

DISCLOSING CHINA’S CORRUPTION RISKS: A SECURITIES REGULATION PERSPECTIVE

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INTRODUCTION

Corruption has long been understood as a pervasive problem plaguing

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China's business environment.¹ The country ranked 80th on the latest annual Corruption Perception Index published by Transparency International in 2013, lower than Brazil and South Africa.² A high degree of government involvement in economic affairs and a business culture emphasizing personal ties and informal relationships are believed to have contributed to widespread corrupt practices, which continue to pose significant challenges to foreign corporations with investment and operations on the ground.³ A long list of high profile multinationals implicated in corruption scandals in China⁴ has in recent months included big names such as Avon Products, Inc., GlaxoSmithKline plc, and J.P. Morgan Chase & Co.⁵

Even without conducting business in China or with Chinese counterparties, investors may become exposed to China's corruption risks by investing in securities issued by Chinese or "China-based" companies.⁶

1. See, e.g., Delia Poon, *Exposure to the Foreign Corrupt Practices Act: A Guide for U.S. Companies with Activities in the People's Republic of China to Minimize Liability*, 19 HASTINGS INT'L & COMP. L. REV. 327, 339-45 (1996) (identifying local conditions that create significant exposure to the FCPA for U.S. companies doing business in China); F. Joseph Warin et al., *FCPA Compliance in China and the Gifts and Hospitality Challenge*, 5 VA. L. & BUS. REV. 33, 59-60 (2010) (discussing the corruption risks presented by Chinese traditions of gift giving in professional contexts).

2. TRANSPARENCY INT'L, CORRUPTION PERCEPTIONS INDEX 2013, available at <http://www.transparency.org/cpi2013/results> (follow "Download Brochure" hyperlink).

3. See, e.g., Daniel Chow, *The Interplay Between China's Anti-bribery Laws and the Foreign Corrupt Practices Act*, 73 OHIO ST. L.J. 1015, 1021-24 (2012) (discussing the FCPA compliance challenges posed by the continued dominance of state-owned enterprises in China's important economic sectors); Nicole Y. Hines, *Cultural Due Diligence: The Lost Diligence That Must Be Found by U.S. Corporations Conducting M&A Deals in China to Prevent Foreign Corrupt Practices Act Violations*, 9 DUQ. BUS. L.J. 19, 55-61 (2007) (discussing how Chinese cultural norms of *guanxi* and *mianzi* affect Chinese corporate culture in connection with FCPA compliance); Warin et al., *supra* note 1.

4. See Warin et al., *supra* note 1, at 48-55 (listing significant China-related FCPA investigations against multinational companies).

5. See Ben Hirschler, *Bribery Scandal Slashes GlaxoSmithKline's Chinese Drug Sales*, REUTERS, Oct. 23, 2013, 10:19 AM EDT, available at <http://www.reuters.com/article/2013/10/23/us-gsk-earnings-idUSBRE99M0DB20131023>; Ben Protess & Jessica Silver-Greenberg, *JPMorgan Tracked Business Linked to China Hiring*, N.Y. TIMES DEALBOOK (Dec. 7, 2013, 1:24 PM), http://dealbook.nytimes.com/2013/12/07/bank-tabulated-business-linked-to-china-hiring/?_r=0; David Voreacos, *China's Bribery Culture Poses Risks for Multinationals*, BLOOMBERG NEWS (Nov. 21, 2013, 12:01 AM ET), <http://www.bloomberg.com/news/2013-11-21/china-s-bribery-culture-poses-risks-for-multinationals.html>.

