivatives violations with a cross-border element."[85] However, its provisions "are not… legally binding obligations,"[86] and a request for assistance may be denied where acting on the request would "require [a country] to violate any applicable law or regulation" or "on grounds of public or national interest."[87] In fact, China has refused to comply with requests for information on grounds of "public or national interest" in fraud cases involving China-based reverse-merger firms,[88] to which we now turn.

B. Chinese Reverse Mergers as a Case in Point

In the last decade, the inability of U.S. investors and U.S. authorities to scale the Great Legal Wall of China became clear following a wave of frauds involving Chinese reverse-merger firms that cost U.S. investors billions of dollars.

1. The Mergers

During the period 2000–2010, over 150 China-based private firms entered U.S. public markets through a reverse merger,[89] in which an existing public shell company[90] (usually

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[84] *See* International Organization of Securities Commissions Enhanced Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, [hereinafter EMMoU] *opened for signature* 2002, https://www.iosco.org/about/pdf/Text-of-the-EMMoU.pdf.

[85] *See* EMMoU Frequently Asked Questions (FAQs), at 2, https://www.iosco.org/about/pdf/EMMoU-Frequently-Asked-Questions.pdf.

[86] *See* EMMoU, art. 2(1)(a).

[87] *See* EMMoU, art. 2(1)(g).

[88] *See* Raymond Tran, *Comply at Your Own Risk: Reconciling the Tension between Western Due Diligence Practices and Chinese State Secrets Law*, 25 CAL. INT'L L.J. 45 (2017), https://www.sec.gov/comments/emerging-markets/cll9-7274725-217747.pdf.

[89] A PCAOB research note found that 159 Chinese companies accessed U.S. capital markets via reverse merger between 2007 and 2010. *See* Pub. Co. Acct. Oversight Bd., Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 2007 Through March 31, 2010, at 3 (2011), https://pcaobus.org//research/documents/chinese_reverse_merger_research_note.pdf.

[90] The shell company is a public reporting company with little or no assets that has registered securities compliant with the Securities Exchange Act of 1934. The company might have been originally registered with the SEC as a shell (a virgin shell) or an active company that underwent an IPO but eventually filed bankruptcy, causing all of its assets and liabilities to shift to the bankruptcy estate (a natural shell). *See* Ioannis V. Floros & Travis R. A. Sapp, *Shell Games: On the Value of Shell Companies*, 17 J. CORP. FIN. 850, 851 (2011).

domiciled in Delaware or Nevada) acquired a private Chinese operating company.[91] The reverse merger enabled the private Chinese company to access U.S. capital markets as if it had conducted an IPO, but without the Securities and Exchange Commission (SEC) scrutinizing and approving its disclosures.[92]

The result typically was a U.S.-listed, U.S-domiciled firm with one or more China-based subsidiaries.[93] Following the reverse merger, the public company would usually issue additional shares and send the proceeds to China-based subsidiaries, where they became available to the firm's China-based insiders.[94] Some of these U.S.-listed firms were complete

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[91] *See* SECURITIES AND EXCHANGE COMMISSION, INVESTOR BULLETIN: REVERSE MERGERS 1 (June 2011), http://www.sec.gov/investor/alerts/reversemergers.pdf. The shareholders of the private firm exchange their shares for a large majority of the shell company's shares, and the shell company survives the merger. *See* Li, *supra* note x, at 158–59.

[92] *See* Li, *supra* note x, at 156.

[93] Thus, the structure is similar to China-based non-state-owned firms that conduct their IPO in the United States, such as Alibaba (*see* Fried & Kamar, *Alibaba*, *supra* note x), except that the parent company is legally domiciled in the United States rather in the Cayman Islands. This difference meant that the reverse-merger firm was treated as a domestic issuer under U.S. securities law, rather than as a foreign private issuer subject to much lighter disclosure requirements. *See infra* Part III.A.2.

[94] *See, e.g.*, Walter Pavlo, *Fraud In Chinese Reverse Mergers on American Exchanges—And We're Surprised?*, FORBES (Apr. 8, 2011), https://www.forbes.com/sites/walterpavlo/2011/04/08/fraud-in-chinese-reverse-mergers-on-american-exchanges-and-were-surprised/; SEC v. Kelley, No. 2:14–cv–2827 (D.N.J.) (LR 22986, May 7, 2014), https://www.sec.gov/litigation/litreleases/2019/lr24696.htm (ordering defendants to pay more than $1.3 million in disgorgement and prejudgment interest for taking two Chinese companies through reverse mergers with U.S. public shell companies, and then "hid[ing] their control over the companies' stock through a vast network of U.S. and international entities, sold that stock in unregistered distributions, and manipulated trading in the stock, ultimately obtaining millions in profits as a result"); SEC v. China Energy Savings Technology, Inc., No. 06–cv–06402–ADS–AKT (E.D.N.Y.) https://www.sec.gov/divisions/enforce/claims/china-energy.htm (finding the defendants guilty of violating federal securities laws "when they orchestrated an elaborate stock manipulation scheme commonly known as a 'pump and dump.' The scheme realized millions of dollars in proceeds from the fraudulent receiving and selling of thousands of shares of China Energy stock," resulting in an order to pay over $39 million in disgorgement, prejudgment interest, and penalties); SEC v. China MediaExpress Holdings, Inc., No. 1:13–cv–00927 (D.D.C.), (LR 22833, Oct. 4, 2013), https://www.sec.gov/litigation/litreleases/2013/lr22833.htm (entering a default judgement against defendant for "engag[ing] in a scheme to mislead and defraud investors by, among other things, grossly overstating China Media's cash balances. . . after China Media materially misrepresented its financial condition and business operations, its stock price tripled to more than $20 per share. . . allowing it to raise more than $53 million from stock sales to investors"); SEC v. Chan Tze Ngon, No. 13–cv–6828 (S.D.N.Y.) (LR 22819, Sept. 26, 2013), https://www.sec.gov/litigation/litreleases/2013/lr22819.htm (stating that the ChinaCast Education Corp. CEO and board chair allegedly transferred $41 million out of $44 million raised by U.S. investors to a purported subsidiary of which Chan owned 50% and then to another entity beyond ChinaCast's control without disclosing any of the transactions in its required filings); Press Release, U.S. Dep't of Just., Former Chief Executive Officer And Chief Financial Officer Of China Medical Technologies Charged In A $400 Million Securities Fraud Scheme (Mar. 20, 2017), https://www.justice.gov/usao-edny/pr/former-chief-executive-officer-and-chief-financial-officer-china-medical-technologies (announcing that the DOJ brought charges against China Medical Technologies CEO/Chair and CFO for diverting $400 million of $426 million raised

frauds.[95] From 2010 to 2012, many of the fraudulent firms were exposed, in some cases by short-sellers who had investigated their activities in China.[96] In 2011 and 2012, more than fifty China-based firms were either delisted or forced to stop trading due to fraud and other violations of U.S. securities law.[97]

A notable example involved Puda Coal, a NYSE-listed China-based mining company whose insiders had secretly sold the firm's assets to a Chinese competitor *before* raising money from U.S. investors.[98] After the scheme was revealed, Puda's market capitalization dropped by nearly $342 million and the shares were delisted.[99]

This fraud wave hit hard the share prices of all Chinese reverse-merger firms, including ones that might not have been involved in fraud,[100] causing their aggregate market capitalization to fall 75%.[101] The collapse in share prices provided an opportunity even for firms not involved in fraud to be taken private on the cheap at the expense of U.S. investors.[102]

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from U.S. investors, but the two remain fugitives).

[95] *See* James S. Ang et al., *Good Apples, Bad Apples: Sorting Among Chinese Companies Traded in the U.S.*, 4 J. BUS. ETHICS 611 (2016).

[96] *See* Masako N. Darrough et al., *The Spillover Effect of Fraud Allegations Against Chinese Reverse Mergers*, 37 CONTEMP. ACCT. RES. 982 (2020). *See generally* Brittany Lang & John R. McGowan, *Chinese Reverse Mergers: Accounting Fraud and Stock Price Collapse*, 5 J. FORENSIC & INVESTIGATIVE ACCT. 175, 179–86 (2013), http://web.nacva.com/JFIA/Issues/JFIA-2013-2_7.pdf (describing several reverse-merger fraud cases).

[97] *See* Yimiao Chen et al., *GAAP Difference or Accounting Fraud? Evidence from Chinese Reverse Mergers Delisted from U.S. Markets*, 7 J. FORENSIC & INVESTIGATIVE ACCT. 122 (2015), http://web.nacva.com/JFIA/Issues/JFIA-2015-1_5.pdf.

[98] *See* Press Release, U.S. Securities and Exchange Commission, SEC Charges China-Based Executives with Securities Fraud (Feb. 22, 2012), https://www.sec.gov/news/press-release/2012-2012-31htm.

[99] *See id*. *See also* Floyd Norris, *A Fraud Went Undetected, Although Easy to Spot*, N.Y. TIMES (Feb. 23, 2012), https://www.nytimes.com/2012/02/24/business/sec-charges-reveal-fraud-in-chinese-company.html; SEC v. Zhao, No. 12–CV–1316 (DLC) (S.D.N.Y. Filed Feb. 22, 2012) (LR 23311, July 24, 2015), https://www.sec.gov/litigation/litreleases/2015/lr23311.htm.

[100] *See* Lewis Ferguson, Remarks at the California State University 11th Annual SEC Financial Reporting Conference, Investor Protection through Audit Oversight (Sept. 21, 2012), https://pcaobus.org/News/Speech/Pages/09212012_FergusonCalState.aspx.

[101] *See* Paul Gillis, Accounting Matters (Guest Series), *The Three Terrors of Investors in Chinese Stocks*, FORENSIC ASIA (July 25, 2013), https://www.chinaaccountingblog.com/weblog/2013_07_25_three_terrors.pdf.

[102] *See* Darrough et al., *supra* note x, at __.

The reverse-merger fraud wave and cheap go-privates that followed it resulted in the loss of an estimated $70 billion for U.S. investors.[103]

2. Investors and Regulators Try in Vain to Scale the Great Legal Wall of China

The reverse-merger frauds exposed the powerlessness of the U.S. legal system in dealing with China-based insiders and China-based firms, even though these firms were subject both to U.S. securities law and to U.S. state corporate law. Neither U.S. investors nor the U.S. authorities had any recourse.[104] The fraudsters could not be extradited and their assets could not be seized; recoveries were minimal; and wrongdoers kept most of their ill-gotten gains.

(a) Securities Claims

U.S. investors filed dozens of securities class-action lawsuits against Chinese reverse-merger companies and their insiders alleging misrepresentations in financial documents, violation of federal securities laws, and failure to comply with Generally Accepted Accounting Principles.[105] Recoveries were rare and small, with payments coming partly at the expense of U.S. investors who owned shares in these firms.[106] There were no recoveries from China-based insiders because they hid behind the Great Legal Wall of China.[107]

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[103] *See id.* at ____; Xianjie He et al., *US Listing of Chinese Firms: Bonding vs. Adverse Selection* (Working Paper, 2012), https://accountancy.smu.edu.sg/sites/default/files/accountancy/pdf/Papers/tjwong2012_paper.pdf; Ferguson, *supra* note x. Presumably, some of this $70 billion was transferred to those U.S. investors selling shares to the U.S. investors left holding the bag.

[104] *See* Gillis, *supra* note __, at 7.

[105] *See* Chen et al., *supra* note __.

[106] *See* Kevin LaCroix, *Cornerstone Research: Aggregate and Average Securities Suit Settlements Surged in 2015*, D&O DIARY (Mar. 29, 2016), https://www.dandodiary.com/2016/03/articles/securities-litigation/cornerstone-research-aggregate-and-average-securities-suit-settlements-surged-in-2015/ (detailing that the proportion of settlements of $2 million or less was at the highest level in eighteen years in 2015, largely as a result of increased settlements related to Chinese reverse mergers); Symposium, *Chinese Companies and U.S. Class Actions: Securities Litigation and Product Liability*, 23 CARDOZO J. INT'L & COMP. L. 727, 738 (2015), https://larc.cardozo.yu.edu/cgi/viewcontent.cgi?article=1214&context=faculty-articles (suggesting that enforcement risk and difficulties in prosecuting securities litigation involving the Chinese company factor into low settlement amounts).

