China and the Rise of Law-Proof Insiders

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Abstract

Alibaba, the e-commerce giant that completed a record-setting IPO in the United States in 2014 and was valued at over $700 billion in early 2021, is one of hundreds of China-based firms listed in the United States whose controlling insiders are largely law-proof: the corporate and securities laws governing these firms are unenforceable because the firms' insiders, records, and assets are in China. This casts doubt on the claim that foreign firms list in the United States to bond insiders to tough securities law. In fact, for China-based firms, listing in the United States but not in China effectively insulates insiders from any securities law. Yet U.S. securities law not only allows these firms to list, but also requires them to disclose less than domestic firms. U.S. securities law thus favors foreign entrepreneurs and likely harms U.S. investors. We suggest ways to reduce this bias and better protect U.S. investors. More generally, we argue that enforceability is key to corporate governance.

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

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Abstract

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

INTRODUCTION

Alibaba Group Holding Limited, which in 2014 conducted a record-breaking initial public offering (IPO) on the New York Stock Exchange[1] and in early 2021 was valued at over $700 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 corporate and securities laws of other jurisdictions.[5] We show 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.

The main problem is that almost everything 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 for private plaintiffs and public prosecutors in the United States. One cannot expect China to extradite defendants, enforce foreign judgments, allow foreigners to file claims in its courts, or even permit information to be shared with foreign authorities or plaintiffs' lawyers.[7] 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

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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 Alibaba Group Market Cap,* YCHARTS.COM (Feb. 5, 2021) https://ycharts.com/companies/BABA/market_cap. This valuation is down slightly from a peak of more than $800 billion in October 2020.

[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 IV.B.

[4] *See* Jesse M. Fried & Ehud Kamar, *Alibaba: A Case Study of Synthetic Control*, 11 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] *See infra* Part III.

[6] Some firms, including Alibaba, are listed also in Hong Kong. *See* Fried & Kamar, *Alibaba*, *supra* note x, at ___. However, the same legal regime that makes China-based insiders law-proof with respect to the United States (*see infra* Part III) also makes them law-proof with respect to any shareholders and regulators outside China, including those in Hong Kong. *See infra* Part IV.B. In 2019, China's Securities Law was revised to provide extraterritorial jurisdiction to firms neither listed nor domiciled in China, but it is unclear whether or how this provision will be applied.

[7] *See infra* Part III.A.

than in the United States.[8] This problem is real: insiders of China-based firms have expropriated billions of dollars from U.S. investors,[9] making clear both the imperviousness of the Great Legal Wall of China and insiders' willingness to exploit it.

A popular view is that a firm lists its securities in a foreign jurisdiction to bond itself and its insiders to that jurisdiction's disclosure and enforcement regime and thereby raise capital at a lower cost.[10] Our analysis suggests the opposite: insiders may list their firms solely outside their home jurisdiction to create enforcement obstacles. We further show that a firm can erect even higher barriers to enforcement by also domiciling in a jurisdiction that is home to neither the firm's investors nor its insiders. More generally, our work suggests that corporate-governance analyses must consider not only the content of rules applicable to a firm, but also their enforceability.

Our analysis has implications also for U.S. securities law. We show that U.S. securities law favors Chinese entrepreneurs taking firms public over American entrepreneurs by giving them more choice.[11] First, while American entrepreneurs cannot lower enforcement by, say, capping liability or eliminating enforcement mechanisms, Chinese entrepreneurs can do so by ensuring that insiders and their assets, and the firm's assets and records, remain in China. Second, while American entrepreneurs' firms are always considered domestic issuers subject to standard disclosure requirements, China-based and other foreign entrepreneurs can have their firms treated as foreign private issuers required to disclose much less.

The premise underlying U.S. securities law is that its mandatory disclosure requirements and enforcement mechanisms applicable to domestic issuers are necessary to protect investors.[12] On this premise, enabling Chinese entrepreneurs to deviate from these arrangements comes at the expense of U.S. investors in China-based firms, who receive insufficient protection. The solution is to level the playing field up by requiring China-based issuers to show that the law is enforceable on their insiders in the United States and to provide standard disclosure. This rule should apply to other non-U.S.-based firms as well. Less disclosure would be permitted only for issuers with a primary listing in a jurisdiction that requires, and can enforce, a high standard of reporting.

Some might argue that U.S. securities law should allow each issuer to choose its level of disclosure and enforcement since investors can price them.[13] On their view, giving no choice to American entrepreneurs comes only at their expense. The solution would be to

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

[9] *See infra* Part III.B.

[10] *See infra* Part V.A.

[11] *See infra* Part VI.A.

[12] *See infra* Part VI.B.

[13] *See infra* Part VI.C.

level the playing field down by allowing all firms to choose their levels of enforcement and disclosure.

Either way, the law needs fixing.[14]

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,[15] or a desire to travel or conduct business in the United States or other countries that will enforce U.S. judgments or effect extradition. Some insiders might also wish to protect assets outside China that are subject to seizure. In addition, while so far China has turned a blind eye to massive expropriation of U.S. investors by Chinese residents,[16] it may prevent expropriation in the future, especially at a highly visible firm.[17] Finally, China-based firms that go public in the United States sometimes employ legally-reachable non-Chinese nationals as directors or officers.[18] As long as they are in office, their China-based colleagues may refrain from wrongdoing to avoid jeopardizing them.[19] These constraints might provide some assurance to U.S. investors who, so far, have

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[14] Yet another alternative is that mandatory rules are needed, but the levels of disclosure and enforcement should be lower or higher than those currently applied to U.S. domestic issuers. In this case, too, the law needs fixing.

[15] Or at least to preserve their reputation in the United States. Massive expropriation of U.S. investors may not harm reputations at home, as Chinese residents often do not pay attention to legal actions in the United States against China-based insiders. *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 (2018) ("Because of the informational barrier created by 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").

[16] 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* Paul Gillis, *Testimony Before the U.S.-China Economic and Security Commission, Chinese Investment in the United States: Impacts and Issues for Policymakers 9* (Jan. 26, 2017) [hereinafter Gillis, *Testimony*], https://www.uscc.gov/sites/default/files/Gillis_USCC%20Hearing%20Testimony012617.pdf.

[17] *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) (hereinafter, Groswald Ozery, *Illiberal Governance*) (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, potentially providing protection to foreign investors in China-based foreign-listed firms). *Cf.* Tamar Groswald Ozery, *The Politicization of Corporate Governance—A Viable Alternative*, 69 AM. J. COMP. L. (forthcoming 2021) (explaining how politicized corporate governance in China provides functional substitutes for traditional corporate governance mechanisms).

[18] For example, Alibaba's President 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.

[19] In some cases, non-Chinese nationals, such as the Canadian CFO of Longtop (*see infra* note x) have been sacrificed to facilitate misappropriation. *See also* SEC v. Subaye, Inc., No. 13 CIV. 3114 PKC, 2014 WL

generally benefited from investing in U.S.-listed China-based firms.[20] But they likely are no substitute for the types of legal protection available to investors in U.S.-based, U.S.-listed firms.

Second, our goal is not to criticize the Chinese law but rather U.S. law, and in particular the incoherence of U.S. securities law.[21] If American entrepreneurs listed U.S.-based firms only in China and were insulated from the law governing Chinese entrepreneurs, we would point out the incoherence of Chinese securities law.

This Article proceeds as follows. Part I describes the kinds of Chinese companies that access U.S. capital equity markets. Part II explains how enforceable securities law and corporate law, along with the threat of imprisonment, monetary damages, and reputational ruin, can deter insiders of a firm listed, domiciled, and based in the United States from expropriating investors. Part III shows how deterrence weakens when the firm's assets and records and its insiders and their assets are in China. Part IV explains how changing the firm's domicile from the United States to the Cayman Islands further insulates insiders. Part V considers implications for the hypothesis that firms list in a foreign jurisdiction to bond to its securities law and thereby reduce their cost of capital. Part VI puts forwards implications for U.S. securities law. A conclusion follows.

I. CHINA-BASED FIRMS IN THE UNITED STATES

Section A describes the types of China-based firms that list in the United States. Section B explains why they do this.

5374957, *1 (S.D.N.Y. Oct. 16, 2014); SEC v. Subaye, Inc., Civil Action No. 13 CIV 3114 (S.D.N.Y.), Litig. Release No. 23116 (Oct. 21, 2014)(describing how China-based insiders of Subaye could not be reached for fraud, but U.S.-based CFO Tom Crane 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).