6. For various regulatory and taxation reasons, many Chinese companies have restructured themselves and have adopted an overseas holding structure when engaging in fundraising transactions, including venture capital/private equity investments and securities offerings in the international capital markets. Typically, these companies will make the issuer of securities a special purpose vehicle, incorporated in the United States or in one of the offshore financial centers (e.g., the Grand Cayman Islands, Bermuda, or the British Virgin Islands), which controls through an equity interest or contractual arrangements the company's operating business assets within China. See, e.g., Jing Li, *Venture Capital*

Corruption risks may affect securities investors in multiple ways. The eruption of corruption and fraud scandals involving China-based companies could lead to market volatility and trading disruption in the companies' securities.⁷ Enforcement actions under Chinese laws and extraterritorially applied anti-corruption laws, such as the Foreign Corrupt Practices Act (the FCPA), generally have a significantly negative impact on a company's normal operations and business prospects and consequently on its investment value.⁸ Those companies that strive to comply with applicable anti-corruption laws may also see their competitiveness and profitability reduced if their competitors engage in corrupt business practices.⁹

Although the latest wave of accounting scandals, shareholder litigation, and regulatory actions led to the delisting and deregistration of dozens of China-based companies,¹⁰ the total count of China-based companies registered with the United States Securities and Exchange Commission (the SEC) likely remains over 200.¹¹ Beyond the public

Investments in China: The Use of Offshore Financing Structures and Corporate Relocations, 1 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 1, 26–37 (2012) (describing laws and regulations that contributed to the prevalent use of this offshore investment structure in venture capital investment in Chinese companies). In this way, many issuers discussed in this article are technically not “Chinese” companies in light of their place of incorporation and should more appropriately be referred to as “China-based” companies.

7. See, e.g., Mia Lamar, *CCTV Investigation Targets Chinese Drug Maker*, WALL ST. J. MONEYBEAT (Sept. 12, 2013, 2:15 AM), <http://blogs.wsj.com/moneybeat/2013/09/12/cctv-investigation-targets-chinese-drug-maker/> (reporting price declines for all China-based pharmaceutical companies listed in Hong Kong following publicized bribery accusation about one drug company).

8. See Hirschler, *supra* note 5 (discussing the negative impact of a bribery scandal on GlaxoSmithKline's sales and reputation).

9. See MINXIN PEI, CARNEGIE ENDOWMENT FOR INT'L PEACE, POLICY BRIEF 55, CORRUPTION THREATENS CHINA'S FUTURE 6 (2007), available at http://www.carnegieendowment.org/files/pb55_pei_china_corruption_final.pdf (“Corruption creates serious obstacles for Western companies facing rivals who engage in illegal practices in order to win business in China.”); but see Shaun Rein, *How To Deal with Corruption in China*, FORBES, Oct. 7, 2009, 5:17 PM, <http://www.forbes.com/2009/10/07/china-corruption-bribes-leadership-managing-rein.html> (advising companies to avoid engaging in corrupt activities in China and noting that commercial corruption in China is declining).

10. *23 Chinese Companies Delisted in US Since Last Year*, WANT CHINA TIMES (Aug. 14, 2012, 11:46), <http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20120814000039&cid=1102>.

11. According to one count, as of June 2012, nearly 300 China-based firms were listing their securities on U.S. exchanges, and many more firms were quoted on the Over-the-Counter Bulletin Board (OTCBB) and on other OTC markets. See Zigan Wang, *US-Listed Chinese Firms in Credibility Crisis: Who Are They? Where Are They?* 2 (Columbia Univ., Working Paper, 2012), available at <http://ssrn.com/abstract=2177450>. Another count mentioned that that there were over 1000 companies in total trading in U.S. markets by the end of 2011. Zhou Xuan & Shen Xing (周焯, 申星), *Zhong Guo Qi Ye Hai Wai Tui Shi Si Kao: Jin Tui Zhi Jian De Pai Huai* (中国企业海外退市思考: 进退之间的徘徊) [*Thoughts on Overseas Delistings of Chinese Companies: Going Forward or Backward*], 100 GUOJI JINGJI PINGLUN (国际经济评论) [INT'L ECON. REV.] 135, 135 (2012) (China). One source mentioned that a net delisting of 53 China-based companies took place between 2010 and 2012.

offering market, many China-based companies have also gained access to massive amounts of U.S. capital over the past decade through exempted global offerings of securities under Rule 144A and Regulation S.¹² Absent dramatic changes in China's domestic capital markets, U.S. investors and regulators should continue to expect a sizable flow of transactions in securities of China-based companies reaching the U.S. market.¹³

China-based securities scandals have so far mainly concerned accounting irregularities as opposed to pure corruption violations. As illustrated in the latest shareholder suits arising from the corruption investigation of PetroChina,¹⁴ however, the continuously intensifying anti-corruption campaign that China's current leadership is implementing¹⁵ may cause more corruption-related scandals to be exposed, to the detriment of issuers and investors.¹⁶ To protect investors, United States regulators should examine whether existing regulations suffice to protect against the corruption risks associated with China-based securities.