[107] Consider NYSE-listed Longtop Financial Technologies, founded by CEO Weizhou Lian, which was revealed as a fraud when its market value exceeded $1 billion. U.S. investors sued both Longtop and Lian. Neither bothered to appear in court. A $882.3 million default judgment entered against them in 2013 was never collected. U.S. investors also sued Derek Palaschuk, the Canadian CFO, who could be legally reached. *See* Nate Raymond, *Ex-CFO of China's Longtop Found Liable in Rare U.S. Investor Trial*, REUTERS (Nov. 21, 2014), https://www.reuters.com/article/classaction-longtop-verdict/ex-cfo-of-chinas-longtop-found-liable-in-

U.S. authorities did not fare better. SEC investigations were stymied by defendants' claims that the handover of information would violate the Chinese State Secrets Law and other laws.[108] Default judgments were not paid. For example, the SEC never collected a $250 million fine imposed on Puda's chair and former CEO because Chinese regulators did not cooperate.[109]

(b) Corporate Claims

Claims under Delaware or Nevada corporate law were also filed.[110] They went nowhere because defendants could not be haled into court. In some cases, defendants would retain lawyers and then refuse to pay them.[111] Any settlements actually paid were just cents on the dollar.[112]

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rare-u-s-investor-trial-idUSL2N0TB1TY20141121. Palaschuk was found liable for fraud and agreed to pay $2.3m. *See* Nate Raymond, *Ex-CFO of China's Longtop to Pay $2.3 Mln in U.S. Investor Lawsuit*, REUTERS (June 19, 2015), https://www.reuters.com/article/classaction-china-trial/ex-cfo-of-chinas-longtop-to-pay-2-3-mln-in-u-s-investor-lawsuit-idUSL1N0Z52KU20150619.

[108] For example, in the Longtop Financial Technologies fraud case, Deloitte cited the State Secrets law in its refusal to turn over documents, stating that "turning over [its Shanghai affiliate's] work papers could violate Chinese law prohibiting the disclosure of 'state secrets,' which it says includes information about the 'national economy and social development.'" Stanley Lubman, *Unpacking the Law around the Chinese Reverse Takeover Mess*, WALL ST. J. (Jan. 24, 2012), https://www.law.berkeley.edu/article/unpacking-the-law-around-the-chinese-reverse-takeover-mess/. *See also* BDO China Dahua CPA Co. Ltd., Initial Decision Release No. 553, at 8 (ALJ Jan. 22, 2014), https://www.sec.gov/alj/aljdec/2014/id553ce.pdf (noting a defendant's letter to the court stating, among other things, that it "'cannot produce documents responsive to the Investigation. . . because such production will violate Chinese law and expose [defendant] and its employees to serious civil and criminal liability," and that the defendant "had sought consent to produce the requested documents from the [China Securities Regulatory Commission], the [Ministry of Finance], the State Secrets Bureau, and the State Archives Bureau, without success, and that absent such consent, it would be 'impossible . . . for [the defendant] to produce its documents.'").

[109] *See* Dan David, *EB–5: The SEC Has Done an Amazing Job Protecting Chinese Investors—Will China Return the Favor?*, GEOINVESTING (Mar. 10, 2016), https://geoinvesting.com/the-sec-has-done-an-amazing-job-protecting-chinese-investors-will-china-return-the-favor/.

[110] *See, e.g.*, In re Puda Coal, Inc., No. 6476–CS, 2014 WL 2469666 (Del. Ch. June 2, 2014) (ordering a default judgment against defendants for failure to appear after being duly served); Siping Fang v. Eighth Judicial Dist. Court of Nev., 425 P.3d 716 (Nev. 2018); *United States Court Issues Arrest Warrant for Wealthy China Businessman Siping Fang*, SEIDEN GRP. (Apr. 26, 2019), https://www.prnewswire.com/news-releases/united-states-court-issues-arrest-warrant-for-wealthy-china-businessman-siping-fang-300839231.html.

[111] *See* Jeff Montgomery, *Owed $1.5M, Skadden Exits from China Firm's Chancery Suit*, LAW360 (Jan. 28, 2019), https://www.law360.com/delaware/articles/1123059.

[112] Consider the long-lived matter of Deutsch v. ZST Digital Networks, Inc., C.A. No. 8014–VCL (Del. Ch.), a books and records action involving a public Delaware corporation formed through a reverse merger with

C. The Continuing Vulnerability of U.S. Investors

Since the Chinese reverse-merger frauds, the SEC and U.S. stock exchanges have taken baby steps to protect U.S. investors in China-based firms, such as making reverse mergers more difficult. Other efforts are being considered. But none gets to the core of the problem: China-based insiders are law-proof.

1. The Restrictions on Reverse Mergers

In the aftermath of the Chinese reverse-merger frauds, the national exchanges tightened their rules on reverse mergers at the behest of the SEC.[113] The goal was to make it harder to list securities on the exchanges without an IPO, where lawyers, investment bankers, accountants, and the SEC can more easily screen out fraud.

However, eliminating future reverse mergers does not make U.S. securities law enforceable on China-based insiders of China-based firms that are currently listed on U.S. exchanges or will list there in the future. The SEC still cannot successfully pursue China-based wrongdoers through civil enforcement or criminal prosecutions referred to the U.S. Department of Justice.[114] Nor can U.S. investors, by bring corporate claims or securities claims.

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a China-based company that raised capital through the sale of stock in U.S. markets, came under SEC investigation, was delisted, abandoned its U.S. presence, and failed to appear before the Court of Chancery. As a sanction for the company's failure to appear, the Court entered an order appointing a receiver and providing plaintiff with an approximately $24 million put right to sell his shares back to the company. The receiver's pursuit of recovery from defendant, described in Deutsch v. ZST Digital Networks, Inc., C.A. No. 8014–VCL, memo. op. (Del. Ch. June 14, 2018), culminated in the Court's issuance of bench warrants for the arrest of defendant's CEO and CFO if they entered the U.S. to compel defendant to comply with the Court's prior orders. *See* Deutsch v. ZST Digital Networks, Inc., C.A. No. 8014–VCL, order (Del. Ch. Jan. 7, 2019). Ultimately, the Court approved a $2 million settlement in Deutsch v. ZST Digital Networks, Inc., C.A. No. 8014–VCL, order (Del. Ch. Mar. 15, 2019), of which 15% went to the receiver.

[113] *See* Li, *supra* note x, at 169–70. Nasdaq, NYSE, and NYSE Amex now prohibit a reverse merger company from applying to list until the company has completed a one-year "seasoning period" by trading in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following the reverse merger. The company must also be current on all its required filing with the SEC, including audited financial statements. The company must also maintain a minimum share price for a sustained period, and for at least 30 of the 60 trading days immediately before its listing application and the exchange's decision to list. *See* Press Release, U.S. Securities and Exchange Commission, SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies (Nov. 9, 2011), https://www.sec.gov/news/press/2011/2011-235.htm.

[114] *See* Cynthia Fornelli, Remarks at the Center for Professional Education, Inc. SEC Conference, (June 21, 2011), https://www.thecaq.org/news/financial-reporting-and-confidence-trading-markets-0/; Opinion, *The SEC Caves on China*, WALL ST. J. (Feb. 26, 2015), https://www.wsj.com/articles/the-sec-caves-on-china-1424967173; Gillis, *Testimony*, *supra* note x.

2. The Difficulty of Inspecting Audit Working Papers

As part of its investigations into Chinese reverse-merger firms, the SEC sought audit working papers from the auditors of these companies,[115] including China-based member firms of the Big Four accounting firms.[116] The Sarbanes-Oxley Act of 2002 (SOX) obliged the firms to comply.[117] But the China-based audit firms refused, claiming that compliance could violate the State Secrets Law and the Archives Law,[118] potentially resulting in the dissolution of their firms and the imprisonment of their management. An administrative judge ruled that the firms violated U.S. law by refusing to comply.[119] Eventually, the SEC obtained the work papers after the China Securities Regulatory Commission (CSRC) allowed them to be shared.[120] In 2015, the audit firms agreed to pay $500,000 each for failing to produce the documents before proceedings had been brought.[121] The press described them as token fines, amounting to less than an average partner's salary.[122] The SEC could have

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[115] Audit work papers can provide helpful information about complex corporate transactions that is often not found in a firm's own internal records. *See* David M. Stuart & Charles F. Wright, *The Sarbanes-Oxley Act: Advocating the SEC's Ability to Obtain Foreign Audit Documentation in Accounting Fraud Investigations*, 2002 COLUM. BUS. L. REV. 749, 751–52 (2002).

[116] *See* Press Release, U.S. Securities and Exchange Commission, SEC Imposes Sanctions Against China-Based Members of Big Four Accounting Networks for Refusing to Produce Documents (Feb. 6, 2015), https://www.sec.gov/news/pressrelease/2015-25.html.

[117] *See* Sarbanes-Oxley Act of 2002 § 106, 15 U.S.C. § 7216(b).

[118] *See supra* Part II.A.3.b; Moncure, *supra* note x, at 296–97.

[119] *See* Press Release, U.S. Securities and Exchange Commission, SEC Imposes Sanctions Against China-Based Members of Big Four Accounting Networks for Refusing to Produce Documents (Feb. 6, 2015), https://www.sec.gov/news/pressrelease/2015-25.html.

[120] *See id.* Because the audit firms are based in China, they are subject to regulation by the CSRC. *See* Qingxiu Bu, *The Chinese Reverse Merger Companies (RMCS) Reassessed: Promising But Challenging?,* 12 J. INT'L BUS. & L. 17, 30 (2013).

[121] *See* Michael Rapoport, *SEC, Big Four Accounting Firms in China Settle Dispute*, WALL ST. J. (Feb 6, 2015), https://www.wsj.com/articles/sec-big-four-accounting-firms-in-china-settle-dispute-1423237083. This was the first SEC enforcement action under Section 106(e) of the Sarbanes Oxley Act. Xiao Luo, *Accessing Foreign Audit Work Papers and the Conflicting Non-U.S. Laws Defense: A Recent Case Study*, 18 N.Y.U. L. J. LEGIS. & PUB. POL'Y 185, 202 (2014).

[122] *See* Opinion, *The SEC Caves on China*, WALL ST. J. (Feb. 26, 2015), https://www.wsj.com/articles/the-sec-caves-on-china-1424967173.

barred public companies from relying on these audit firms but, as China's state-owned media outlet trumpeted, these audit firms were "too big to ban."[123]

While the SEC prevailed in this battle, it has been losing the larger war over access to audit papers of China-based firms. Under SOX, the Public Company Accounting Oversight Board (PCAOB), which the SEC oversees, is required to conduct regular inspections of all U.S. and foreign firms that issue audits for U.S.-listed firms or play a substantial role in the preparation of these audits.[124] Any such audit firm, by nature of these activities, is deemed to have consented to produce its audit working papers for PCAOB inspection, as well as to be subject to the jurisdiction of U.S. for enforcement of any request for production of documents.[125] These inspections protect investors in U.S. capital markets by ensuring that all such accounting firms adhere to U.S. auditing standards.[126]

While the PCAOB has reached agreement with other foreign jurisdictions on inspection protocols for local firms that play a role in auditing U.S.-listed firms,[127] the PCAOB reports that it has generally not been able to conduct inspections in China.[128] The

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[123] *See id*.

[124] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 STAT. 745 (July 30, 2002), *codified at* 15 U.S.C. § 7201 (2002). The PCAOB was established by SOX in the wake of various high-profile accounting scandals such as Enron. It sets rules for auditing U.S.-listed firms; inspects accounting firms that audit U.S.-listed firms to determine if they are in compliance with these rules; and investigates and disciplines non-complying auditors. Accounting firms conducting audits of U.S.-listed firms must register with the PCAOB and be inspected at least once every three years.

[125] *See* SOX, *supra* note x, § 106(b)(1).

[126] *See* Paul Gillis, *Destroyers and the PCAOB*, CHINA ACCT. BLOG (Nov. 6, 2015), https://www.chinaaccountingblog.com/weblog/destroyers-and-the-pcaob.html; *Inspected Firms*, PUB. CO. ACCT. OVERSIGHT BD., https://pcaobus.org/Inspections/Pages/InspectedFirms.aspx.

[127] *See* Huang, *supra* note x, at 10.