[20] *See* Hendrik Bessembinder et al., *American Depository Receipts: The Long-Term U.S. Investor Experience* 2-3 (Working Paper, 2021) (reporting that returns in ADRs of China-based firms have far exceeded returns from investing in shares of U.S-based firms).

[21] We focus on China-based firms because (i) hundreds of China-based firms that are neither listed nor domiciled in China, with a total value exceeding $1 trillion, trade in the United States (*see infra* Part I); and (ii) the enforcement challenges associated with them are well-known (*see infra* Part III). No other jurisdiction compares to China along both dimensions.

A. *Types of China-Based Firms in the United States*

Although China has robust and growing capital markets,[22] hundreds of China-based firms are listed outside China,[23] mostly in Hong Kong or the United States.[24] 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.[25] They generally fall into one of three categories.

*State-owned enterprises (SOE*s): firms controlled by the Chinese government, which are domiciled and generally also listed in China.[26] They were among the first China-based firms to arrive in the United States. They are also beyond the scope of our project because they are subject to Chinese corporate law and usually also Chinese securities law, which China can readily enforce on their China-based insiders.

Reverse-merger firms: private-sector firms that have entered the U.S. stock exchanges through reverse mergers and thereby became domiciled in a U.S. state, typically Nevada or Delaware.[27] Numbering in the hundreds,[28] these firms began arriving in the United States after the SOEs. They tend to be small and in the past have been fraud-prone.[29] Their domicile and only listing is in the United States, so their insiders are not subject to Chinese corporate law or securities law.

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[22] *See* Groswald Ozery, *Illiberal Governance, supra* note x, at ____.

[23] *Id*., at ___.

[24] *Id*., at ___; Gillis, *Testimony, supra* note x, at 1 (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).

[25] *See* U.S.-China Econ. & Sec. Rev. Comm'n, Chinese Companies Listed on Major U.S. Stock Exchanges 1 (Oct. 2, 2020) [hereinafter, U.S.-China Review Comm'n Report], https://www.uscc.gov/sites/default/files/2020-10/Chinese_Companies_on_US_Stock_Exchanges_10-2020.pdf.

[26] *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). Of the 13 national-level SOEs listed in the Fall 2020 US-China Review Comm'n Report, *supra*, only four trade in Hong Kong and not in China: China Mobile, China Telecom, China Unicom, and CNOOC. The first three were recently delisted from the NYSE, *see* Jesse Fried, *Why Trump's attempt to delist China from US will backfire* (FIN. TIMES, January 13, 2021), leaving only CNOOC.

[27] *See infra* Part III.B.

[28] A January 2019 Bloomberg search turned up approximately 220 firms in this category.

[29] *See infra* Part III.B.

Technology firms: over a hundred private-sector firms, mostly technology-based, that conducted an IPO on a U.S. exchange.[30] Alibaba is the most prominent.[31] Most arrived after the SOEs. They are typically domiciled in a tax haven like the Cayman Islands or the British Virgin Islands. Some of them list also in Hong Kong, but none lists also in China. Like reverse-merger firms, their insiders are not subject to Chinese corporate law or securities law. The total market capitalization of the reverse-merger and the technology firms exceeds $1.2 trillion, most of which is attributable to the latter.

B. Reasons for Listing in the United States

China has strict merit-based approval requirements and a long waiting list for IPOs,[32] making it difficult for young companies to conduct a public offering.[33] Most, if not all, Chinese reverse-merger companies could not have gone public in China. The same is true for many of the Chinese technology firms.

By contrast, accessing the U.S. capital markets is relatively easy. Historically, there have been few regulatory barriers to effecting a reverse merger, a loophole that many China-based firms exploited.[34] IPOs have more regulatory barriers. But if a firm provides adequate disclosure, the SEC cannot bar it from selling shares to willing investors.[35]

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[30] A January 2019 Bloomberg search indicated that there were approximately 160 such firms.

[31] *See supra* note x.

[32] *See* Groswald Ozery, *Illiberal Governance, supra* note x, at ____.

[33] *See* Jesse M. Fried & Matthew Schoenfeld, *The Risky Business of Investing in Chinese Tech Firms*, https://corpgov.law.harvard.edu/2019/02/04/the-risky-business-of-investing-in-chinese-tech-firms/.

[34] *See infra* Part III.B.

[35] *See* Commissioner Paul S. Atkins, Speech by SEC Commissioner: Is Excessive Regulation and Litigation Eroding U.S. Financial Competitiveness? (Apr. 20, 2007), https://www.sec.gov/news/speech/2007/spch042007psa.htm ("Except in a few, narrowly-defined areas, the federal securities laws impose no substantive or merit-based requirements on securities offerings").

In addition, capital tends to cheaper in the United States.[36] One reason is easier access to U.S. retail investors.[37] There are also other advantages of a U.S.-listing, including prestige.[38]

II. How Enforceable Law Protects Investors in Controlled Firms

This Part explains how enforceable corporate law and securities law can reduce the diversion economic value from investors. Section A describes the potential types of tunneling in a 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 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 who appoints the directors and the officers (along with the controller, "insiders").

Absent legal constraints, insiders could expropriate investors via transactions between the firm and insiders or related parties;[39] securities transactions involving insiders, investors, and the firm;[40] and insiders taking a corporate opportunity from the firm. These forms of value extraction occur in many controlled firms around the world.[41]

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[36] *See* Yiming Qian et al., *Initial Public Offering Chinese Style*, Working Paper (Nov. 5, 2020), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3682089; Hudson Lockett & Thomas Hale, *Chinese IPOs Underpriced by Up to $200bn Due to Valuation Limits,* FIN. TIMES (Feb. 4, 2021), https://www.ft.com/content/a4826697-2160-4472-9605-2f9820936ab7.

[37] *See* Robert Bartlett et al., *The Myth of* Morrison*: Securities Fraud Litigation against Foreign Issuers* 74 BUS. LAW. 967, __ (2019). *Cf.* John Ammer et al., *U.S. International Equity Investment,* 50 J. ACCOUNT. RES. 1109 (2012), https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1475-679X.2012.00464.x (showing that a U.S. listing is the single most important determinant of the quantity of U.S.-based investment in foreign companies).

[38] *See infra* Part V.A.

[39] *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).

[40] *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).

[41] *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).

At the end of the firm's life as a public company, there could also be tunneling via a freeze-out at a low price. For example, the controller could cause the firm to merge with a controller-owned shell corporation in consideration for cash.[42] Whatever the deal structure, a freeze-out price below the stock's value expropriates investors.[43]

B. The Role of Enforceable Law in Deterring Tunneling

Corporate law and securities law play complementary roles in deterring tunneling. When enforceable, they can deter or at least substantially limit tunneling.[44]

1. Corporate Law and Securities Law

Corporate law provides various forms of protection to investors, but its most fundamental purpose is to reduce tunneling. To this end, it imposes fiduciary duties on controllers and other insiders, which investors and their attorneys enforce via litigation.

Securities law requires listed firms to publicly disclose accurate information about their financial condition and insider transactions.[45] This provides investors with information about the firm's value to facilitate trading and alerts investors to violations of corporate law, enabling them to enforce their rights. Without disclosure about possible tunneling transactions, these rights would be worth little. Securities law is enforced by investors and the government.

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[42] The controller can also cause a firm to sell all of its assets to the wholly-owned entity for cash, which is then distributed to shareholders.

[43] Freeze-outs often occur at a premium to the market price. However, a controller may depress the market price in advance. *Cf.* In re Dole Food Co., Inc. S'holder Litig., CA 8703–VCL, 2015 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 freeze-out).

[44] The law does not protect against two additional risks that investors in a controlled firm face. The first is the risk that the business will fail due to market developments or regulatory shifts. The second is the risk the controller will seek nonpecuniary benefits at the expense of shareholders. The law targets only financial conflicts of interest.

[45] With the exception of restrictions on insider trading, U.S. securities law does not ban unfair self-dealing as long as there is full disclosure. *See* Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

2. *Enforcement Mechanisms*

Corporate law and securities law deter violations only if insiders expect punishment will ensue. Punishment includes formal penalties and litigation-related costs.[46] As the likelihood of punishment declines, so does deterrence.[47]

The law provides for monetary fines and damages and for imprisonment. While financial penalties on the firm hurt insiders only to the extent they own shares, financial penalties on insiders can have real sting.[48] If an insider cannot protect her assets from seizure, the possibility of financial loss will have a deterrent effect. And so will the possibility of imprisonment. Insiders can be imprisoned for violating U.S. securities laws,[49] theft,[50] fraud (including wire fraud),[51] perjury,[52] or contempt of court.[53]

The enforcement of corporate law and securities law against an insider also imposes 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 creates reputational harm even if the defendant is later

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[46] Corporate and securities laws also operate through injunctions. However, an injunction will be effective only if the enjoined party is deterred from violating it.