LESSONS TO BE LEARNT – US SECURITIES CLASS ACTIONS AGAINST CHINESE DOMICILED COMPANIES (2013), available at <http://stage.plusweb.org/Portals/0/Event%20Material/Lessons%20to%20be%20Learnt%20-%20US%20Securities%20Class%20Actions%20Against%20Chinese%20Domiciled%20Companies.pdf>. Starting with the second half of 2013, market sentiment has visibly improved for China-based stocks. The U.S. initial public offering (IPO) market seems to have thawed for China-based companies after an extended frozen period, with eight new listings completed in 2013 and more reportedly in the pipeline for 2014. Rebecca Fannin, *China Venture Capitalists and Entrepreneurs Set to Get Boost from Improved IPO Outlook, Finally!*, FORBES, Dec. 19, 2013, 2:21 PM, <http://www.forbes.com/sites/rebeccafannin/2013/12/19/china-venture-capitalists-and-entrepreneurs-set-to-get-boost-from-improved-ipo-outlook-finally/>.

12. See Weitseng Chen, *Institutional Arbitrage: China's Economic Power Projection and International Capital Markets*, 26 COLUM. J. ASIAN L. (forthcoming 2013) ("In practice, [private placements under Rule 144A and Regulation S] have become the dominating mechanism for Chinese firms and the Chinese government to gain access to U.S. capital.").

13. In January 2014, an SEC administrative law judge suspended the Chinese units of the Big Four accounting firms from auditing U.S.-traded companies for six months. Michael Rapoport, *Judge Suspends Chinese Units of Big Four Auditors*, WALL ST. J., Jan. 23, 2014, 1:42 AM, <http://online.wsj.com/news/articles/SB10001424052702303448204579337183810731744>. If the ruling becomes final, it could create significant obstacles for China-based companies to obtaining U.S. listings. The accounting firms appealed the ruling in February 2014, but the review process within the SEC and potentially in a court of appeals (if the SEC upholds the ruling and the firms seek further court review) could take a long time (months at least for administrative review and years for judicial proceedings); as a result, the ruling is not expected to take effect soon, if at all. Michael Rapoport, *China Units of Big-Four Firms Appeal Audit Ban*, WALL ST. J., Feb. 12, 2014, 5:47 PM, <http://online.wsj.com/news/articles/SB10001424052702303704304579379410335942436>.

14. See sources cited *infra* note 72.

15. See, e.g., *China Probes Vice Public Security Chief amid Graft Crackdown*, BLOOMBERG NEWS (Dec. 21, 2013), available at <http://www.businessweek.com/news/2013-12-20/china-probes-deputy-public-security-chief-amid-graft-crackdown>.

16. Kevin LaCroix, *Corruption Allegations: More Securities Suits Against U.S.-Listed Chinese Companies?*, D&O DIARY (Sept. 10, 2013), <http://www.dandodiary.com/2013/09/articles/securities-litigation/corruption-allegations-more-securities-suits-against-u-s-listed-chinese-companies/>.

This Article discusses the ways in which securities disclosure requirements can and should be used to potentially enhance investor protections with respect to China's corruption risks. In particular, it argues that the current securities disclosure rules' reliance on a standard-based requirement for corruption risk disclosures is problematic; to address certain practical challenges facing the parties involved in the disclosure drafting process, a more specific rule-based directive that can be expected to enhance due diligence and disclosure practices over corruption risks of China-based securities should be adopted. Part I discusses the information rationale for using risk disclosure to regulate corruption risks. Part II describes the current disclosure requirement for corruption risks, which is based on a materiality standard that leaves to the issuers the exercise of considerable judgment over disclosure. Part III demonstrates the deficient corruption risk disclosures made by China-based companies under the standard-based requirement. Part IV discusses certain practical challenges present in the disclosure drafting process that have contributed to the deficient disclosures and due diligence of the corruption risks of China-based companies. Parts V and VI propose using a rule-based disclosure requirement and preliminarily discuss possible objections to such a proposal, respectively.