[128] *See* Gillis, *Three Terrors*, *supra* note x, at 6; Huang, *supra* note x, at 19. In May 2013, the PCAOB and the CSRC signed a memorandum of understanding on enforcement cooperation, aiming at "establish[ing] a cooperative framework between the parties for the production and exchange of audit documents relevant to investigations in both countries … and provid[ing] a mechanism for the parties to request and receive from each other assistance in obtaining documents and information in furtherance of their investigative duties." *See* Memorandum of Understanding on Enforcement Cooperation between the Public Company Accounting Oversight Board of the United States and the China Securities Regulatory Commission and the Ministry of Finance of China, May 7, 2013, http://upload.news.esnai.com/2013/0617/1371444412766.pdf. However, the PCAOB noted that since signing of the memorandum of understanding, "Chinese cooperation has not been sufficient for the PCAOB to obtain timely access to relevant documents and testimony necessary for the PCAOB to carry out enforcement matters." Press Release, Public Company Accounting Oversight Board, PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators (May 24, 2013). The memorandum of understanding does not carry meaningful force, as it provides for assistance and cooperation only when

PCAOB therefore does not systematically audit China-based accounting firms,[129] which collectively audit hundreds of public companies with a combined global market capitalization of over $1 trillion.[130] As a result, U.S.-listed China-based firms operate with little oversight, exposing U.S. investors to fraud and expropriation.[131]

During the summer of 2019, amid mounting trade tensions between the United States and China, bipartisan bills were introduced both in the House and in the Senate to force the delisting of firms whose auditors failed to undergo required PCAOB inspections.[132] In May 2020, one of these bills—the Holding Foreign Companies Accountable Act (HFCA)—passed unanimously in the Senate.[133] The bill bars trading in any firm whose audits go uninspected for three years.[134] The House passed the HFCA in early December 2020; it now awaits President Trump's signature.[135] Meanwhile, in August 2020 a federal inter-agency working

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"consistent with the domestic laws of the respective States." *Id*.

[129] *See* Gillis *Testimony*, *supra* note x; Reuters Staff, *Timeline: U.S., HK Regulators Struggle to Get China Audit Papers*, REUTERS (Dec. 20, 2017), https://www.reuters.com/article/china-audit-timeline/timeline-u-s-hk-regulators-struggle-to-get-china-audit-papers-idUSKBN1EE0HT.

[130] *See Data about Our China-Related Access Challenges*, PUB. CO. ACCT. OVERSIGHT BD., https://pcaobus.org/International/Pages/data-about-our-china-related-access-challenges.aspx.

[131] *See* Shaswat Das, *Testimony Before the U.S-China Security and Economic Commission, Chinese Investment in the United States: Impacts and Issues for Policymakers* (Jan. 26, 2017), https://www.uscc.gov/sites/default/files/Das_USCC%20Hearing%20Testimony.pdf. The PCAOB has a website listing the other 200 China-based or Hong-Kong-based firms whose auditors are not inspected by the PCAOB, including Alibaba. *See Public Companies That Are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions Where the PCAOB Is Denied Access to Conduct Inspections*, PUB. CO. ACCT. OVERSIGHT BD. (last updated with information filed before July 1, 2020), https://pcaobus.org/oversight/international/denied-access-to-inspections. Alibaba itself notes that its unnamed auditor and its audit work is not "inspected fully by the PCAOB." Alibaba Form 20–F (2020), at 58. Alibaba goes on to warn investors that "[t]he inability of the PCAOB to conduct inspections of auditors in China makes it more difficult to evaluate the effectiveness of our auditor's audit procedures or quality control procedures as compared to auditors outside of China that are subject to PCAOB inspections." *See id*.

[132] *See* Akiko Fujita*, New Bipartisan Bills Threaten Chinese IPOs and Chinse Companies Listed in the U.S.*, YAHOO FIN. (June 8, 2019), https://finance.yahoo.com/news/bipartisan-bills-threaten-chinese-companies-listed-in-us-000758485.html; Marco Rubio, *You Can't Trust a Chinese Audit*, WALL ST. J. (June 4, 2019), https://www.wsj.com/articles/you-cant-trust-a-chinese-audit-11559687739.

[133] *See* S. 945, 116th Cong. (2020), https://www.congress.gov/bill/116th-congress/senate-bill/945/text.

[134] *See id.* § 2(i)(3)(A) ("If the Commission determines that a covered issuer has 3 consecutive non-inspection years, the Commission shall prohibit the securities of the covered issuer from being traded—'(i) on a national securities exchange; or '(ii) through any other method that is within the jurisdiction of the Commission to regulate, including through the method of trading that is commonly referred to as the 'over-the-counter' trading of securities").

[135] *See* Daniel Flatley and Benjamin Bain, *House Backs Curbs on China Stock Listings, Sends Bill to*

group convened by President Trump recommended that the SEC implement rules that would have similar effect.[136] The SEC appears likely to publish proposed rules before the end of 2020.[137]

We doubt that China will permit the PCAOB to inspect China-based auditors, should the HFCA or a similar bill or regulation come into effect.[138] If we are correct, such a measure may well force China-based firms to delist. An announcement of an impending trading-ban could cause the stock price to drop as investors flee before shares become illiquid. This can facilitate cheap go-private transactions.[139]

But even if these measures lead to PCAOB inspections in China, U.S. investors would still face the obstacles to enforcement we describe in Part II.A: in the event of wrongdoing by China-based insiders, U.S. investors and regulators have little recourse given the inability to extradite these insiders, seize China-based assets, or gather litigation-critical information.[140]

Trump (Bloomberg, December 2, 2020), https://www.bloomberg.com/news/articles/2020-12-02/house-set-to-vote-on-restricting-chinese-firms-listing-in-u-s?sref=IrXjXN7s.

[136] *See* Alexandra Alper, *Trump Advisers Urge Delisting of U.S.-Listed Chinese Firms That Fail to Meet Audit Standards*, REUTERS (Aug. 6, 2020), https://www.reuters.com/article/us-usa-china-audits/trump-advisers-urge-delisting-of-u-s-listed-chinese-firms-that-fail-to-meet-audit-standards-idUSKCN25235B.

[137] *See* Dave Michaels and Alexander Osipovich, *SEC Pursues Plan Requiring Chinese Firms to Use Auditors Overseen by U.S.*, WALL ST. J. (Nov. 17, 2020), https://www.wsj.com/articles/sec-pursues-plan-requiring-chinese-firms-to-use-auditors-overseen-by-u-s-11605614403.

[138] There are a number of non-sinister reasons why Chinese regulators might be reluctant to allow PCAOB inspections, including (1) fear of permitting release of information that China later decides is a state secret, (2) and the need to get permission from multiple overlapping bureaucracies, many of which have no incentive to provide permission. *See* Huang, *supra* note x, at 24–25. But as one of us has argued, China is also unlikely to want American regulators probing domestic transactions because some may well involve payments to government officials and their relatives that China prefers to keep hidden. Moreover, Chinese regulators may see little upside in preventing a delisting of U.S.-listed China-based firms to the extent they prefer to see those firms leave America and relist in Hong Kong or China, to boost the prestige of local markets and enable domestic investors to profit from their future growth. *See* Jesse M. Fried, *Delisting Chinese Companies Plays Straight into Their Hands*, FIN. TIMES (June 1, 2020) (hereinafter Fried, *Delisting*), https://www.ft.com/content/7bb80406-a0c6-11ea-ba68-3d5500196c30.

[139] *See* Fried, *Delisting, supra* note x.

[140] Around the same time as the Senate passed the HFCA, NASDAQ proposed changes to its listing rules aimed at making it more difficult for certain China-based firms to list on NASDAQ: those most likely to create a fraud risk. One requirement is that firms in certain markets (including China) raise at least $25m or 25% of the firm's post-IPO market capitalization (whichever is lower) in an IPO. *See Notice of Filing of Proposed Rule Change To Apply Additional Initial Listing Criteria for Companies Primarily Operating in Restrictive Markets*, 85 Fed. Reg. 35,962 (proposed June 8, 2020), https://www.federalregister.gov/documents/2020/06/12/2020-12685/self-regulatory-organizations-the-nasdaq-stock-market-llc-notice-of-filing-of-

D. Insulation from Law Allows Tunneling

To understand how locating assets, insiders, and records in China all but eliminates the deterrent effect of U.S. securities law and state corporate law, let us return to our tunneling example from Part I.B.3 above but suppose that, while the firm remains Delaware-domiciled and listed on the NYSE, its insiders and their assets, and the firm's assets and records, are in China.

Lawyers asked to explain the consequences of a massive tunneling transaction will tell the controller, as the reverse-merger fraudsters described in Part II.B.1 above might have been told, that there is little attorneys for U.S. investors and authorities can do if the controller proceeds with the tunneling plan.

The firm's assets and records and insiders' assets are in China and cannot be accessed. Lawyers for U.S. investors and the U.S. government will have difficulty understanding what happened, especially if the firm's disclosures to the SEC are misleading, a violation for which there is likely to be no additional punishment. Attorneys for U.S. investors will likely press claims without investing in them too much, since at most they will expect a small settlement.

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proposed-rule-change. This will screen out smaller firms, which are more likely to have corporate-governance problems. However, a number of China-based firms that would like to conduct an IPO on NASDQ that would not meet these criteria might be able to increase the size of their IPOs to get over this hurdle. Thus, the hurdle is unlikely to have much protective effect.

Another requirement is that a firm from certain markets (including China) have a senior manager or director familiar with U.S. regulatory and reporting requirements. *See Notice of Filing of Proposed Rule Change To Adopt a New Requirement Related to the Qualification of Management for Companies From Restrictive Markets*, 85 Fed. Reg. 35,967 (proposed June 8, 2020), https://www.federalregister.gov/documents/2020/06/12/2020-12686/self-regulatory-organizations-the-nasdaq-stock-market-llc-notice-of-filing-of-proposed-rule-change. But one executive's familiarity with U.S. regulatory and reporting requirements does not mean that the law-proof China-based insiders controlling the firm will comply with these requirements. Moreover, the knowledgeable executive could be removed. NASDAQ could then delist the firm, but may be reluctant to force a paying customer to leave. And if NASDAQ does delist the firm, the controller could arrange a cheap go-private at the expense of U.S. investors. *See* Fried, *Delisting*, *supra* note x.

A third proposed rule relates to auditing. *See Notice of Filing of Proposed Rule Change To Amend IM–5101–1 (Use of Discretionary Authority) To Deny Listing or Continued Listing or To Apply Additional and More Stringent Criteria to an Applicant or Listed Company Based on Considerations Related to the Company's Auditor or When a Company's Business Is Principally Administered in a Jurisdiction That Is a Restrictive Market*, 85 Fed. Reg. 35,134 (proposed June 2, 2020), https://www.federalregister.gov/documents/2020/06/08/2020-12271/self-regulatory-organizations-the-nasdaq-stock-market-llc-notice-of-filing-of-proposed-rule-change. To the extent NASDAQ uses this rule to deny listing of fraudulent companies, U.S. investors will benefit. But to the extent it is used to delist companies, it is likely to have same adverse effect as the HFCA (namely, facilitating a cheap-price freeze-out). In any event, none of the proposed changes would affect firms that will list (or are already traded) on the NYSE, such as Alibaba.

There will be accounts of the insiders' misbehavior in U.S. media, but in China few may pay attention to U.S. media.

The U.S. government is unlikely to issue an arrest warrant. If it does, its only effect will be to prevent the insiders from traveling to the United States or another country that would be willing to extradite them to the United States. If that is a concern to the insiders, they could undertake the tunneling transactions without misleading investors about them. Or they could use a fraction of the expropriated value to settle claims against them.

In short, the Great Legal Wall of China makes it almost impossible for U.S. investors and regulators to enforce U.S. corporate and securities laws against China-based U.S.-listed firms.

III. THE EFFECTS OF A CAYMAN DOMICILE AND A HONG KONG LISTING

Putting aside China-domiciled Chinese state-owned enterprises, most of the largest China-based firms listed in the United States are domiciled in the Cayman Islands.[141] A number of them, including Alibaba, are listed also in Hong Kong.[142] This Part explains the effects of these features on U.S. investors. In Section A, we show that domiciling in the Cayman Islands rather than the United States increases the insulation of insiders. In Section B, we show that listing in Hong Kong in addition to the United States does not reduce their insulation.

A. The Effects of a Cayman Domicile

We now consider how U.S. investors are affected when a China-based firm's domicile is not a U.S. state but rather the Cayman Islands. As we will see, the incremental effect is to further insulate insiders of China-based, U.S.-listed firms from liability both under corporate

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[141] The majority of China-based, U.S.-listed firms are domiciled in the Cayman Islands, including some that have redomiciled there from Delaware, and another 15% are domiciled in British Virgin Islands, which has a similar legal system. *See* William J. Moon, *Delaware's Global Competitiveness*, 106 IOWA L. REV. __ (forthcoming 2021). Some, including China Biologic Company and Sohu.com, reincorporated to the Cayman Islands from Delaware.