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

[48] In the United States, controllers and affiliated directors have paid financial damages in certain going-private cases. *See, e.g.*, *Dole Food*, *supra* note x.

[49] A willful violation of the substantive provisions of the securities law, including provisions relating to registration and fraud, is a criminal offense. *See* 15 U.S.C. § 78ff. Insiders of U.S.-domiciled or Cayman-domiciled firms cannot be imprisoned for violations of corporate law, willful or otherwise.

[50] *See, e.g.*, 11 Del. C. § 841(b) (describing theft); 11 Del. C. § 4205(b) (describing imprisonment for theft).

[51] *See* 18 U.S.C. § 1343.

[52] *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.

[53] *See id.* at 30. A number of U.S. insiders have been jailed for criminal violations in connection with firm governance. *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 were sentenced to prison for accounting fraud); *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 went to prison on fraud and conspiracy charges).

cleared. Embarrassing information might come to light in the litigation, generating additional reputational costs.[54]

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

The deterrent effect of penalties for violating corporate law and securities law and litigation-related costs thus depends on enforcement.[55] While ethical or reputational considerations may motivate insiders to follow these laws even if the likelihood of enforcement is low, 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, consider a controlled firm that is domiciled in Delaware and listed on the NYSE, and is thus a domestic issuer under U.S. securities law. Suppose also 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 major tunneling transaction and asks her lawyer to spell out the consequences. The lawyer will say that 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 documents in discovery, submit to depositions, and testify. At trial, they would have to prove that the tunneling transaction was fair. They presumably could not do so, and thus would be hit by damages that could require them to pay back more than their gains. The terms of any settlement would reflect what plaintiffs could obtain at trial. The controller would also bear litigation-related costs, such as a damaged reputation.

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[54] 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). *See also* 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).

[55] *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 markets).

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

The insiders could not thwart legal proceedings by failing to respond 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 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 and other insiders are legally reachable. But what if 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, deterrence would fail. As Part III will show, this is the situation of the hundreds of China-based firms that are listed in the United States and are neither domiciled nor listed in China.

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

This Part explains that locating individuals, information, and assets in China puts them beyond the reach of U.S. authorities and investors. Section A explains that Chinese rules make it difficult to extradite China-based insiders, seize assets, or obtain information about tunneling transactions. Section B shows how these obstacles have 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, prevents the seizure of their personal assets in China, and hinders depositions and the sharing of documents. In short, China surrounds its residents and firms by a "Great Legal Wall" that is virtually impossible to scale for U.S. authorities or investors.[56]

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[56] We assume litigation originates in the United States, which is where U.S. authorities will always sue. As for investors, Chinese courts are not considered a viable option for resolving disputes that arise outside 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

This Great Legal Wall consists of laws and courts that apply them in accordance with the wishes of the Chinese Communist Party.[57] 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 persist, 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.[58] Imprisonment is also the punishment for perjury or contempt of court in securities cases and in corporate cases.[59] Arrest warrants have been issued against insiders of China-based, U.S.-listed firms for these infractions.[60]

But China does not have an extradition treaty with the United States.[61] 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.[62] As long as insiders remain in China, they cannot be taken to the United States for trial. They are likely safe also in Hong

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firm is domiciled in the Cayman Islands and listed in Hong Kong, investor litigation could also commence in either jurisdiction. However, as we explain *infra* Part IV, procedural hurdles in these jurisdictions make that unlikely. In any event, such suits would still encounter the Great Legal Wall of China.

[57] *See* Ling Li, *The Chinese Communist Party and People's Courts: Judicial Dependence in China*, 64 AM. J. COMP. L. 37 (2016).

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

[59] *See id.*

[60] For example, in Deutsch v. ZST Digital Networks Inc., C.A. 8014 (Del. Ch. Jan. 7, 2019), the court issued an arrest warrant for Chinese executives who failed to comply 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.

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

[62] *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-hunter-tracks-chinese-companies-that-dupe-investors.html (reporting that a Nevada court had found an executive of Sino Clean Energy in criminal contempt and ordered his arrest). As of February 2021, there is no record of his being detained or extradited to the United States.

Kong. Although the United States had an extradition treaty with Hong Kong,[63] it was suspended in 2020.[64] Even earlier, China had successfully pressured Hong Kong not to extradite a fugitive to the United States pursuant to the treaty.[65]

To be sure, the insiders could not travel the United States or other countries with extradition treaties with the United States. This can be a hardship.[66] But as China grows more powerful, the number of countries willing to extradite Chinese nationals to the United States may shrink.[67]

2. *No Enforcement of U.S. Judgments*

Below we explain why neither U.S. investors nor U.S. authorities seeking to enforce U.S. judgments can seize assets in China.

U.S. investors asserting corporate claims or securities claims in the United States cannot recover from insider assets or firm assets in China. China does not have an enforcement

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[63] *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.

[64] *See* The President's Executive Order on Hong Kong Normalization, Exec. Order No. 13,936, 85 Fed. Reg. 43,413 (July 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 China's imposition of the National Security Law in Hong Kong. *See* Press Statement, Morgan Ortagus, Spokesperson, U.S. Dep't 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/.

[65] *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.

[66] *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. (describing story of Kobi Alexander, an Israeli national who was CEO of Delaware-domiciled, U.S.-listed Comverse, who fled to Namibia to avoid extradition for criminal violations of U.S. securities laws but later returned to the United States for trial and sentencing because he had been prevented from visiting family in Israel, which has an effective extradition treaty with the United States).

[67] In 2018, Canada arrested the CFO of Huawei for extradition to the United States on fraud charges. Following the arrest, China pressured Canada to release the CFO by detaining two Canadian nationals on various charges. As of February 2021, this extradition request is yet to be resolved. *See* Jacquie McNish, Jonathan Cheng & John Lyons, *As Huawei Talks Stall, Detention of Two Canadians in China Drags On*, WALL ST. J. (Feb. 11, 2021). Canada's experience may discourage other countries from extraditing Chinese nationals to the United States.

treaty with the United States.[68] Attempts to enforce a foreign judgment that has not been recognized by a Chinese court can be punished as violation of Chinese judicial sovereignty.[69]

A Chinese court can still choose to enforce a U.S. judgment.[70] Two courts have done so, although only one of the cases involved a U.S. plaintiff.[71] But these decisions have no precedential value in China.[72] Because China generally does not enforce U.S. judgments,[73] China-based insiders can ignore foreign judgments obtained by U.S. investors.[74]

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[68] *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 it enables a party with a court judgment in one signatory country to enforce the judgment in another signatory state, it has not been ratified by either the United States or China. Moreover, it 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.

[69] *See* White Paper, *China's Derivatives Market and Judicial Trends*, ISDA / KING & WOOD 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 British Virgin Islands court's judgment that had been recognized by Chinese courts as evidence 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").

[70] A foreign judgment from a country with which China does not have a bilateral treaty is enforceable if there is reciprocity between China and that country and the foreign judgment does not violate the principles of the laws of China and the sovereignty, security, and public interest of China. *See* Tsang, *supra* note x, at 4.

[71] *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/.

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

[73] *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).

[74] *See* Dan Harris, *China Enforces United States Judgment: This Changes Pretty Much Nothing*, CHINA

U.S. authorities, which could bring securities claims, have enforcement tools unavailable to investors. But any judgments they obtain are also unlikely to be enforced in China.

The United States and China have agreed to mutual legal assistance in criminal matters, including in forfeiture proceedings.[75] 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."[76] Such refusal is routine.[77] In fact, to our knowledge, U.S. authorities have never used this agreement successfully.

In addition, the U.S. government may seize funds in foreign bank accounts by seizing an equivalent amount from the foreign bank's correspondent or interbank account in the United States.[78] However, the 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. The Great Legal Wall of China impedes information gathering, placing another roadblock on the path to enforcement.

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

L. BLOG (Sept. 5, 2017), https://www.chinalawblog.com/2017/09/china-enforces-united-states-judgment-this-changes-pretty-much-nothing.html.

[75] *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 Assistance].

[76] *See id*.

[77] *See* John Hill, *DC Circ. Won't Let 3 Chinese Banks Duck US Subpoenas*, LAW360 (Aug. 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 try to use this agreement to obtain records from Chinese banks in connection with an investigation into evasion of North Korean sanctions because China's cooperation under this agreement has been "poor").