I. REGULATING CORRUPTION RISKS THROUGH INFORMATION DISCLOSURE

When Congress enacted the FCPA in 1977, it gave the SEC civil authority to enforce both the Act's anti-bribery and accounting provisions.¹⁷ Given the SEC's traditional role as the chief regulator of the capital markets, critics have questioned the appropriateness of having the SEC enforce the FCPA, especially the anti-bribery provision.¹⁸ This Article does not engage in similar debate about whether and how the SEC and other regulators should fight overseas corruption in China through enforcing substantive laws such as the FCPA. Instead, it proposes that the SEC's traditional regulatory toolkit, in particular the disclosure rules, should not be overlooked when the Commission considers protecting investors from corruption risks.

17. See Wallace L. Timmeny, *SEC Enforcement of the Foreign Corrupt Practices Act*, 2 LOY. L.A. INT'L & COMP. L. ANN. 25, 26-27 (1979) (noting that the SEC may use its civil enforcement power under the Exchange Act and the SEC's Rules of Practice to enforce the FCPA and related rules, whereas the Department of Justice was not provided with civil investigative tools).

18. See, e.g., Barbara Black, *The SEC and the Foreign Corrupt Practices Act: Fighting Global Corruption is Not Part of the SEC's Mission*, 73 OHIO ST. L.J. 1093 (2012) (challenging the SEC's role in enforcing FCPA).

U.S. securities regulation fundamentally relies on disclosure requirements and related liabilities to regulate investment risk issues. As early as 1979, the SEC sought, though unsuccessfully, to bolster the FCPA's accounting provision through disclosure mechanisms that would have imposed certain Sarbanes-Oxley-style requirements of internal control reporting.¹⁹ Although such a requirement was ultimately incorporated into the securities laws decades later,²⁰ requirements for risk factor disclosures, another avenue that the securities laws often pursue to regulate risks, have not been afforded sufficient attention from lawmakers and regulators.

U.S. securities laws currently require domestic and foreign securities issuers to disclose important risk factors affecting their operations and prospects in the registration statements that contain their offering prospectuses and also in periodic filings.²¹ In theory, there are at least two important ways in which risk disclosure requirements could be used to regulate securities investment risks and to protect investors. First, risk disclosures could reduce information asymmetry in the market and enable investors to make informed investment decisions.²² Second, mandatory disclosure requirements might motivate corporate executives to implement enhanced risk management.²³ This Part considers the potential information benefits of risk disclosures in the context of the corruption risks of China-based securities.

Although there have long been complaints that risk disclosures are

19. U.S. SEC. & EXCH. COMM'N, REPORT ON REVIEW OF DISCLOSURE REQUIREMENTS IN REGULATION S-K 22 n.58 (2013), available at <http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf>.

20. See Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, 68 Fed. Reg. 36,636 (June 18, 2003).

21. In practice, due to liability management considerations, offering documents in connection with non-registered transactions under Rule 144A and Regulation S also disclose risk factors because, although Rule 144A and Regulation S offerings are not subject to the same mandatory disclosure requirements imposed on registered offerings under the securities laws, they are not exempt from the anti-fraud liability provisions. See ZE'EV D. EIGER, FREQUENTLY ASKED QUESTIONS ABOUT REGULATION S 21 (2013), available at <http://www.mofo.com/files/Uploads/Images/FAQs-Regulation-S.pdf> (noting that, compared with a registered offering, a Rule 144A/Regulation S offering is subject to more flexible disclosure requirements but that the anti-fraud provisions are still applicable). To simplify discussion, this Article focuses on the risk disclosure requirements for companies and securities registered with the SEC.

22. See Susanna Kim Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements*, 2005 U. ILL. L. REV. 929, 929-31 (noting that investors use specialized forward-looking statements disclosed by issuers to evaluate risks of investments).