[142] *See* Fried & Kamar, *Alibaba*, *supra* note x, at ___. *See also* Yujing Liu, *JD.com Debuts With 3.5 Per Cent Gain in Hong Kong's Biggest Initial Public Offering of 2020 As Joyous Investors Embrace E-Commerce*, S. CHINA MORNING POST (June 18, 2020), https://www.scmp.com/business/markets/article/3089511/jdcom-rises-hong-kongs-biggest-listing-year-its-dog-mascot-banging ("JD.com is part of a raft of US-traded Chinese companies seeking a secondary listing in Hong Kong"); Grady McGregor, *Gaming Giant NetEase Soars in Hong Kong IPO As Chinese Firms Seek U.S. Alternative*, FORTUNE (June 11, 2020), https://fortune.com/2020/06/11/netease-ipo-hong-kong/ ("Many analysts predict NetEase's offering Thursday will be the first of many Hong Kong debuts by U.S.-listed Chinese firms now under closer American scrutiny"); Chad Bray & Georgina Lee, *NYSE-Listed Chinese Delivery Firm ZTO Express to Raise Up to US$1.6 Billion in Hong Kong Secondary Listing*, S. CHINA MORNING POST (Sept. 16, 2020), https://www.scmp.com/business/banking-finance/article/3101710/nyse-listed-chinese-delivery-firm-zto-express-raise-us16.

law and under securities law. This additional insulation can matter when some of the firm's insiders are not completely law-proof because, for example, they have assets in the United States.

We begin by examining the corporate-law dimension, making two points. First, a Cayman domicile accords public investors of a controlled firm less substantive legal protection than a Delaware domicile. Second, a Cayman domicile imposes on investors procedural barriers to enforcement both in the Cayman Islands and in the United States.[143]

We then turn to the securities-law dimension, making two analogous points. First, a non-U.S. domicile enables a China-based firm to be treated as a foreign private issuer (FPI) under U.S. securities law, reducing required disclosure. Second, the SEC monitors and enforces securities law less vigilantly against FPIs than against domestic issuers.

1. The Effects of Cayman Law

Cayman corporate law applies to a Cayman-domiciled firm even if it is based in China and subject to litigation in the United States by U.S. investors.[144] As we explain below, Cayman law is less protective of shareholders than Delaware law because of its substance and especially because of its defendant-friendly procedural rules. In fact, these rules are so defendant-friendly that public shareholders have never brought a lawsuit in the Cayman Islands against a listed Cayman firm and its insiders.[145]

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[143] A less important form of insulation created by domiciling a firm in the Cayman Islands rather than in the United States is that there is no treaty requiring the Cayman Islands to enforce U.S. judgments. *See* James Corbett QC & Pamela Mendez, *Cayman Islands, in* ENFORCEMENT OF FOREIGN JUDGEMENTS 2015, at 34 (Gibson Dunn, 2015), https://kobrekim.com/assets/Uploads/PDFs/Getting-the-Deal-Through-Enforcement-of-Foreign-Judgments-Cayman-2015.pdf. *See also* Alibaba Group Holding Limited, Registration Statement, at 67 (Form F–1) (May 6, 2014), https://www.sec.gov/Archives/edgar/data/1577552/000119312514184994/d709111df1.htm ("Maples and Calder, our counsel as to Cayman Islands law…[has] advised us that there is uncertainty as to whether the courts of the Cayman Islands…would… recognize or enforce judgments of United States courts obtained against us or our directors or officers predicated upon the civil liability provisions of the securities laws of the United States or any state in the United States.").

[144] *See, e.g.,* Winn v. Schafer, 499 F. Supp. 2d 390, 393 (S.D.N.Y. 2007) [hereinafter, *Winn*] (holding that, under the "internal affairs doctrine," suits regarding breach of fiduciary duty apply Cayman law); Feiner Family Trust v. VBI Corp., No. 07 CIV. 1914 (RPP), 2007 WL 2615448, at *5 (S.D.N.Y. Sep. 11, 2007) [hereinafter, *Feiner*] (holding that Cayman law applies to shareholders' derivative fiduciary-duty claims); Davis v. Scottish Re Grp. Ltd., 46 Misc. 3d 1206(A), at *5 (N.Y. Sup. Ct. 2014) (holding that Cayman Islands law also applies to claims of waste, aiding and abetting breach of fiduciary duty, breach of certificate of designation, and double-derivative claims).

[145] Hedge funds occasionally bring appraisal claims in the Cayman Islands against corporations taken private at allegedly cheap prices. *See* Henny Sender, *Cayman Lawsuits Challenge Valuations of Delisted Chinese Companies*, FIN. TIMES (Feb. 28, 2017), https://www.ft.com/content/ed8768f4-fd1a-11e6-8d8e-a5e3738f9ae4 (describing appraisal proceedings brought in connection with the go-privates of China-based

(a) Narrow Scope of Fiduciary Duty

Delaware imposes fiduciary duties not only on directors but also on controllers, who owe a duty of loyalty directly to minority shareholders. Some of the largest recoveries in Delaware have been from controllers who violated this duty.[146] Delaware also imposes liability on financial advisors for aiding and abetting breach of fiduciary duty.[147]

By contrast, Cayman law does not impose liability on a controller unless she is also a director.[148] A controller might be deemed to be a "shadow director" subject to fiduciary duties, at least in the context of a winding up the company, if the plaintiff demonstrates that the directors follow her instructions.[149] But demonstrating control is difficult when

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U.S.-listed firms such as Bona Film, Focus Media, Giant Interactive, and Perfect World, whose shares were valued in these proceedings at much more than the merger price). But recoveries in these cases are small relative to the total losses inflicted on the firm's public investors, as hedge funds typically own a small fraction of the shares. *See, e.g.,* Shanda Games Ltd. v. Maso Capital Investments Ltd., Hilary Term [2020] UKPC 2, Privy Council Appeals Nos. 0062 and 0058 of 2018 (Jan. 27, 2020), https://www.bailii.org/uk/cases/UKPC/2020/2.html (reporting that appraisal-seeking Maso Capital owned 1.64% of Shanda's shares).

[146] *See, e.g., Dole Food*, *supra* note x; In re Southern Peru Copper Corp. S'holder Deriv. Litig., 30 A.3d 60 (Del. Ch. 2011); Americas Mining Corp. v. Theriault, 51 A.3d 1213 (Del. 2012) (affirming an award of more than $2 billion in damages and more than $304 in attorneys' fees).

[147] *See generally* Joel Edan Friedlander, *Confronting the Problem of Fraud on the Board*, 75 BUS. LAW. 1441, 1455 (Winter 2019/2020) (referencing several cases in which financial advisors were found to have aided and abetted breaches of fiduciary duty by company boards, including RBC Capital Mkts., LLC v. Jervis, 129 A.3d 816 (Del. 2015), a fraud case in which the Delaware Supreme Court affirmed a damages award against the primary financial advisor to a board of directors for aiding and abetting the board's breaches of its duty of care).

[148] *See Feiner*, *supra* note __, at *7 ("[U]nder Cayman Islands law, majority shareholders do not owe fiduciary duties to the company or to minority shareholders"). *See also* Wimbledon Fin. Master Fund, Ltd. v. Weston Capital Mgmt. LLC, 2017 N.Y. Misc. LEXIS 2725, at *49–50 (N.Y. Sup. Ct. July 17, 2017); Davis v. Scottish Re Grp. Ltd., 73 N.Y.S.3d 533 (N.Y. App. Div. 2018); In re CIL Ltd., Case No. 13–11272–JLG (Bankr. S.D.N.Y. Apr. 24, 2018).

[149] The term "shadow director" is defined as "in relation to a company, any person in accordance with whose directions or instructions the directors of the company are accustomed to act. . ." *See* Cayman Companies Law (2018 Revision), https://conyers-cdn.scdn5.secure.raxcdn.com/wp-content/uploads/2019/10/Cayman_Companies_Law_Compendium-CAY.pdf. But it is referenced only in the insolvency sections of Cayman companies law, leading commentators to conclude is not applicable outside of that context. *See, e.g.,* Walkers, *Client Memo, Cayman Islands—Duties and Liabilities of Directors* 7 (August 20, 2019), https://www.walkersglobal.com/images/Publications/Memo/Cayman/Cayman_Duties_and_Liabilities_of_Directors.pdf. By contrast, Hong Kong (which also does not impose fiduciary duties on controlling stockholders) requires holders of high-vote shares in firms with a primary listing in Hong Kong to serve as directors, thus ensuring they are subject to fiduciary duties. *See* Robin Hui Hang et al., *The (Re)introduction of Dual-Class Share Structures in Hong Kong: A Historical and Comparative Analysis*, 20 J. CORP. L. STUD. 121, 135–36

documents (including phone records) and individuals are on the other side of the Great Legal Wall of China.[150]

(b) Procedural Barriers to Shareholder Litigation

Suits to enforce corporate claims fall into one of two categories: direct suits by shareholders, which can be brought as class actions by at least one shareholder on behalf of a class of shareholders, and derivative suits by at least one shareholder on behalf of the corporation.

Delaware law and Cayman law classify claims similarly.[151] Most claims arising from midstream tunneling would be derivative because the corporation is considered to be the directly injured party.[152] Any recovery thus goes to the corporation. Most claims arising from endgame tunneling in a freeze-out would be direct because shareholders are considered to be injured directly by receiving insufficient consideration.[153]

In the United States, plaintiffs' lawyers working on a contingent basis bring derivative and direct claims on behalf of a public firm's dispersed shareholders, obviating the need for shareholders to finance the suit. In the Cayman Islands, contingent-fee arrangements are illegal.[154] Thus, there will be no derivative or direct suit in the Cayman Islands unless public shareholders band together to hire attorneys on an hourly basis. Collective-action problems

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(2020).

[150] *See supra* Part II.A.3.

[151] *See* In re Harbinger Capital Partners Funds Investor Litig., No. 12 CIV. 1244 AJN, 2013 WL 5441754, at *7 (S.D.N.Y. Sept. 30, 2013) ("Cayman law and Delaware law are substantially the same on this issue") (citing ABF Capital Mgmt. v. Askin Capital Mgmt., L.P., 957 F. Supp. 1308, 1332 (S.D.N.Y. 1997)).

[152] Shareholder claims against Cayman corporations "based on breach of fiduciary duty, corporate mismanagement or third party action that result in the diminution of share value belong to the corporation and can only be brought by it or a shareholder suing derivatively." *See ABF Capital Mgmt*., *supra* note ___, at 1332; Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004); Johnson v. Gore Wood & Co., [2002] 2 A.C. (H.L.) 1, 35.

[153] Other types of direct claims under Cayman law include nondisclosure claims (*see* In re Harbinger Capital Partners Funds Inv'r Litig., No. 12 CIV. 1244 AJN, 2013 WL 5441754 (S.D.N.Y. Sept. 30, 2013), at *9); negligent misrepresentation and fraud claims related to the initial shareholder decision to invest (*see id.* at *10); and tortious interference claims (*see* Davis v. Scottish Re Grp. Ltd., 46 Misc. 3d 1206(A), at *5 (N.Y. Sup. Ct. 2014)).

[154] *See* Peter McMaster et al., *Cayman Islands: The Changing Landscape of Litigation Funding in Cayman,* APPLEBY GLOBAL (Sept. 23, 2018), https://www.applebyglobal.com/publications/the-changing-landscape-of-litigation-funding-in-cayman/.

make this unlikely.[155] The lack of contingent-fee arrangements is presumably the main reason there has never been a derivative or direct case brought in the Cayman Islands by public shareholders against a listed Cayman firm.

Even if public shareholders banded together and hired a Cayman lawyer to bring derivative or direct claims, they would face additional challenges.

First, derivative claims are more difficult to bring than under Delaware law.[156] Cayman law follows the English precedent of *Foss v. Harbottle*, which "provides that derivative claims are owned and controlled by the company, not its shareholders, and that a shareholder is not permitted to bring a derivative action on behalf of that company."[157] The one relevant exception is "fraud on the minority," namely that the alleged wrongdoers control a majority of the voting stock and that they committed fraud.[158] U.S. investors in China-based firms may well have difficulty proving these elements given their lack of information, especially in a firm with complex control arrangements.[159] If they fail, they will lack standing to sue.