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

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.[79] By contrast, when the defendant is China-based, service can take months or years. In some cases, the Chinese bureaucracy simply refuses to cooperate.[80]

No depositions. Even if service of process in China succeeds, U.S. investor-plaintiffs seeking information will run into a brick wall. China prohibits depositions of its citizens by foreigners on its soil.[81] 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 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.[82] State secrets are broadly defined to include matters involving state security and

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[79] 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).

[80] *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/; Dan Harris, *How to Sue a Chinese Company: The 101*, China Law Blog (August 22, 2019), https://perma.cc/M5B8-QJVQ. Service against a U.S.-listed firm will be simple because stock exchange rules require that the firm have a local agent. 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). However, service against individual defendants is more difficult. *See* Rachel Hayes & Roger Silvers, *Global Cooperative Networks as a Solution for Cross-Border Issues in Securities Law Enforcement* 15 (Working Paper, 2020) (describing difficulty of serving Chinese individuals). *Cf.* Roger Silvers, Comment Letter to SEC Chair W.J. Clayton (June 18, 2020), https://www.sec.gov/comments/emerging-markets/cll9-7328594-218510.pdf (noting the difficulty of serving foreign defendants and suggesting the creation of a comprehensive registry for the officers and directors of U.S.-listed foreign issuers, with a prearranged agent for service of process).

[81] *See* Harris, *supra* note __. Even if attorneys could depose China-based insiders, the insiders would not fear punishment for perjury as long as they remained in China. *See supra* Parts II.A.1–II.A.2.

[82] 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

national interests, including matters of national economic and social development, science and technology, and the investigation of criminal offences.[83] The law contains a catchall 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.[84] Material can be classified as a state secret after litigation commences.[85] The law applies to commercial enterprises[86] and has been used to justify refusals to turn over documents in U.S. securities-law cases.[87]

Similarly, 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 to foreigners.[88] Archive documents are

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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.

[83] *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).

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

[85] *See id.* at 14.

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

[87] *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").

[88] *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 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, 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:*

broadly defined to include accounting books, financial reports, and bank statements.[89] Thus, virtually any export of financial documents and data could violate the law.[90] Like the State Secrets Law, the Archives Law has been used to justify refusal to turn over corporate documents, including audit papers.[91]

Finally, information not shielded by these two statutes and related regulations can be subject to other statutes limiting the transfer of information on China-based businesses. For example, a Chinese public accountancy statute generally prohibits accountants from disclosing information on a Chinese company.[92] And Article 177 of the Chinese Securities Law provides that no entity or individual in China may provide documents and information relating to securities to foreign regulators without the approval of the Chinese securities regulator and various government officials.[93]

Other limits on discovery. U.S. shareholders face additional obstacles to discovery. First, China prohibits foreigners from obtaining evidence in China by any means other than

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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.

[89] The Accounting Archives Management Measures indicates that archives include all financial 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).

[90] *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").

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

[92] *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 Aug. 31, 2014), art.19, http://www.cicpa.org.cn/introcicpa/laws/201210/t20121021_35703.html.

[93] *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.

the relatively slow Hague Convention or diplomatic channels.[94] Second, China does not allow pretrial discovery and is slow and often unwilling to provide other types of information.[95]

U.S. authorities have more information-gathering tools than U.S. investors, but these tools are of little use. The authorities therefore run into the same problems as investors.[96]

As noted above, the United States and China have agreed to provide mutual legal assistance in criminal matters.[97] This assistance includes serving documents, executing requests for inquiry, and freezing and seizing evidence.[98] 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.[99] And China has in fact done so.[100]

The United States and China have also signed the Enhanced Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information.[101] This agreement "encourages and enables cooperation between securities regulators through exchanging information to combat securities and derivatives violations with a

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[94] *See* China Civil Procedure Law, art. 263 (providing that, except when provided for by an international treaty 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").

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

[96] *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.

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

[98] *See id.* at __.

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

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

[101] *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.

cross-border element."[102] However, its provisions are not binding,[103] and a request for assistance may be denied where acting on it would violate any law or regulation or on grounds of public or national interest.[104] In fact, China has refused to comply with requests for information on these grounds in fraud cases involving China-based reverse-merger firms,[105] 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 years 2000–2010, over 150 China-based private firms entered U.S. public markets through a reverse merger[106] in which a public shell company[107] (usually domiciled

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

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

[104] *See* EMMoU, art. 2(1)(g). That said, there is evidence that the EMMoU has increased cross-border enforcement and improved liquidity in the capital markets of participating countries, as most signatories act in accordance with the spirit of the agreement. *See* Roger Silvers, *Cross-border cooperation between securities regulators*, 69 J. ACC. & ECON. 1 (2020).

[105] *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.

[106] 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.

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

in Nevada or Delaware) acquired a private Chinese operating company.[108] The reverse merger, unlike an IPO, enabled the Chinese company to access U.S. capital markets without the Securities and Exchange Commission (SEC) first scrutinizing its disclosures.[109]

The result typically was a U.S.-listed, U.S-domiciled firm with one or more China-based subsidiaries.[110] 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.[111] Some of these U.S.-listed firms were frauds.[112] From 2010 to 2012, many fraudulent firms were exposed.[113] In 2011 and 2012,

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[108] *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.

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

[110] 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 IV.A.2.

[111] *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. 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 U.S. Department of Justice brought charges against China Medical Technologies CEO/Chair and CFO for diverting $400 million of $426 million raised from U.S. investors, but the two remain fugitives).

[112] *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).

[113] *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).

more than fifty China-based firms were delisted or were forced to stop trading due to fraud and other violations of U.S. securities law.[114]

A case in point is 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.[115] After the scheme was revealed, Puda's market capitalization dropped nearly $342 million and its shares were delisted.[116]

The reverse-merger fraud wave hit hard the share prices of all Chinese reverse-merger firms, including ones that might not have been fraudulent,[117] causing their aggregate market capitalization to fall 75%.[118] The collapse in share prices provided an opportunity even for firms not involved in fraud to be taken private on the cheap.[119] The fraud wave and cheap freeze-outs that followed it resulted in the loss of about $70 billion for U.S. investors.[120]

2. *Attempts to Scale the Great Legal Wall of China Fail*

The reverse-merger frauds exposed the powerlessness of the U.S. legal system in dealing with 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

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[114] *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.

[115] *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.

[116] *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.

[117] *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.

[118] *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.

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

[120] *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.

recourse.[121] 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.

U.S. investors filed dozens of securities class-action lawsuits against Chinese reverse-merger companies and their insiders alleging misrepresentation, violation of federal securities law, and failure to comply with Generally Accepted Accounting Principles.[122] Recoveries were rare and small, with payments coming partly at the expense of U.S. investors who owned shares in these firms.[123] There were no recoveries from China-based insiders because they hid behind the Great Legal Wall of China.[124]

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.[125] Default judgments were not paid. For example, the SEC never collected a

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

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

[123] *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/ (noting that the portion of settlements amounting to $2 million or less was at its highest level in eighteen years in 2015, largely on account of 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 difficulties in prosecuting securities claims involving China-based firms reduce settlement amounts).

[124] 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 appeared 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. *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-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.

[125] 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]

$250 million fine from Puda's board chair and former CEO because Chinese regulators did not cooperate.[126]

Claims under Nevada or Delaware corporate law were also filed.[127] They went nowhere because defendants could not be haled into court. In some cases, defendants would retain lawyers and then refuse to pay them.[128] Any settlements actually paid were just cents on the dollar.[129]

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.

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to produce its documents'").

[126] *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/.

[127] *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.

[128] *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.

[129] 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 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. 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 issuance of warrants for the arrest of defendant's CEO and CFO upon entry to the United States to compel defendant to comply with prior court 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.

1. The Restrictions on Reverse Mergers

In the aftermath of the Chinese reverse-merger frauds, the national exchanges tightened their rules on reverse mergers.[130] 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, reducing the number of future reverse mergers does not make U.S. securities law enforceable on China-based insiders of China-based firms that are already 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.[131] Nor can U.S. investors do so by bringing corporate or securities claims.

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,[132] including China-based affiliates of the Big Four accounting firms.[133] The Sarbanes-Oxley Act of 2002 (SOX) obliged the firms to comply.[134] But the China-based audit firms refused, claiming that compliance could violate the State Secrets Law and the Archives Law,[135] potentially resulting in the dissolution of their firms and the imprisonment of their management. An SEC administrative judge ruled

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[130] *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 year of trading on another approved platform following the reverse merger. The company must also be current on all its required filings with the SEC, including audited financial statements, and stay above a threshold share price for a sustained period. *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.

[131] *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.

[132] Audit working papers can provide information about complex corporate transactions that is often unavailable in firm 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).

[133] *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.

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

[135] *See supra* Part III.A.3; Moncure, *supra* note x, at 296–97.

that the firms violated U.S. law by refusing to comply.[136] Eventually, the SEC obtained the working papers after the China Securities Regulatory Commission (CSRC) allowed them to be shared.[137] In 2015, the audit firms agreed to pay $500,000 each for failing to produce the documents before proceedings had been brought.[138] These were token fines, amounting to less than an average partner's salary.[139] The SEC could have barred public companies from relying on these audit firms but, as China's state-owned media trumpeted, they were "too big to ban."[140]

While the SEC prevailed in this battle, it has been losing the war over access to audit papers of China-based firms. Under SOX, the Public Company Accounting Oversight Board (PCAOB) must 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.[141] Any such audit firm is deemed to have consented to produce its audit working papers for PCAOB inspection and to be subject to the jurisdiction of the United States for enforcement of requests for production of documents.[142] These inspections ensure adherence to U.S. auditing standards.[143]

While the PCAOB has reached agreements with other foreign jurisdictions on inspection protocols for local firms that play a role in auditing U.S.-listed firms,[144] it generally has been unable to conduct inspections in China.[145] It therefore does not systematically inspect

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[136] *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.

[137] *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).

[138] *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).

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

[140] *See id*.

[141] *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).

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

[143] *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.

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

[145] *See* Gillis, *Three Terrors*, *supra* note x, at 6; Huang, *supra* note x, at 19. In May 2013, the PCAOB

China-based accounting firms,[146] which audit hundreds of public companies worth over $1 trillion.[147] U.S.-listed China-based firms therefore operate with little regulatory oversight, exposing U.S. investors to greater risk of fraud and expropriation.[148]

In 2020, the U.S. Congress passed and President Trump signed into law the Holding Foreign Companies Accountable Act (HFCA).[149] It bars trading in any firm whose audits go uninspected for three years.[150] China may nonetheless continue to prevent the PCAOB from inspecting China-based auditors.[151] If so, the HFCA may well force China-based firms to

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

[146] *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.

[147] *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.

[148] *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 China that are subject to PCAOB inspections." *See id.*

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

[150] *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").

[151] Reasons why China might continue to prevent PCAOB inspections include fear of permitting release of information that China later decides is a state secret, and the need to get permission from multiple

delist. Unless the firm is dual-listed and voluntarily offers U.S. investors shares tradable in Hong Kong or elsewhere, an announcement of an impending trading-ban would cause the stock price to drop as investors flee before shares become illiquid. This can facilitate cheap freeze-out transactions.[152]

But even if the HFCA leads 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 their inability to extradite these insiders, seize China-based assets, or gather information.[153]

D. *Insulation from Law Allows Tunneling*

To understand how placing assets, insiders, and records in China weakens the deterrent effect of U.S. securities law and state corporate law, consider the tunneling example from

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overlapping bureaucracies, many of which have no incentive to provide permission. *See* Huang, *supra* note x, at 24–25. But China is also unlikely to want U.S. regulators probing domestic transactions because some may involve payments to government officials and their relatives. 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 list in Hong Kong or China to boost the prestige of local markets and enable domestic investors to profit from their future growth. *See* Jesse 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.

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

[153] In 2020, NASDAQ proposed changes to its listing rules aimed at making it more difficult for China-based firms to list or remain listed on NASDAQ. *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-proposed-rule-change (requiring firms from certain markets, including China, to raise in an IPO at least the lesser of $25 million or 25% of the firm's post-IPO market capitalization). *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 (requiring firms from certain markets, including China, to have a senior manager or director familiar with U.S. regulatory and reporting requirements); *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 (allowing NASDAQ to deny to listing or delist firms with inadequate auditing). These changes are likely to have little effect on the number of China-based firms that trade in the United States except to bar very small firms from NASDAQ. And, critically, they will not affect the law-proofness of the China-based insiders of China-based firms that are already listed in the United States or will list in the United States in the future.

Part I.B.3, but suppose that the firm's assets and records and insiders and their assets are in China, not the United States.

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 might have been told, that there is little that 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. 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. U.S. investors will likely press claims without investing in them too much, since at most they will expect a small settlement. There will be accounts of the insiders' misbehavior in U.S. media, but in China few may pay attention.

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 extradite them to the United States. If that is a concern to the insiders, they could undertake the tunneling transactions without misleading investors. Or they could use a fraction of the expropriated value to settle the claims.

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 firms.

IV. THE EFFECTS OF A CAYMAN ISLANDS DOMICILE AND A HONG KONG LISTING

The largest private-sector China-based firms listed in the United States are typically domiciled in the Cayman Islands.[154] A number of them, including Alibaba, are listed also in Hong Kong.[155] 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 this insulation.

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[154] The majority of China-based, U.S.-listed firms are domiciled in the Cayman Islands, including some originally domiciled in Delaware; another 15% are domiciled in the British Virgin Islands, whose legal system is similar to that of the Cayman Islands. *See* William J. Moon, *Delaware's Global Competitiveness*, 106 IOWA L. REV. (forthcoming 2021).

[155] *See* Fried & Kamar, *Alibaba*, *supra* note x, at ___. *See also* Fred Greguras, *China VIE Structure 2020*, INVENTUSLAW (Feb. 24, 2020), https://www.inventuslaw.com/china-variable-interest-entity-structure-2020/ (noting that "[o]f the 11 Chinese IPOs in the US in the 3 months ending January 31, 2020 . . . [a]ll 11 of the companies were incorporated in the Cayman Islands").

A. The Effect of a Cayman Islands Domicile

Domiciling in the Cayman Islands rather than a U.S. state further insulates insiders from liability under corporate law and securities law. This can matter when, for example, certain insiders have assets in the United States and are thus not fully law-proof.

We begin by making two points on the corporate-law dimension. First, a Cayman Islands domicile leaves investors of a controlled firm with weaker substantive protection than a Delaware domicile. Second, a Cayman Islands domicile imposes on investors procedural barriers to enforcement both in the Cayman Islands and in the United States.[156] We then turn to the securities-law dimension, where we explain that a non-U.S. domicile allows a China-based firm to be treated as a foreign private issuer (FPI) under U.S. securities law, reducing the disclosure it must provide.

1. The Effect of Cayman Islands Corporate Law

Cayman Islands corporate law applies to a Cayman Islands-domiciled firm even if it is based in China and subject to litigation in the United States.[157] As we explain below, Cayman Islands law is less protective of shareholders than Delaware law because of its substantive rules and especially because of its procedural rules. The latter are so defendant-friendly that public shareholders have never brought a lawsuit in the Cayman Islands against a listed Cayman firm or its insiders.[158]

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156 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.

[157] *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. Sept. 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).

[158] 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 freeze-outs of China-based 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 investors, as hedge funds typically own a small fraction of the shares. *See, e.g.,* Shanda Games Ltd. v. Maso Cap. Inv. Ltd., [2020] UKPC 2 (Jan. 27, 2020), https://www.bailii.org/uk/cases/UKPC/2020/2.html (reporting that appraisal-seeking Maso Capital owned

(a) Narrow Scope of Fiduciary Duty

Delaware imposes fiduciary duties not only on directors but also on controllers, who owe a duty of loyalty to minority shareholders. Some of the largest recoveries in Delaware have been from controllers who violated this duty.[159] Delaware also imposes liability on financial advisors for aiding and abetting breach of this duty.[160]

By contrast, Cayman Islands law does not impose liability on a controller unless she is also a director.[161] A controller might be deemed 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.[162] But demonstrating control is difficult when individuals and documents (including phone records) are on the other side of the Great Legal Wall of China.[163]

1.64% of Shanda's shares).

[159] *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).

[160] *See generally* Joel Edan Friedlander, *Confronting the Problem of Fraud on the Board*, 75 BUS. LAW. 1441, 1455 (Winter 2019/2020) (referencing 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).

[161] *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 Cap. 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).

[162] 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 it is inapplicable in other contexts. *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 (2020).

[163] *See supra* Part III.A.3.

(b) Procedural Barriers to Shareholder Litigation

Suits to enforce corporate-law claims fall into one of two categories: direct suits brought as class actions on behalf of shareholders, and derivative suits on behalf of the corporation.