Second, the default rule for both derivative and direct claims in the Cayman Islands is that the loser pays the winner's legal expenses.[160] Thus, shareholders joining together to hire a Cayman lawyer to sue a China-based firms and its China-based insiders could be liable for all of the defendants' expenses, should the plaintiffs lose. Even if the shareholders were

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[155] *Cf.* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 679 (1986).

[156] *See* William J. Moon, *Delaware's New Competition*, 114 NW. U. L. REV. 1405, 1445–46 (2020) (explaining how Cayman law restricts availability of derivative lawsuits relative to Delaware law).

[157] *See Winn*, *supra* note x, at 396-97 (describing the rule and its exceptions). For a more recent application of *Foss v. Harbottle* in the Cayman Islands, see Top Jet Enterprises Limited and Sino Jet Holdings Limited/Jet Midwest, Inc. [Grand Court of the Cayman Islands, Cause no. FSD 106 of 2017 (NSJ), 2018].

[158] *See id.*

[159] *See, e.g.,* Fried & Kamar, *Alibaba*, *supra* note x (describing Alibaba's "synthetic control" structure in which lead founder exercises control through a variety of contractual, employment and commercial arrangements).

[160] *See Cayman Islands: Guide to Litigation Costs in the Cayman Islands (September 2011)*, APPLEBY GLOBAL (Oct. 4, 2011) https://www.mondaq.com/caymanislands/offshore-financial-centres/147572/guide-to-litigation-costs-in-the-cayman-islands-september-2011; *see also* Ian Huskisson et al., *Litigation & Dispute Resolution 2020 | Cayman Islands*, GLOB. L. INSIGHTS (2020), *https://www.globallegalinsights.com/practice-areas/litigation-and-dispute-resolution-laws-and-regulations/cayman-islands*; Renova Resource Private Equity Limited v. Gilbertson and Four Others [2012 (2) CILR 416] (holding that loser-pay applies in a derivative action).

able and willing to hire a lawyer out of pocket, they would be reluctant to take this additional risk. Because loser-pay is merely a default rule in the Cayman Islands, at least one China-based U.S.-listed Cayman-domiciled firm (Alibaba) explicitly incorporated loser-pay for direct claims into its articles of association, to create even more powerful deterrence.[161]

(c) The Difficulty of Bringing Claims in the United States

Lawyers representing public investors of a China-based, Cayman-domiciled, U.S.-listed firm could also sue in the United States, where a contingent fee is permitted. But suing in the United States does not overcome the tough standing requirements for derivative claims[162] and any charter-based loser-pay rule for direct claims.[163]

Moreover, suing in the United States creates new obstacles. First, the plaintiffs may have difficulty overcoming the argument that the Cayman Islands is a more appropriate forum for claims involving a China-based, Cayman-domiciled firm.[164] Second, the plaintiffs may find it challenging to convince the court that it has personal jurisdiction over foreign defendants who do not reside or do business in the United States.[165] For example, New York state courts have held that they lack personal jurisdiction over directors of Cayman-domiciled firms who did not reside in the state or personally conduct business in it.[166] Had those firms

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[161] *See* Alibaba Form 20–F (2020), at 63. Such a provision would be invalid in a Delaware-domiciled firm. *See* 8 Del. C. § 102(f).

[162] *See supra* note x.

[163] *See supra* note x (Alibaba).

[164] *See, e.g.,* Fasano v. Li, No. 16 Civ. 8759 (KPF), 2020 WL 5096001 (S.D.N.Y. Aug. 28, 2020) (dismissing shareholder claims against a China-based, Cayman-domiciled defendant Dangdang Holding Company Ltd. and China-based insiders because of *forum non conveniens* despite a forum selection clause covering some of the claims and some of the defendants). U.S. investors bringing securities claims against a Cayman-domiciled, China-based firm in U.S. courts can face hurdles similar to those faced by investors bringing corporate claims. *See* Jennifer Bennet, *Dangdang Investors Don't Have to Sue in Cayman Islands*, BLOOMBERG L. (Apr. 12, 2019), https://www.bloomberglaw.com/document/XE5TH8F8000000?bwid=0000016a-123c-de4b-a97f-b2be25770003%26email%3D0000016a-11d4-d641-ad6e-d5f700dd0001%E2%80%A6 (reporting that the Second Circuit granted plaintiff shareholders bringing securities and corporate claims in connection with a go-private of a China-based, Cayman-domiciled, U.S.-listed firm another chance to bring their claims in federal district court that had dismissed their claims on the grounds of *forum non conveniens*).

[165] A defendant's status as a director or officer of a U.S.-listed company does not by itself create personal jurisdiction. *See* In re Alstom SC Sec. Litig., 406 F. Supp 2d 236, 399 (S.D.N.Y. 2005). Signing an SEC registration statement might not be enough. *See, e.g.*, In re AstraZeneca Sec. Litig., 559 F. Supp. 2d 453, 467 (S.D.N.Y. 2008) (signing the F–3, an SEC filing incorporated into company's allegedly false 20–F, "is insufficient for personal jurisdiction"); Tracinda Corp. v. DaimlerChrysler AG, 364 F. Supp. 2d 362, 390–91 (D. Del. 2005) (declining to exercise jurisdiction where claims not predicated on Registration Statement signed by defendant).

[166] *See, e.g.,* Davis, 46 Misc. 3d at *9 (finding lack of personal jurisdiction over director defendants of

domiciled in Delaware, directors and other fiduciaries would have been deemed to have consented to the jurisdiction of Delaware courts.[167]

2. The Effects of Being an FPI

A Cayman domicile for a China-based firm also weakens the protection that U.S. securities law provides to U.S. investors by enabling the firm to be treated as a foreign private issuer (FPI).[168]

First, the FPI disclosure regime eliminates many of the rules applicable to domestic issuers because it was designed to induce listing by foreign firms on U.S. exchanges.[169]

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a Cayman firm, except for those that had waived the objection, because none of them resided in New York nor *personally* conducted sufficient business in the state). *Cf.* Renren, Inc. v. XXX, 67 Misc. 3d 1219(A) *9 (N.Y. Sup. Ct. 2020) (finding court had personal jurisdiction over insider-defendants of Cayman-domiciled, China-based firm and that shareholder-plaintiffs, in part because the defendants were California residents and one was a U.S. citizen, and that shareholder-plaintiffs had standing to sue derivatively).

[167] *See* 10 Del. C. § 3114; Eric A. Chiappinelli, *Jurisdiction over Directors and Officers in Delaware*, *in* RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION 316, 319 (Sean Griffith et al., eds., 2018). Nevada, a popular domicile among China-based firms that domicile in the United States, has a similar statutory provision. *See* Nev. Rev. Stat. § 75.160 (2013).

[168] Under both the Securities Act of 1933 and the Securities Exchange Act of 1934, a "foreign private issuer" (FPI) is a corporation or other organization incorporated or organized under the laws of a foreign country. However, a company that would otherwise be considered an FPI will be considered a domestic issuer if (a) more than 50% of its shares are owned by residents of the United States; *and* (b) one of the following three conditions is satisfied: (1) the majority of its executive officers or directors are U.S. citizens or residents; (2) more than 50% of its assets are located in the United States; or (3) its principal place of business is the United States. *See* Exchange Act Rule 3b–4, 17 C.F.R. § 240.3b–4 (2016). Most China-based, U.S.-listed firms do not satisfy any of the conditions in (b), and thus qualify for FPI status. If they domiciled in the United States, they would not qualify.

[169] *See* Steven M. Davidoff Solomon, *Rhetoric and Reality: A Historical Perspective on the Regulation of Foreign Private Issuers*, 79 U. CIN. L. REV. 619, 624 (2010). In addition, the listing rules of the national stock exchanges in the United States exempt FPIs from key corporate governance requirements that apply to domestic issuers. FPIs need not have a majority of directors meeting the independence requirements that the listing rules prescribe, need not have a compensation committee comprising only independent directors and governed by a charter, need not entrust director nominations to a majority of the independent directors or to a committee of independent directors, and need not obtain shareholder approval to issue more than a fifth of the outstanding stock in a private placement or an acquisition. *See* NYSE Listed Company Manual § 303A.00; Nasdaq Rules §§ 5615(a)(3), 5635; Form 20–F, Item 16G (17 CFR § 249.220f). Exchange rules are of secondary importance to our analysis because the sanction for violating them is only delisting, which pains the exchange and the firm's investors alike and is therefore rare. Moreover, delisting can actually play into the hands of a Chinese controller by facilitating a cheap take-private. *See supra* note x.

Unlike a domestic issuer, an FPI need not file quarterly reports[170] or current reports.[171] It must only file an annual report containing less detail than an annual report filed by a domestic issuer.[172]

Nor must an FPI abide by the standard disclosure rules when soliciting shareholder votes,[173] the requirement to make simultaneous or prompt public disclosure when sharing material nonpublic information with a market actor,[174] and the requirement to disclose executive compensation on an individual basis.[175] In the same vein, insiders of an FPI are exempt from the requirement to disclose their securities trades and are free to make short-swing profits.[176] Investors in an FPI thus get much less timely information than investors in a domestic issuer. As Professor Amir Licht puts it, these exemptions rid FPIs of the provisions that "bothered [their] insiders most."[177] The FPI regime thus expressly cuts corners in key areas of corporate governance.[178]

Second, the SEC exerts less effort in enforcing securities law against FPIs relative to domestic issuers, so potential violations are less likely to be detected, investigated, and appropriately sanctioned. Thus, the SEC not only cut corners with respect to FPI disclosures,

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[170] *See* Exchange Act Rule 13a–13(b)(2) (17 CFR § 240.13a–13). The NYSE requires FPIs to file at least semiannual reports. *See* NYSE Listed Companies Manual § 203.03.

[171] *See* Exchange Act Rule 13a–11(b) (17 CFR § 240.13a–11).

[172] *See* Form 20–F, General Instruction A(a) (17 CFR § 249.220f).

[173] *See* Exchange Act Rule 3a12–3(b) (17 CFR § 240.3a12–3). An FPI is required to make a current report in the United States only when it discloses or is required to disclose information publicly abroad. *See* Form 6–K, General Instruction B (17 CFR § 249.306).

[174] *See* Regulation FD, Rule 101(b) (17 CFR § 243.101).

[175] *See* Form 20–F, Item 6(b) (17 CFR § 249.220f). *See also* Ehud Kamar & Sharon Hannes, *The* Teva *Case: A Tale of a Race to the Bottom in Global Securities Regulation, in* RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION 372 (Jessica Erickson et al. eds., 2018).

[176] *See* Exchange Act Rule 3a12–3(b) (17 CFR § 240.3a12–3) (exempting FPIs from Section 16(a) of the Securities Exchange Act). This exemption makes it extremely difficult to detect violations of Rule 10b-5. *See* Jesse M. Fried, *Insider Trading via the Corporation*, 164 U. PA. L. REV. 801, ___ (2014) (explaining why disclosure of trades is important for policing insider trading). FPI insiders are also exempt from Section 16(b)'s short-swing profit rule, which reduces insider trading. *See* Roger M. White, *Insider Trading: What Really Protects U.S. Investors*, 55 J. FIN. & QUANTITATIVE ANALYSIS 1305 (2020), (finding that the Section 16(b) short-swing profit rule plays a substantial role in protecting outside investors from insider trading).

[177] *See* Amir N. Licht, *Crosslisting and Corporate Governance: Bonding or Avoiding*?, 4 CHI. J. INT'L L. 141, 152 (2003).

[178] *See* Licht, *supra* note x, at 142-43.

but also complements this strategy with an informal policy of non-enforcement toward FPIs.[179] Although the SEC does monitor FPIs,[180] it brings enforcement actions against them at a much lower rate than against domestic issuers and focuses heavily on issues that are mostly irrelevant to public investors, such as the Foreign Corrupt Practices Act.[181] Meaningful action against FPI insiders for harming public investors is rare.[182]

B. The Effect of a Hong Kong Listing

China-based firms that conduct IPOs in the United States sometimes list their shares also on the Hong Kong Stock Exchange.[183] By doing so, they subject themselves to the listing rules of that exchange and to enforcement by the Hong Kong Securities and Futures Commission (SFC) and Hong Kong investors.[184] But a Hong Kong listing does not reduce the insulation of China-based insiders of China-based firms.

Like the Cayman Islands, Hong Kong does not allow for contingent fees or class actions, and has a loser-pay default rule.[185] Consequently, private litigation is rare and the enforcement of corporate law and securities law is left to public authorities.[186] But Hong

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[179] *See* Licht, *supra* note x, at 143. *See also* Jordan Siegel, *Can Foreign Firms Bond Themselves Effectively by Renting US Securities Laws?*, 75 J. FIN. ECON. 319 (2005) (finding that the SEC shareholders had not effectively enforced the law against Mexican firms cross-listed in the United States and their insiders, who expropriated corporate resources).

[180] *See* Roger Silvers, *The Valuation Impact of SEC Enforcement Actions on Nontarget Foreign Firms*, 54 J. ACCT. RES. 187 (2015) (reporting that SEC monitoring of foreign issuers increased after 2002).

[181] Natalya Shnitser, *A Free Pass for Foreign Firms? An Assessment of SEC and Private Enforcement against Foreign Issuers*, 119 YALE L.J. 1638, 1693 (2010) (reporting that the enforcement of U.S. law on foreign issuers is lacking, and the SEC focuses on "hard to miss FCPA cases or lower-profile, easy to enforce infractions").

[182] *See* Siegel, *supra* note x, at 321 (reporting that the SEC rarely takes meaningful steps against foreign issuers).

[183] For example, Alibaba. *See, e.g.*, Fried & Kamar, *Alibaba*, *supra* note x, at ___.

[184] *See* Alibaba Group, Supplement to Prospectus dated November 13, 2019, at S–29 https://www.sec.gov/Archives/edgar/data/1577552/000104746919006309/a2240097z424b5.htm#da15203_risk_factors ("Upon the Listing, we will be subject to Hong Kong and NYSE listing and regulatory requirements concurrently.").

[185] *See* David C. Donald & Paul W. H. Cheuk, *Hong Kong's Public Enforcement Model of Investor Protection*, 4 ASIAN J.L.S. 349, 352 (2017).

[186] *See id*. at 372–73 ("all judicial actions taken against false and misleading securities prospectuses or to punish violations of rules against insider dealing or market manipulation have been commenced by a public body," primarily the SFC).

Kong, like the United States, is on the other side of the Great Legal Wall of China. Its authorities lack investigation and enforcement jurisdiction in China and must rely on Chinese cooperation.[187] There is no extradition treaty between Hong Kong and China,[188] and Chinese courts are not obligated to enforce Hong Kong judgments.[189] And litigation-critical

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[187] *See* Andrei Filip et al., *Cross-Listing and Corporate Malfeasance: Evidence from P-Chip Firms*, 63 J. CORP. FIN. 101232 (2017).

[188] Although the Hong Kong legislature proposed the *Fugitive Offenders and Mutual Legal Assistance in Criminal Matters Legislation (Amendment) Bill 2019*, which would have established a mechanism for transfers of fugitives between Hong Kong and Mainland China, the bill was withdrawn after months of protests. *See* James Pomfret & Claire Jim, *Hong Kong Leader Pulls Extradition Bill, But Too Little Too Late, Say Some*, REUTERS (Sept. 3, 2019), https://www.reuters.com/article/us-hongkong-protests/hong-kong-leader-pulls-extradition-bill-but-too-little-too-late-say-some-idUSKCN1VP05B.

[189] In January 2019, China and Hong Kong entered into an arrangement regarding reciprocal recognition and enforcement of judgments in civil and commercial matters, although the arrangement is not yet effective. *See* Mun Yeow, *Hong Kong: Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters*, CLYDE & CO. (Apr. 4, 2019), http://www.mondaq.com/hongkong/x/794838/Contract+Law/Arrangement+on+Reciprocal+Recognition+and+Enforcement+of+Judgments+in+Civil+and+Commercial+Matters. Even if the arrangement becomes effective, it excludes cases brought by the Securities and Futures Commission (SFC). *See* Gareth Thomas et al., *A Significant Step Towards Simpler Judicial Procedures and Reduced Re-litigation: Hong Kong and the Mainland Sign a Broader Arrangement to Recognize and Enforce Judgments in Civil and Commercial Matters*, HERBERT SMITH FREEHILS (Jan. 25, 2019) https://hsfnotes.com/asiadisputes/2019/01/25/a-significant-step-towards-simpler-judicial-procedures-and-reduced-re-litigation-hong-kong-and-the-mainland-sign-a-broader-arrangement-to-recognise-and-enforce-judgments-in-civil-and-commercial-matte/. Exclusion of the SFC means that the treaty is likely to have little effect because, as we explained, public shareholders do not typically bring claims in Hong Kong. Even if shareholders bring such an action and get a judgment in Hong Kong, a Chinese court can refuse to enforce the treaty on grounds that enforcement would be "manifestly contrary to the basic legal principles of Mainland law or the social and policy interests of the Mainland." *See* Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region, Section E, 22(g) (2019) https://www.doj.gov.hk/en/mainland_and_macao/pdf/Doc6_481354e.pdf.

information is shielded by the Chinese State Secret or the Chinese Archives Law or is otherwise unavailable.[190] Insiders can thus avoid enforcement by staying in China.[191]

IV. THE LEGAL UNBONDING HYPOTHESIS

This Part uses our analysis to cast doubt on the hypothesis that foreign firms list in the United States to bond to U.S. securities law and thereby lower their cost of capital. Section A describes the hypothesis. Section B explains why the hypothesis cannot explain a decision by a China-based firm to list its securities in the United States. Section C argues that, when a China-based firm lists its securities only outside of China, it shelters its insiders from enforcement of securities law. Similarly, Section D argues that, when a firm domiciles in a jurisdiction from which it and its insiders cannot easily be reached, it shelters its insiders from enforcement of corporate law. Section E discusses the implications of this analysis for the applicability of the legal-bonding hypothesis to non-China-based companies.

A. Legal Bonding: Theory and Evidence

The United States attracts hundreds of listings by foreign companies,[192] which collectively make up about 25% of the market capitalization of U.S.-traded stocks.[193]

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[190] There is a litigation information-sharing treaty between China and Hong Kong. *See* Arrangement on Mutual Taking of Evidence in Civil and Commercial Matters between the Courts of the Mainland and the Hong Kong Special Administrative Region (2016) [hereinafter Evidence Arrangement] https://www.hklawsoc.org.hk/mem/download/attachment.asp?issue=17-146a1.pdf. But it excludes administrative litigation, and thus actions by the SFC, *see* Consultation Paper, Hong Kong Dep't of Just., *Proposed Arrangement Between Hong Kong and the Mainland on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters*, at 5–6 (July 2018), https://www.doj.gov.hk/en/miscellaneous/pdf/lpdpapere.pdf (stating that "administrative litigation. . . would be *excluded* from the Proposed Arrangement," which, as we have explained, is likely to be the only party bringing claims against insiders of a China-based firm. Moreover, requests for information can be rejected if the request "does not comply with the relevant legal provisions of its jurisdiction." Evidence Arrangement, art. 3. However, we have been told that China's CSRC sometimes chooses to share audit papers with the SFC. Interestingly, but not surprisingly, the CSRC requires that those papers not be shared with the SEC.

[191] *See* Filip et al., *supra* note x, at __. Not surprisingly, China-based firms listed in Hong Kong engage in more misbehavior than Hong-Kong based firms listed in Hong Kong. *See id.* at __.

[192] *See* U.S. Securities and Exchange Commission, *Market Summary: Number of Foreign Companies Registered and Reporting with the U.S. Securities and Exchange Commission*, https://www.sec.gov/divisions/corpfin/internatl/foreignmarketsumm2015.pdf.

[193] *See International Listings*, N.Y. STOCK EXCHANGE, https://www.nyse.com/listings/international-listings (last visited Nov. 30, 2020).

Listing in the United States subjects a firm either to U.S. securities law applicable to domestic issuers or to a lighter version applicable to FPIs.[194] Even the lighter version imposes costs on firm insiders. Some costs fall directly on the insiders. For example, disclosure requirements can reveal wrongdoing, creating for the insiders enforcement risk and reputational damage. Other costs fall indirectly on the insiders as shareholders. For example, the firm bears compliance costs.[195]

To justify these costs, the insiders personally must expect direct or indirect benefits from listing in the United States. For example, a listing in the United States might enable their firm to raise capital from U.S. retail investors, who would otherwise face barriers to cross-border investing in the firm;[196] increase trading volume;[197] and obtain wider analyst and media coverage.[198] Any of these effects can increase the stock price and indirectly benefit insiders as shareholders.

But being subject to U.S. securities law by itself can also benefit a firm and thus indirectly benefit insiders. According to the popular legal-bonding hypothesis, firms based in jurisdictions with poor investor protection list in the United States to reduce their cost of capital.[199] Professor John Coffee describes this idea as follows:

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[194] *See supra* Part III.A.2.

[195] *See* Davidoff Solomon, *supra* note x, at 629 (referencing the "costs imposed upon issuers by Sarbanes-Oxley's § 404 requirements"); Licht, *supra* note x, at 143 (noting that "cross-listing on an American national market is not a cost-free transaction," which includes the indirect costs of legal and accounting fees);

[196] *See, e.g.,* Stephen R. Foerster & G. Andrew Karolyi, *The Effects of Market Segmentation and Investor Recognition on Asset Prices: Evidence from Foreign Stocks Listing in the United States*, 54 J. FIN. 981 (1999); Darius P. Miller, *The Market Reaction to International Cross-Listings: Evidence from Depositary Receipts*, 51 J. FIN. ECON. 103 (1999).

[197] *See* Christian Leuz & Robert E. Verrecchia, *The Economic Consequences of Increased Disclosure*, 38 J. ACCT. RSCH. 91 (reporting in a study that German firms committing to U.S. GAAP, which are more stringent than the German reporting requirements, experience higher share turnover than those firms using only the German GAAP).

[198] *See, e.g.,* H. Kent Baker et al., *International Cross-Listing and Visibility*, 37 J. FIN. & QUANTITATIVE ANALYSIS 495 (2002); Mark H. Lang et al., *ADRs, Analysts, and Accuracy: Does Cross-Listing in the United States Improve a Firm's Information Environment and Increase Market Value?* 41 J. ACCT. RES. 317 (2003).

[199] *See generally* René M. Stulz, *Globalization, Corporate Finance, and the Cost of Capital*, 12 J. APP. CORP. FIN. 8 (1999); John C. Coffee, Jr., *Racing Towards the Top: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (2002); Edward B. Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure,* 23 CARDOZO L. REV. 675, 687 (2002) (noting that by "…opting in to the U.S. disclosure system, a system that demands a high level of disclosure, with severe sanctions for incomplete or inaccurate disclosure… foreign issuers, like domestic closely held firms, are able to make a credible commitment to provide high quality

> [C]ross-listing may also be a bonding mechanism by which firms... in jurisdictions with weak protection of minority rights or poor enforcement mechanisms can voluntarily subject themselves to higher disclosure standards and stricter enforcement in order to attract investors who would otherwise be reluctant to invest . . .[200]

Accordingly:

> Listing on a US exchange [commits the listing firm to respect minority investor rights and to provide fuller disclosure] because (1) the listing firm becomes subject to the enforcement powers of the . . . SEC . . .; (2) investors acquire the ability to exercise effective and low-cost legal remedies, such as class actions and derivative actions, that are simply not available in the firm's home jurisdiction; and (3) entry into the US markets commits the firm . . . to provide fuller financial information in response to SEC requirements. . .[201]

The legal bonding hypothesis for cross-border listing in the United States is superficially plausible. However, it is unclear why insiders, especially ones with small equity stakes, would subject themselves to direct enforcement risk only to benefit indirectly as shareholders. In fact, insiders of foreign firms consistently report that they find U.S. securities law unappealing.[202] Moreover, there is little to stop a foreign firm listed in the United States from delisting and exiting this regime.[203] In any event, the empirical evidence bearing on the legal-bonding hypothesis is at best mixed.[204]

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disclosure into the indefinite future"). A separate "reputational bonding hypothesis" asserts that the insiders of some firms that list in the United States act lawfully not for fear of legal sanctions but rather to develop a good reputation. *See* Siegel, *supra* note x, at ____. However, reputational considerations carry no weight in a final-period game. We cannot rule out that the controlling insiders of some China-based firms that have (so far) behaved well are engaged in such reputational bonding

[200] *See* Coffee *supra* note x, at 1767.

[201] *See* Coffee, *supra* note x, at 1780-81.