Delaware law and Cayman Islands law classify claims similarly.[164] Most claims arising from midstream tunneling would be derivative because the corporation is considered to be the directly injured party.[165] Any recovery thus goes to the corporation. Most claims arising from a freeze-out would be direct because shareholders are considered to be injured directly.[166]

In the United States, plaintiffs' lawyers working on a contingent basis bring derivative and direct claims on behalf of public shareholders, obviating the need for shareholders to finance the suit. In the Cayman Islands, by contrast, contingent fees are illegal.[167] Accordingly, there will be no suit unless shareholders band together to hire attorneys. Collective-action problems make this unlikely.[168] Unsurprisingly, no case has ever been brought in the Cayman Islands by public shareholders against a listed firm.

Even if public shareholders banded together to bring derivative or direct claims, they would face additional challenges.

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[164] *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)).

[165] 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.

[166] Other types of direct claims under Cayman law include nondisclosure claims (*see* In re Harbinger Capital Partners Funds Inv. 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)).

[167] *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/.

[168] *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).

First, derivative claims are more difficult to bring under Cayman Islands law than under Delaware law.[169] Cayman Islands 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."[170] An exception exists when the defendants control a majority of the stock and use this control in certain wrongful ways.[171] But U.S. investors in China-based firms will have difficulty proving this exception applies given their lack of information, especially in a firm with complex control arrangements.[172] 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.[173] Even if shareholders were otherwise willing to pay a lawyer out of pocket, they would be reluctant to take this risk.[174]

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

Investors of a China-based, Cayman Islands-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.[175]

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[169] *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).

[170] *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].

[171] *See id.*

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

[173] *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).

[174] Alibaba has incorporated this default rule for direct claims into its articles of association to ensure its application. *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).

[175] *See supra* note x. And if the firm has a loser-pay provision in its articles of association (*see supra* note x), that provision would apply in any United States litigation unless nullified by the court.

Moreover, suing in the United States creates new obstacles. First, the plaintiffs may have difficulty overcoming the claim that the Cayman Islands is a more appropriate forum.[176] Second, the plaintiffs may find it challenging to convince the court that it has personal jurisdiction over foreign defendants.[177] For example, New York state courts have held that they lack personal jurisdiction over directors of Cayman Islands-domiciled firms who did not reside in the state or personally conduct business in it.[178] Had those firms domiciled in Delaware, their directors and other fiduciaries would have been deemed to consent to the jurisdiction of Delaware courts.[179]

2. The Effect of Being an FPI

A Cayman Islands domicile also weakens the protection that U.S. securities law provides to U.S. investors by enabling the China-based firm to be treated as a foreign private

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[176] *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 Islands-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 Islands-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 corporate and securities claims in connection with a freeze-out of a China-based, Cayman Islands-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*).

[177] 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).

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

[179] *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).

issuer (FPI).[180] In particular, the FPI disclosure regime eliminates many of the rules governing domestic issuers because it was designed to facilitate listing by foreign firms.[181] Unlike a domestic issuer, an FPI need not file quarterly reports[182] or current reports.[183] It must only file an annual report containing less detail than the one filed by a domestic issuer.[184]

Nor must an FPI abide by standard disclosure requirements when soliciting shareholder votes,[185] the requirement to make public disclosure when sharing material nonpublic information with a market actor,[186] and the requirement to disclose executive compensation on an individual basis.[187] Insiders of an FPI are also exempt from the requirement to disclose

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[180] 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. Were they U.S.-domiciled, they would not qualify.

[181] *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. For example, FPIs need not have a majority of directors meeting certain independence requirements 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* Fried*, Delisting, supra* note x.

[182] *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.

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

[184] *See* Form 20–F, General Instruction A(a) (17 CFR § 249.220f). *See generally* Audra L. Boone et al., *Ongoing SEC Disclosures by Foreign Firms*, ACCOUNT. REV. (2020) (describing low level of information provided by foreign issuers domiciled in "disclosure havens" such as the Cayman Islands).

[185] *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).

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

[187] *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).

their securities trades and so they are free to make short-swing profits.[188] The FPI regime thus cuts corners in key areas of corporate governance.[189]

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.[190] 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.[191] But unless the insiders of these firms have assets in Hong Kong, a listing there does not reduce their insulation.

Like the Cayman Islands, Hong Kong has a loser-pays default rule and does not allow for contingent fees or class actions.[192] Consequently, private litigation is rare and the enforcement of corporate law and securities law is left to the authorities.[193] But the authorities must rely on Chinese cooperation as they lack investigation and enforcement jurisdiction in China.[194] There is no extradition treaty between Hong Kong and China,[195] and Chinese

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[188] *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).

[189] *See* Amir N. Licht, *Crosslisting and Corporate Governance: Bonding or Avoiding*?, 4 CHI. J. INT'L L. 141, 142–43 (2003).

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

[191] *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").

[192] *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); Wai Yee Wan et al., *Public and Private Enforcement of Corporate and Securities Laws: An Empirical Comparison of Hong Kong and Singapore*, 20 EUR. BUS. ORG. L. REV. 319, 322 (2019) (noting rarity of private enforcement in Hong Kong).

[193] *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).

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

[195] 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*,

courts are not obligated to enforce Hong Kong judgments.[196] And information is shielded by the Chinese State Secrets Law or the Chinese Archives Law, or is otherwise unavailable.[197] Insiders who stay in China can thus avoid enforcement.[198] In short, Hong Kong, like the United States, is on the far side of the Great Legal Wall of China.

V. UNBONDING

Using the foregoing analysis, this Part casts doubt on the hypothesis that foreign firms list in the United States to bond their insiders to U.S. securities law and thereby lower their cost of capital. Section A describes the hypothesis. Section B explains why this hypothesis cannot explain a decision by a China-based firm to list its securities in the United States.

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.

[196] 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 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.

[197] 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". *See* Evidence Arrangement, art. 3. We have been told that China's CSRC sometimes shares audit papers with the SFC, though not with the SEC.

[198] *See* Filip et al., *supra* note x, at __. Unsurprisingly, China-based firms listed in Hong Kong engage in more misbehavior than Hong-Kong based firms listed in Hong Kong. *See id.* at __.

Section C argues that, when a China-based firm lists its securities *only* in the United States, it insulates its insiders from *any* securities law. Section D argues that, when a firm domiciles in a jurisdiction from which its insiders cannot be reached, it insulates its insiders from any corporate law. Section E discusses the implications for foreign firms not based in China.

A. Bonding: Theory and Evidence

The United States attracts hundreds of listings by foreign companies,[199] which collectively make up about 25% of the market capitalization of U.S.-traded stocks.[200]

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.[201] Even the lighter version imposes costs on firm insiders. Some costs fall directly on the insiders. For example, disclosure requirements can reveal wrongdoing, creating enforcement risk and reputational risk for the insiders. Other costs fall indirectly on the insiders as shareholders. For example, the firm bears compliance costs.[202]

To justify these costs, the insiders must expect personal benefits from listing in the United States.[203] 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

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[199] *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.

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

[201] *See supra* Part IV.A.2.

[202] *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).

[203] *See* Craig Doidge et al., *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J. FIN. ECON. 205, __ (2004) (explaining how cross-listing in the U.S. reduces insiders' private benefits but may enable them to benefit via their equity in the firm).

in the firm;[204] increase trading volume;[205] and obtain wider analyst and media coverage.[206] Any of these effects can increase stock price and benefit insiders as shareholders.

But being subject to U.S. securities law can also benefit insiders by benefitting the firm. According to the bonding hypothesis, firms based in jurisdictions with poor investor protection list in the United States to better protect their investors and thereby reduce their cost of capital.[207]

The 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 enforcement risk only to benefit as shareholders. In fact, insiders of foreign firms consistently report that they find U.S. securities law unappealing.[208] Moreover, there is little to stop a foreign firm listing in the United States from subsequently delisting.[209] In any event, the evidence on the bonding hypothesis is at best mixed.[210]

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[204] *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).

[205] *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).

[206] *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).

[207] *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 (2002).

[208] *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").

[209] Exchange Act Rule 12h–6, adopted in 2007, facilitates 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").

[210] 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). *Cf.* Roger Silvers, *The Valuation of SEC Enforcement Actions on Nontarget Foreign Firms*, 54 J. ACCOUNT. RES. 187 (2016) (describing increased SEC enforcement against foreign issuers and its salutary effects). For studies by skeptics, *see, e.g.,* Jordan Siegel, *supra* note x

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

Even if the bonding hypothesis can explain listing in the United States, it cannot explain listing in the United States by China-based firms.[211] Bonding depends on being subject to the SEC's enforcement powers, the availability of legal remedies for investors, and increased disclosure requirements.[212] However, we showed that insiders of China-based firms are immune to enforcement of U.S. securities law.[213] There is no possibility of extradition from China, no hope of enforcement of judgments in China, and no access to information in China.[214] Coming to America does not bond these firms at all.