[202] *See* Licht, *supra* note x, at 157 ("Managers do not even pretend to mention increased disclosure as a plus. In their mind, the US disclosure regime is a liability more than an asset. . . piggybacking on the American regulatory regime is not among the reasons for coming to America.").

[203] Exchange Act Rule 12h–6, promulgated in 2007, facilitated deregistration by foreign firms. *See* Nuno Fernandes et al., *Escape from New York: The Market Impact of Loosening Disclosure Requirements*, 95 J. FIN. ECON. 129 (2010) (noting that since the passage of Rule 12h–6, "an unprecedented number of firms have deregistered, and these firms often had been previous targets of U.S. class action securities lawsuits or SEC enforcement actions.").

[204] For a review of the evidence from one of the theory's proponents, see G. Andrew Karolyi, *Corporate Governance, Agency Problems and International Cross-Listings: A Defense of the Bonding Hypothesis*, 13 EMERGING MKTS. REV. 516 (2012) (surveying studies). For studies by skeptics, see, e.g., Jordan Siegel, *supra*

B. Listing China-Based Firms in the United States Is Not Bonding

Even if the legal-bonding hypothesis can explain listing in the United States by some foreign firms, it is unlikely to apply to China-based firms listed both in China and the United States.[205] Recall that Coffee's account of the mechanisms for bonding involve listing firms being subject to the SEC's enforcement powers, the availability of legal remedies for investors, and increased disclosure requirements.[206] However, we showed that insiders of China-based firms are immune to enforcement of U.S. securities law.[207] There is no possibility of extradition from China, no enforcement of judgments in China, and no access to litigation-critical information in China.[208] Coming to America does not bond these firms at all.

The reverse-merger scandals made these impediments to enforcement painfully clear.[209] Shareholder lawsuits went nowhere. Default judgments were not paid. SEC investigations were blocked. Moreover, the Chinese reverse-merger firms were subject to standard U.S. securities law because they were U.S.-domiciled. U.S. investors in firms domiciled outside the United States and reporting as FPIs are in an even worse position to the extent these firms qualify as FPIs, which are subject to lighter requirements and less SEC enforcement.[210]

To be sure, attorneys representing U.S. investors do sue China-based firms for disclosure violations and occasionally obtain settlements. But these settlements are small and come mainly at the expense of all shareholders, including U.S. investors who may hold

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note x (finding that the SEC and minority shareholders had not effectively enforced the law against Mexican firms cross-listed in the United States and their insiders, who expropriated corporate resources); Amir N. Licht et al., *What Makes the Bonding Stick? A Natural Experiment Testing the Legal-bonding hypothesis*, J. FIN. ECON. 329 (2018) (finding that the stock prices of U.S.-listed foreign firms increased or did not change in response to the *Morrison* decision decreasing potential liability for violations of the securities law, and concluding that the results go against the legal-bonding hypothesis).

[205] We are not the first to argue that China-based firms listing in the United States are unlikely to be driven by bonding considerations. *See* Clarke, *supra* note x. Clarke bases his conclusion primarily on the fact that U.S. judgments are not enforceable in China. *See id.* at 94–99. He does not consider, as we do here, the difficulty of obtaining litigation-critical information and the impossibility of extraditing defendants, which make bonding even less plausible.

[206] *See* Coffee, *supra* note x, at 1780-81.

[207] *See supra* Part II.

[208] *See supra* Part II.A.

[209] *See supra* Part II.B.

[210] *See supra* Part III.A.

most of the economic equity of these companies.[211] The SEC can delist a firm that violates the securities law,[212] but generally refrains from doing so. For example, it has not delisted Alibaba, whose auditors have gone uninspected by the PCAOB in violation of SOX.[213] This restraint is understandable: delisting would cause the stock price to fall, harming the investors that the SEC seeks to protect and inviting a cheap go-private that would harm them further.[214] The SEC is thus essentially powerless.

C. Listing China-Based Firms Only Outside of China as Unbonding

While the legal-bonding hypothesis was developed to explain why a foreign-listed firm would list *also* in the United States, it can also explain why an unlisted foreign firm would list *only* in the United States: if U.S. securities law is enforceable, it provides better investor protection than the law of the foreign jurisdiction.

But listing only in the United States by a foreign firm whose insiders are law-proof anywhere outside their home jurisdiction achieves the opposite of bonding: it insulates the insiders from *any* securities law. The law of their home jurisdiction does not apply to them and U.S. law cannot be enforced on them. Most China-based firms listed in the United States fit this description.[215] Instead of bonding they *unbonded*.[216] U.S. investors might be better protected if those firms listed also in China and were at least reachable by securities regulators there.

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[211] By way of illustration: in 2019, Alibaba and several insiders settled a securities class action lawsuit which claimed defendants knowingly or recklessly concealed certain negative information by Alibaba at the time of IPO, enabling Alibaba to sell shares at an inflated price. The lawsuit was settled for $250 million (1/2000 of its market capitalization), all of which was paid by Alibaba. *See* Christine Asia Co. v. Alibaba Grp. Holding Ltd., 192 F. Supp. 3d 456 (S.D.N.Y. 2016); Christine Asia Co. Ltd. v. Jack Yun Ma (2d Cir. 2017); Alibaba Group Holding Form 6–K (Apr. 29, 2019). Since Alibaba insiders own less than 10% of Alibaba's equity, *see* Fried & Kamar, *Alibaba*, *supra* note x, at ___, the cost to them was less than $25 million, which may well be less than any extra value they gained at the IPO by inflating the price.

[212] *See* 15 U.S.C. § 78l(j) ("The Commission is authorized, by order. . . to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules or the regulations thereunder.").

[213] *See supra* Part II.C.

[214] *See* Fried, *Delisting*, *supra* note x.

[215] *See supra* note x.

[216] Others share this view. *See* Carcello et al., *supra* note x, at 5 ("Our findings suggest many mainland Chinese companies may have chosen to list in the US, not because of bonding reasons, but, rather, as part of an orchestrated and well-organized attempt to defraud poorly-informed US investors.").

D. Corporate-Law Unbonding by Chinese Firms

By domiciling outside of China, China-based firms insulate their insiders from corporate law as well. A firm could bond itself to the superior corporate law of a foreign jurisdiction by domiciling in that jurisdiction, just as it can bond itself to the superior securities law of a foreign jurisdiction by listing in that jurisdiction. But in both cases the foreign law must be enforceable. Because non-Chinese corporate law is unenforceable against China-based insiders, a China-based firm that domiciles outside of China and lists only outside of China unbonds its insiders with respect to both securities law and corporate law.

E. Implications for Legal Bonding Generally

Our analysis focuses on China-based firms listed in the United States. But it applies to any U.S.-listed firm whose insiders and assets are located outside the United States. Legal bonding requires that the foreign jurisdiction help U.S. authorities and U.S. investors to obtain a firm's books and records, make foreign defendants available for deposition and extradition, and enforce U.S. judgments. While China is extreme in its unwillingness to assist enforcement by U.S. regulators and investors, there may well be additional countries—especially ones with adversarial relations with the United States or with corrupt or undeveloped legal systems—that cannot be relied upon to assist enforcement in the United States. Firms and insiders in these countries list in the United States not for bonding purposes. And if the United States is their only listing venue, they may well list in the United States for unbonding.

V. THE PRO-FOREIGN BIAS OF U.S. SECURITIES REGULATION

Our analysis reveals a strange pro-foreign bias in U.S. securities regulation: it favors Chinese entrepreneurs taking their firms public in the United States over American entrepreneurs. This Part discusses the bias and what should be done about it.

Section A explains that U.S. securities law leaves an American entrepreneur taking a firm public in the United States no choice over the extent of disclosure or the level of enforcement. By contrast, a Chinese entrepreneur taking a firm public in the United States can choose a regime of either low or high disclosure and, to a certain extent, choose the degree of insulation from enforcement. U.S. securities law thus disfavors American entrepreneurs by giving them fewer options.

Whether this bias also disfavors American investors depends on investors' ability to price variations in disclosure and enforcement at the IPO and thereafter: if investors cannot adequately price these variations, as the mandatory approach of securities laws around the world, including the United States, assumes, American investors are likely harmed. Section B takes this assumption as given and makes the case for leveling the playing field *up*. Specifically, it argues that all foreign firms should be subject to the same basic disclosure requirements as domestic firms and should demonstrate that their insiders would not be law-

proof in the United States as a condition to listing in the United States. The light disclosure standards of FPIs should apply, as originally envisioned, only to firms with a primary listing in their home country.

Section C considers the possibility that, as some academics have argued,[217] investors can adequately price variations in enforcement and disclosure. This assumption is inconsistent with the mandatory approach of securities laws around the world, including the United States. If it is correct, the current system does not harm American investors. However, it still harms American entrepreneurs by depriving them of the ability to choose optimal securities-law arrangements. The solution here would be to level the playing field *down*, so that all firms listed in the United States would be free to choose any combination of disclosure and enforcement they like. This would of course be a radical change in U.S. securities law. Thus, whether or not investors can price protection risk, current U.S. securities regulation is incoherent and needs fixing.

A. Favoring Chinese Entrepreneurs over American Entrepreneurs

U.S. securities regulation leaves an American entrepreneur taking a firm public in the United States no choice over the extent of disclosure or the level of enforcement. By contrast, a Chinese entrepreneur taking a firm public in the United States can make herself law-proof and, ironically, can also choose to have the firm governed by a much lighter securities regime than the one governing the firms of American entrepreneurs.

1. Disclosure

When an American entrepreneur takes a firm public in the United States, U.S. securities law treats the firm as a domestic issuer.[218] Among other things, the firm will have to file quarterly financial reports,[219] provide detailed disclosures about executive pay,[220] and report a variety of other firm metrics.[221] Now consider a Chinese entrepreneur of a China-

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[217] *See infra* note x.

[218] Even if the firm were domiciled outside the United States (in, say, the Cayman Islands), it could not be considered an FPI because (a) more than 50% of its shares will be owned by residents of the United States; *and* (b) at least one (and probably each) of the following three conditions will be satisfied: (1) the majority of its executive officers or directors are U.S. citizens or residents; (2) more than 50% of its assets are located in the United States; or (3) its principal place of business is the United States. *See* Exchange Act Rule 3b–4, 17 C.F.R. § 240.3b–4 (2008).

[219] *See* Exchange Act Rule 13a–13, 17 C.F.R. § 240.13a–13 Quarterly Reports on Form 10–Q.

[220] *See* Regulation S–K, Item 601, 17 C.F.R. § 229.601 Exhibits; Regulation S–K, Item 404, 17 C.F.R. § 229.404 Transactions with related persons, promoters and certain control persons.

[221] For example, companies are required to disclose the ratio of the median of the annual total compensation of their employees (other than the Chief Executive Officer) and the annual total compensation of

based firm planning to conduct an IPO. She can choose between having the firm treated as a domestic issuer (by, for example, incorporating in the United States) or as an FPI (by incorporating outside of the United States).

2. Enforcement

When an American entrepreneur takes a firm public in the United States, she enters a world of strict enforcement. The U.S. authorities may investigate or sue her and the firm, and American investors may bring class actions and derivative suits against them. Both the authorities and attorneys representing investors will pursue claims aggressively because they can easily obtain the firm's records and reach the firm's assets and the entrepreneur and her assets. The entrepreneur can be subject to fines, monetary damages, embarrassing revelations, and imprisonment. She cannot lower the level of enforcement, say, by using the IPO charter to cap damages for violations of securities laws or to channel private securities claims to arbitration.

By contrast, a Chinese entrepreneur can choose the level of enforcement. The entrepreneur can make herself and other insiders law-proof by filling the board and top executive positions with Chinese residents whose personal assets are primarily in China, and keeping the firm's assets and records in China. Or the entrepreneur can reduce the extent to which firm and its insiders are law-proof by appointing U.S. residents to top positions in the firm, or placing key firm assets or hard-to-move personal assets in the United States or other reachable jurisdictions.[222]

B. The Case for Leveling the Playing Field Up

While corporate laws and securities laws around the world vary, in all developed economies they contain a mandatory core of substantive investor protection,[223] disclosure

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their Chief Executive Officer. *See* Regulation S–K, Item 402(u), 17 C.F.R. § 229.402(u) (Item 402) Executive compensation.

[222] Placing firm assets in the United States could interfere with its business and will likely be rare. Having insiders move to the United States and bring with them personal assets is simpler but also easy to undo and so less effective as a bond.

[223] *See, e.g.*, Luca Enriques et al., *Related-Party Transactions, in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 145, 161 (3d ed. 2017) ("All jurisdictions impose standards—which we group under the umbrella phrase 'duty of loyalty'—to control related-party conflicts and limit the risk of asset or information diversion").

requirements,[224] and enforcement mechanisms.[225] The underlying premise of this approach is that investors do not fully price the protection they receive. If they did, the law would allow each firm to choose its own arrangements.[226]

If this premise is correct, allowing Chinese entrepreneurs to raise capital in the United States with less investor protection than U.S. law deems necessary both disadvantages American entrepreneurs and harms American investors. This harm can be substantial: the market value of China-based firms listed in the United States and neither listed nor domiciled in China exceeds $1 trillion.[227] The solution is to subject Chinese entrepreneurs raising capital in the United States to the same rules and enforcement as American entrepreneurs.

1. Disclosure

To level the playing field up, Congress and the SEC should require all firms to provide the same level of disclosure. This level could be the one currently required of domestic issuers, the one currently required of FPIs, or some other level. But there is no reason to let Chinese entrepreneurs choose among two disclosure regimes while forcing American entrepreneurs to stick to one.

Indeed, there is a particular perversity to the current FPI disclosure regime: it is available only to an issuer that takes steps to reduce the protection that U.S. investors receive on other dimensions. First, the issuer must have a foreign legal domicile (say, the Cayman Islands). Thus, the FPI regime is not available unless the firm provides less corporate-law protection to U.S. investors.[228] Second, a Cayman-domiciled firm will not qualify as an FPI

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[224] *See, e.g.,* Luca Enriques et al., *Corporate Law and Securities Markets*, *in* REINIER KRAAKMAN ET AL., *supra* note x, at 243, 245–46 (3d ed. 2017) ("All of our core jurisdictions make compliance with extensive mandatory disclosure regimes a condition of issuers' access to public trading markets. In addition, they restrict firms' freedom to exit such markets, thereby strengthening their commitment to high disclosure standards and to a liquid market for their securities").

[225] *See, e.g., id.* at 258–59 ("[A] key component of an effective securities law regime is an enforcement apparatus making up for the serious collective action problems affecting investors in public markets. Our core jurisdictions rely on . . . public and private enforcement and gatekeeper control . . . for this purpose. Yet jurisdictions differ dramatically in the mix of enforcement modes they employ, as well as in the severity and intensity of enforcement").

[226] It is possible that all these corporate and securities regimes are wrong-headed and that in fact investors fully price the protection they receive. *See generally* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993) (advocating firm choice of the corporate regime); ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION (2002) (advocating firm choice of the securities regime). We address the implications of this possibility *infra* Part V.C.

[227] *See* U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION, *supra* note x.

[228] *See supra* Part III.A.1.

if too many executives or directors are U.S. citizens or residents (and therefore legally reachable). Thus, the FPI's lower disclosure requirements are obtainable only if enough of the executives and directors are law-proof. This makes little sense. If anything, firms with worse corporate-law protection or more legally-remote insiders should disclose more, not less. [229]

The FPI regime might still be justified for firms also listed in another jurisdiction that holds them to a high standard of reporting. But it cannot be justified for firms with no listing outside of the United States.[230]

2. Enforcement

To level the enforcement playing field up, the law should require foreign firms to bond themselves and their insiders to enforcement in the United States as condition to listing. We predict, however, that firms with law-proof insiders, including China-based firms, will have difficulty meeting this requirement.

What makes the insiders of China-based firms law-proof is the fact that they and their assets, as well as their firm's assets and records, are in China. Both of these facts are hard to change. Even if insiders relocate to the United States and bring with them their personal assets, both actions will likely be reversible and therefore of limited use as a bond. Nothing can stop those insiders from closing their bank accounts in the United States and returning to China at the first sign of legal trouble. Basing the firm's operations in the United States is costlier to undo and therefore more effective as a bond. But it can significantly interfere with the firm's business, which may depend on access to labor, supplies, and customers in China.

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[229] Political-economy considerations explain how this perverse approach has arisen. Historically, foreign firms contemplating a listing in the United States were already listed in their home countries. *See* Davidoff Solomon, *supra* note x, at 625 (noting that regulation for foreign issuers would "largely come from their home regulator[, which] made sense at the time because the overwhelming majority of foreign private issuers were European and already regulated by their domestic regulator"). Wall Street sought to bring these firms to the United States to generate fees, and pressured the SEC to make a U.S. listing more attractive to them by offering them a light disclosure regime. This made sense because they were already subject to securities regulation in their home country. The SEC therefore agreed after an initial resistance to offer them a light FPI regime. However, concerned that domestic issuers might classify themselves as FPIs to lighten their disclosure obligations, the SEC restricted the FPI status to firms that were sufficiently foreign: the center of gravity for their insiders and assets was not in the United States.

[230] *See* Davidoff Solomon, *supra* note x, at 620 (questioning the wisdom of subjecting a Chinese issuer listed only in the United States to the same type of regulation as U.K. issuer listed on the London Stock Exchange and the NYSE).

It is thus doubtful that China-based firms can bond to enforcement of investor protection law in the United States. If they cannot, the only way to level-up enforcement is to prevent such firms from listing in the United States.

Importantly, this new regime should apply only prospectively. Requiring China-based firms already traded in the United States to delist would not protect investors. On the contrary, it would backfire by creating downward pressure on the share prices of issuers, allowing insiders to effect a cheap go-private as happened in the reverse-mergers debacle.[231]

C. The Case for Leveling the Playing Field Down

Many China-based firms with law-proof insiders have seen their stock prices rise since their IPOs even though their insiders were law-proof. Did their investors assess the full range of mechanisms protecting them, both legal and non-legal, and make a considered judgment to invest?

We cannot rule out the possibility that corporate laws and securities laws in all developed markets (or at least the United States) are wrong-headed, and that investors fully price the various forms of protection at their disposal at the IPO. If so, the law should allow each firm to choose a level of investor protection to suit its needs, with the state stepping in only to enforce that choice.

Even in this efficient-market scenario, U.S. securities law must change to level the playing field. Only now the playing field should be leveled down. Instead of allowing China-based firms to list in the United States only if the rules that apply to U.S.-based firms are enforceable on the insiders of the China-based firms, any firm should be allowed to choose rules and enforcement to suit its needs. Denying only U.S.-based firms the freedom to choose their level of investor protection harms American entrepreneurs by over-regulating their firms, causing investors to pay a lower price for shares at the IPO.

1. Disclosure

Variation in disclosure practices of different firms within a single jurisdiction is not new. U.S. securities law, for instance, has different rules for smaller reporting companies,[232]

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[231] *See* Fried, *Delisting*, *supra* note x.

[232] *See* Regulation S–K, Item 10(f)(1), 17 C.F.R. § 229.10(f)(1).

emerging growth companies,[233] accelerated filers,[234] large accelerated filers,[235] and well-known seasoned issuers.[236] The law today allows an issuer to choose only from the disclosure regimes for which it qualifies.[237]

If the IPO market fully prices investor protection, there is no reason to dictate to issuers which disclosure regime will govern them. American issuers should choose whether to report as today, report as FPIs, report according to some other template, or not report at all. Foreign issuers should have the same choice, which should not depend on their choice of domicile. Although this freedom permits infinite variation in disclosure styles, a handful of industry standards may develop over time, though the market could price each issuer's choice even without standardization.[238]

Right now, the only way a Chinese entrepreneur can opt into the lighter disclosure regime is by domiciling outside the United States, say, in the Cayman Islands. However, as we have explained, domiciling in the Cayman Islands as opposed to an American state increases the insulation of insiders from corporate law. Tying weak investor protection under securities law to weak investor protection also under corporate law makes no sense. If the IPO market is efficient, issuers should be free to choose a mix of securities and corporate law optimal for them regardless of where they are based.

2. Enforcement

If markets can price protection, firms should be allowed to choose their own level of enforcement both for securities law and for corporate law. To our knowledge, a menu of enforcement options from which each firm could select for its investors and the government has never been proposed.[239] But if the IPO market fully prices investor protection, such a

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[233] *See* Securities Act of 1933 § 2(a)(19), 15 U.S.C. § 77b(a)(19).

[234] *See* Securities Exchange Act Rule 12b–2, 17 C.F.R. § 240.12b–2.

[235] *See id.*

[236] *See* Securities Act of 1933 Rule 405, 17 C.F.R. § 230.405.

[237] *See* Securities Exchange Act Rule 3b–4, 17 C.F.R. § 240.3b–4(e).

[238] *See generally* Michael Klausner & Marcel Kahan, *Standardization and Innovation in Corporate Contracting (or the 'Economics of Boilerplate')*, 83 VA L. REV. 713 (1997).

[239] "Corporate law," broadly defined, already allows tailoring as to substantive duties (which is different from enforcement). While corporate law still imposes a non-waivable duty of loyalty, firms can choose to go public as a limited partnership or LLC with provisions that eliminate fiduciary duties altogether. *See, e.g.*, Brent J. Horton, *The Going-Private Freeze-Out: A Unique Danger for Investors in Delaware Non-Corporate Business Associations*, 38 DEL. J. CORP. L. 53 (2013) (examining publicly traded non-corporate entities and finding that 29.41% of limited liability companies and 57.97% of limited partnerships have operating

menu should be available to all firms. Each issuer could then decide whether to expose its insiders to vigorous enforcement of U.S. securities law, to limit their exposure, or to completely insulate them as China-based insiders are. In such a world, for example, firms could relegate all securities claims to arbitration, as broker-dealers do to their customers.[240]

CONCLUSION

Hundreds of U.S.-listed firms are based in China but subject only to the securities and corporate laws of other jurisdictions. We have shown that this arrangement renders their insiders law-proof. As a result, the law cannot prevent or deter them from expropriating substantial value from U.S. investors. The main problem, we have explained, is that almost every person or thing required to enforce the law—the insiders, the insiders' assets, the firms' records, and the firms' assets—is behind China's "Great Legal Wall" and out of reach both for private plaintiffs and for public prosecutors in the United States. China cannot be expected to extradite defendants, enforce foreign judgments, allow foreigners to file claims in its courts, or even permit litigation-critical information to be shared with foreign authorities or plaintiffs' lawyers. Enforcement is even harder when, as is typically the case for large Chinese technology companies like Alibaba, the firm domiciles in the Cayman Islands, rather than in the United States.

Our analysis has implications for understanding the motivation and effect of cross-border listing. A common view is that a firm lists its securities in a foreign country to bond itself and its insiders to that country's tough disclosure and enforcement regime and thereby raise capital at a lower cost. Our analysis suggests that listing in a foreign country can have the opposite effect and purpose: insiders may list their firms solely outside their home jurisdiction to raise enforcement obstacles and make themselves legally unreachable. We further show that a firm can erect even higher barriers to enforcement by domiciling in a jurisdiction like the Cayman Islands that is home to neither the firm's insiders nor the firm's investors. More generally, our work suggests that one must know the extent to which corporate-governance rules are enforceable to evaluate their effect.

Our analysis has implications also for U.S. securities regulation. We show that U.S. securities regulation oddly favors Chinese entrepreneurs taking firms public over American entrepreneurs along two dimensions: enforcement and disclosure. Whether this bias harms American investors depends on whether they can fully price expropriation risk at the time of the IPO.

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agreements that eliminate fiduciary duties altogether); Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence From Publicly Traded LPs And LLCs*, 37 J. CORP. L. 555 (2012).

[240] *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (upholding an arbitration agreement a broker-dealer and its customers).

If investors cannot fully price this risk, the presence of China-based firms with law-proof insiders in U.S. markets likely harms them. The proper remedy is for U.S. securities regulation to level the playing field up by requiring China-based firms (and other firms based outside of the United States) to demonstrate that the law is enforceable on their insiders in the United States, and by subjecting them to the same disclosure requirements as U.S.-based firms—all as a condition for listing in the United States.

Conversely, if investors can fully price the expropriation risk, the presence of China-based firms with law-proof insiders in U.S. markets does not harm them. But the system disadvantages American entrepreneurs, as they cannot freely choose the level of enforcement and disclosure that is optimal for their firms. In this case, U.S. securities regulation should move closer to a system of private ordering, in which each firm chooses its own enforcement and disclosure arrangements and the law's only role is to enforce the firm's commitments at IPO. In either case, our analysis makes clear that U.S. securities regulation needs fixing.

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