The reverse-merger scandals made these impediments to enforcement painfully clear.[215] 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 less as FPIs are in an even worse position.[216]

To be sure, 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 most of the equity.[217] The SEC

(finding that the SEC and minority shareholders failed to 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*, 129 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, a result inconsistent with the legal-bonding hypothesis). A separate hypothesis is that the insiders of some U.S.-listed firms act lawfully out of reputational considerations. *See* Jordan Siegel, *Can Foreign Firms Bond Themselves Effectively by Renting US Securities Laws?*, 75 J. FIN. ECON. 319 (2005). But reputational considerations carry no weight in a final-period game, such as a freeze-out by a controller who does not expect to raise money from U.S. investors again.

[211] *Cf.* Clarke, *supra* note x (arguing that U.S. listing of China-based firms is unlikely to be for bonding). Clarke bases his conclusion primarily on the fact that U.S. judgments are unenforceable in China. *See id.* at 94–99. He does not consider, as we do here, the difficulty of obtaining information and the impossibility of extraditing defendants, which make bonding even less plausible.

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

[213] *See supra* Part III.

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

[215] *See supra* Part III.B.

[216] *See supra* Part IV.A.

[217] For example, in 2019, Alibaba and several insiders settled a lawsuit for concealing negative information at the IPO. The lawsuit settled for $250 million (1/2,000 of Alibaba's market capitalization), all 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. Ma (2d Cir. 2017); Alibaba Group Holding Form 6–K (Apr. 29, 2019). Since Alibaba's insiders own less than 10% of Alibaba's equity (*see* Fried & Kamar, *Alibaba*, *supra* note x, at ___), the cost to

can delist a firm that violates the securities law,[218] but refrains from doing so. For example, it has not delisted Alibaba, whose auditors have gone uninspected by the PCAOB in violation of SOX.[219] This restraint is understandable: delisting would cause the stock price to fall, harming the investors that the SEC seeks to protect and potentially inviting a cheap freeze-out that would harm them even more.[220] The SEC is essentially powerless.

C. Listing China-Based Firms Only in the United States as Unbonding

While the 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 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.[221] Instead of bonding they *unbonded*.[222] U.S. investors might be better protected if those firms listed also in China and were at least reachable by securities regulators there.

D. Unbonding from Corporate Law

By domiciling outside China, China-based firms insulate their insiders from corporate law as well. A firm can 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

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them was less than $25 million, which may well be less than any benefit to them from inflating the IPO price.

[218] *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").

[219] *See supra* Part III.C.

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

[221] *See supra* note x.

[222] *Cf.* 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").

enforceable. Because non-Chinese corporate law is unenforceable against China-based insiders, a China-based firm that both domiciles and lists its securities outside China unbonds both from securities law and from corporate law.

E. Implications for 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. Bonding requires that the foreign jurisdiction help U.S. authorities and 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 provide this help, there may be additional countries—with adversarial relations with the United States or corrupt or undeveloped legal systems—that will not assist enforcement by U.S. authorities or investors. Firms based in these countries list in the United States not for bonding purposes. And if the United States is their only listing venue, their goal may be to unbond.

VI. THE PRO-FOREIGN BIAS OF U.S. SECURITIES LAW

Our analysis reveals a pro-foreign bias in U.S. securities law: it favors Chinese entrepreneurs taking their firms public in the United States over American entrepreneurs. We now discuss this bias.

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

How this bias affects U.S. investors depends on a key premise underlying U.S. securities law: that investors need all of the disclosure and enforcement mechanisms mandated for domestic issuers. If this premise is correct, U.S.-based issuers are properly regulated but China-based issuers are under-regulated, harming their investors. The solution, Section B argues, is to level the playing field *up*: foreign firms seeking to list in the United States should show that their insiders are not law-proof and provide the same disclosure as domestic issuers. Less disclosure could be permitted only for issuers with a primary listing in a jurisdiction that requires, and can enforce, a high standard of reporting.

Section C considers the possibility that, as some argue, mandatory securities law is unnecessary because IPO investors can price future disclosure and enforcement, incentivizing insiders to choose optimal arrangements when going public.[223] If this is correct, U.S. investors buying stock in China-based issuers are not harmed: they pay a price reflecting whatever protection they receive. But American issuers are very over-regulated, at American entrepreneurs' expense.[224] The solution here would be to level the playing field *down*, so that all issuers would be free to choose any combination of disclosure and enforcement they like. This would be a radical change in the law, which we assume few would endorse. However, it would at least make the law coherent.[225]

A. Favoring Chinese Entrepreneurs over American Entrepreneurs

U.S. securities law gives an American entrepreneur taking a firm public in the United States no choice over the level of disclosure or enforcement. By contrast, a Chinese entrepreneur taking a firm public in the United States can choose the level of disclosure and make herself more or less law-proof.

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.[226] The firm will have to file quarterly financial reports,[227] provide detailed disclosures about executive pay,[228] and report a variety of other firm metrics, some of which appear irrelevant to investors.[229] In contrast, when a Chinese entrepreneur takes a firm public in the United States, she can choose to have the firm treated

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[223] *See infra* note x.

[224] Chinese entrepreneurs are also harmed if their current arrangements are not optimally tailored for them. But they have more choices, are thus harmed less, than American entrepreneurs.

[225] Another possibility is that mandatory disclosure and enforcement are needed but their optimal levels are different from the ones currently mandated for domestic issuers. If so, securities law would still need fixing.

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

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

[228] *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.

[229] 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 their Chief Executive Officer. *See* Regulation S–K, Item 402(u), 17 C.F.R. § 229.402(u) (Item 402) Executive compensation. This disclosure does not help investors price shares or detect wrongdoing.

as a domestic issuer by incorporating in the United States or as an FPI by incorporating outside the United States.[230]

2. *Enforcement*

An American entrepreneur who takes a firm public in the United States enters a world of strict enforcement. The authorities may investigate or sue her and the firm, and investors may bring class actions and derivative suits against them. Both the authorities and 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 violation of securities law or to channel private securities claims to arbitration.

By contrast, a Chinese entrepreneur can modulate the level of enforcement. She can shield herself and other insiders from the law by filling the board and top executive positions with Chinese residents whose personal assets are in China, and keeping firm assets and records in China. Or she can expose insiders to the law by, for example, appointing U.S. residents to key positions in the firm or putting personal funds in an escrow account reachable by investors or the government.[231] In short, she can make firm insiders less law-proof.[232]

B. *The Case for Leveling the Playing Field Up*

A basic tenet of U.S. securities law is that its disclosure requirements and enforcement mechanisms are mandatory. The United States is not alone. While securities laws around the world vary, in all developed economies they have mandatory disclosure requirements[233]

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[230] *See supra* Part IV.A.2.

[231] The Securities Investor Association of Singapore (SIAS) suggested this approach when it asked the Singapore Stock Exchange (SGX) to require that insiders of China-based firms provide a bank guarantee as a form of bond, which would have required insiders to keep funds at the bank. *See* Press Release, SIAS Launches New Initiative—Corporate Governance Page—in Collaboration with SMU (Oct. 3, 2012), https://sias.org.sg/latest-updates/sias-13th-investors-choice-awards-2012-news-release/. But the SGX refused. *See* Letter from Richard Teng, Deputy Chief Regulatory Officer of SGX, to David Gerald, President of SIAS (Feb. 18, 2013), https://sias.org.sg/wp-content/uploads/2018/08/180213-Letter-from-SGX-on-SIAS-safegaurd-proposals-for-investors-of-foreign-issuers-listed-on-Singapore-Exchange.pdf.

[232] Of course, if investors price legal protection and law-proof Chinese entrepreneurs' cost of capital is much higher than that of their American counterparts, the Chinese entrepreneurs might wish they were also not law-proof. But our point is only that U.S. securities law gives Chinese entrepreneurs choice over both disclosure and enforcement, while straightjacketing American entrepreneurs.

[233] *See, e.g.,* Luca Enriques et al., *Corporate Law and Securities Markets*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 243, 245–46 (3d ed.

and enforcement mechanisms.[234] Their underlying premise is that the government knows what investors need and that issuers will not offer it on their own because investors do not fully price it at the IPO.[235]

This suggests that allowing Chinese entrepreneurs to raise capital in the United States with less investor protection than U.S. law deems necessary benefits Chinese entrepreneurs at U.S. investors' expense. The harm can be substantial: the market value of China-based firms listed in the United States (and neither domiciled nor listed in China) exceeds $1 trillion.[236] The solution is to subject Chinese entrepreneurs who raise capital in the United States to the same rules and enforcement as American entrepreneurs.

1. *Disclosure*

To level the disclosure playing field up, the law should apply the domestic-issuer disclosure regime to all firms.[237] 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 FPI regime: it is available only to an issuer that reduces the protection of U.S. investors on other dimensions. First, the issuer must have a foreign legal domicile (say, the Cayman Islands). Thus, the FPI regime depends on the firm providing less corporate-law protection to U.S. investors.[238] Second, a Cayman Islands-domiciled firm will not qualify as an FPI if too many of its executives or directors are U.S. citizens or residents. Thus, the FPI's lower disclosure requirements are available only if enough executives and directors are relatively hard to reach. This makes no sense. If

2017) ("All of our core jurisdictions make compliance with extensive mandatory disclosure regimes a condition of issuers' access to public trading markets").

[234] *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").

[235] For the contrary view, see *infra* Part V.C.

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

[237] We assume in this Section that the disclosure required of domestic issuers by U.S. securities law is optimal. If the optimal level is different, that level should apply both to American entrepreneurs and to Chinese entrepreneurs.

[238] *See supra* Part IV.A.1.

anything, firms with less corporate-law protection or more insulated insiders should disclose more, rather than less.[239]

The FPI regime might still be justified for firms also listed in another jurisdiction that holds them to, and can enforce, a high standard of reporting. But it cannot be justified for firms with no listing outside the United States.[240]

2. Enforcement

To level the enforcement playing field up, the law should require foreign firms to bond to enforcement in the United States as condition to listing. We predict, however, that China-based firms will be unable or unwilling to meet this requirement unless China's law changes.

What makes the insiders of China-based firms law-proof is 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 their personal assets, both actions will be reversible and thus of limited use as a bond. In theory, China-based firms and their China-based insiders could be required to obtain bank guarantees or put funds in escrow accounts to ensure their compliance with corporate and securities laws.[241] But the amounts needed for real protection would likely exceed the insiders' willingness and ability to pay. It is therefore doubtful that China-based firms can, on their own, bond to enforcement of investor protection law in the United States.

If they cannot, the only way to level the enforcement playing field up is to ban them from listing. But the ban should apply only prospectively. Requiring China-based firms

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[239] Political-economy considerations explain how this perverse approach developed. Historically, foreign firms contemplating a U.S. listing 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 asked the SEC to make U.S. listing more attractive by offering a light disclosure regime. After initial resistance, the SEC agreed to offer a light FPI regime. However, concerned that domestic issuers might try to classify themselves as FPIs to lighten disclosure obligations, the SEC restricted FPI status to firms that were sufficiently foreign in terms of the location of insiders and assets. *See id.* at __.

[240] *See* Davidoff Solomon, *supra* note x, at 620 (questioning the wisdom of subjecting a China-based issuer listed only in the United States to the same type of regulation as U.K.-based issuer listed on the London Stock Exchange and the NYSE); Boone et al., *supra* note x, at ___.

[241] As noted earlier, the Securities Investor Association of Singapore (SIAS) asked the Singapore Stock Exchange (SGX) to require that insiders of China-based firms provide a bank guarantee as a form of bond, but the SGX refused. *See supra* note x. Putting their U.S.-traded shares in an escrow account would not provide much protection because the firm's China-based assets could be tunneled out of the firm, leaving the U.S.-listed company a worthless shell.

already traded in the United States to delist would harm investors by depressing share prices and facilitating cheap freeze-outs as occurred in the reverse-mergers debacle.[242]

C. A 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 most of their insiders were law-proof.[243] Indeed, shares of Chinese SOEs and technology firms have dramatically outperformed the shares of U.S.-based firms.[244] In retrospect, U.S. investors in China-based firms have on average done well so far.

Perhaps they will be expropriated in the future. Or perhaps they have correctly reasoned that the firms' light disclosures as an FPI are sufficient and that their law-proof insiders are adequately constrained by ethical beliefs, a need to preserve their reputation, a desire to travel or conduct business in the United States or other countries that will enforce U.S. judgments or effect extradition, the Chinese Communist Party, or a desire to shield legally-reachable non-Chinese nationals serving as directors or officers.[245]

If the latter, the mandatory approach of securities laws in all developed economies may well be misguided; instead, the law should let issuers choose their level of investor protection.[246] The premise underlying this view is that investors fully price disclosure and enforcement arrangements, incentivizing firms to offer optimal levels of both at the IPO. The law's main role would be to implement the firm's disclosure and enforcement commitments once trading starts. If Alibaba's Jack Ma can take his firm public in the United States as a law-proof controller and offer FPI-style disclosure, so should Facebook's Mark Zuckerberg.

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[242] *See* Fried, *Delisting*, *supra* note x; Jesse Fried, *Why Trump's Attempt to Delist China from US Will Backfire*, FIN. TIMES (Jan. 13, 2021), https://www.ft.com/content/cbca56a9-2026-4176-8045-fe82248f0452.

[243] *See supra* Part III.

[244] *See* Bessembinder et al., *supra* note x. The study focuses on ADRs, and thus excludes the reverse-merger firms that have been heavily fraud-prone. *See supra* Part III.B. However, because reverse-merger firms are relatively small, their exclusion is unlikely to matter.

[245] For example, Alibaba's President and several members of the company's 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 control Alibaba. *See* Fried & Kamar, *Alibaba*, *supra* note x.

[246] *See generally* ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION (2002) (advocating firm choice of the securities regime); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993) (advocating firm choice of the corporate regime); Stephen J. Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998) (advocating firm choice of the securities regime); Stephen J. Choi & Andrew Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207, 231–32 (1996) (same).

This may strike many as a bold change, and we do not endorse it here. But at least it would make the law coherent.

1. Disclosure

If the IPO market fully prices investor protection, there is no reason to dictate a disclosure regime. 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 regardless of their 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.[247]

Currently, 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 increases the insulation of insiders from corporate law.[248] Tying weaker securities-law protection to weaker corporate-law protection makes no sense. If the IPO market is efficient, issuers should be free to choose their favored mix of corporate and securities law regardless of where they domicile.

2. Enforcement

If markets can price protection, firms should be free to choose their level of securities-law enforcement. To our knowledge, a menu of securities-law enforcement options from which each firm could select for its investors and the government has never been proposed. But if the IPO market fully prices investor protection, such a menu should be available to all firms. Each issuer could then decide whether to expose its insiders to enforcement of U.S. securities law as domestic issuers are exposed today, limit their exposure, or completely insulate them as China-based insiders are.[249]

CONCLUSION

Hundreds of U.S.-listed firms are based in China but subject only to the corporate and securities laws of other jurisdictions. As a result, the law cannot prevent or deter their insiders

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

[248] *See supra* Part IV.A.

[249] In such a world, for example, firms could relegate all securities claims to arbitration, as broker-dealers do to their customers. *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (upholding an arbitration agreement between a broker-dealer and its customers).

from expropriating value from U.S. investors. The main problem is that almost everything 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 for private plaintiffs and 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 information to be shared with foreign authorities or plaintiffs. Enforcement is even harder when, as is typically the case for large Chinese technology companies like Alibaba, the firm domiciles in the Cayman Islands.

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 jurisdiction to bond to that jurisdiction's tough disclosure and enforcement regime and thereby raise capital at a lower cost. Our analysis suggests that listing in a foreign jurisdiction 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 that is home neither to 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 law. We show that current law favors Chinese entrepreneurs taking firms public over American entrepreneurs, who cannot freely choose their level of disclosure and enforcement. How this bias affects U.S. investors depends on a key premise underlying U.S. securities law: that the disclosure and enforcement mechanisms required for domestic issuers are not only optimal but also must be mandated to protect U.S. investors, as they will not arise via private ordering.

If this premise is correct, U.S. investors are harmed because China-based firms are under-regulated. The remedy is for U.S. securities law to level the playing field up by requiring China-based firms (and other firms based outside the United States) to demonstrate that the law is enforceable on their insiders as a condition for listing in the United States and provide the same disclosure as U.S.-based firms.

Conversely, if U.S. investors can fully price disclosure and enforcement mechanisms and private ordering thus leads to optimal arrangements, U.S. investors in China-based firms are not hurt. But U.S.-based issuers are over-regulated, harming the entrepreneurs taking them public. In this case, U.S. securities law should move closer to a system in which each firm chooses its disclosure and enforcement mechanisms. This would constitute a radical change in the law, but at least it would make the law coherent.

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