23. See Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROBS. 113, 123-25 (Summer 1999) ("Required disclosure . . . will make [the management] try harder to avoid actions that will generate negative information.").

often meaningless boilerplates, the available empirical evidence demonstrates that legally-required risk disclosures do have an impact on the market perception of risks.²⁴ For example, in a recent study, researchers found a positive correlation between risk disclosures and post-disclosure trading patterns, suggesting that, on average, risk disclosures are meaningful even under the current disclosure requirements.²⁵ Furthermore, studies have also shown that there is sound basis for the market to respond to risk disclosures because issuers subject to the disclosure requirements are generally motivated to produce risk information that corresponds to their own risk assessment.²⁶ Even if they do not have much faith in the empirics, however, lawmakers and the SEC should consider risk disclosure as a potentially useful mechanism for regulating securities risks by informing investors.

Empirical studies on the market perception of the disclosure of corruption risk factors have not been performed at this time. But relevant considerations can still be debated and analyzed. Practitioners in the United States disagree on whether corruption risk disclosures provide any benefits to investors. For example, one lawyer criticized the typical FCPA risk factor language as mostly superfluous, referencing as an example Google's filings.²⁷ Specifically, such disclosure tends to state little more than the obvious: that U.S. companies with foreign operations are subject to the FCPA.²⁸ In addition, the disclosing company tends to admit in such a

24. See, e.g., John L. Campbell et al., *The Information Content of Mandatory Risk Factor Disclosures in Corporate Filings*, 19 REV. ACCT. STUD. 396, 398 (2014) (finding a positive association between risk factor disclosures and post-disclosure market beta and stock return volatility, suggesting that investors incorporate risk disclosures into their assessments of firm risk and value); Todd Kravet & Volkan Muslu, *Textual Risk Disclosures and Investors' Risk Perceptions*, 18 REV. ACCT. STUD. 1088 (2013) (finding that changes in the number of risk sentences in disclosures correlate with investors' assessments). But see Feng Li, *Do Stock Market Investors Understand the Risk Sentiment of Corporate Annual Reports?* 5–6 (Univ. of Mich. Stephen M. Ross Sch. of Bus., Working Paper, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=898181 (finding that when risk sentiment increases, future earnings decrease, and investors underreact—or fail to react altogether—to the disclosures); Yatin Mirakur, *Risk Disclosure in SEC Corporate Filings* (Univ. of Pa. Wharton Res. Scholars J., Working Paper, 2011), available at http://repository.upenn.edu/cgi/viewcontent.cgi?article=1088&context=wharton_research_scholars (finding that risk disclosures do not accurately predict a disclosing firm's future events).

25. See Campbell et al., *supra* note 24.

26. *Id.*; see also Karen K. Nelson & A. C. Pritchard, *Litigation Risk and Voluntary Disclosure: The Use of Meaningful Cautionary Language* (2d Annual Conference on Empirical Legal Studies, Working Paper, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=998590 (showing that firms' risk disclosure corresponds to the level of litigation risks that they face).

27. See Nicole Di Schino, *When and How Companies Should Include FCPA Risk Disclosures in SEC Filings*, FCPA REP., Sept. 26, 2013, available at <http://www.troutmansanders.com/files/Uploads/Documents/brownfcparisksecfilings.pdf>.

28. *Id.*

risk factor that despite its efforts, the acts of its employees or of third parties may still render it in violation of the law.²⁹ Such practice was criticized for unnecessarily raising question about the effectiveness of such a company's compliance program.³⁰ But reasonable minds could certainly differ. Since the FCPA does not apply to every U.S. publicly traded company, the risk factors associated with the FCPA are in fact less "generic" than some more universally applicable risk factors, such as that of the potential absence of a trading market for new securities, that are nevertheless recommended by the Commission.³¹ Furthermore, when a company believes that it could be subject to the FCPA and as a result could face the associated regulatory burdens and consequences, such a belief is usually derived from legal advice. Reasonable investors would more than likely appreciate if such private knowledge procured at cost were shared with them and would take that information into consideration.

As for China-based companies, investors could conceivably benefit even more from the corruption risk information that the issuer discloses. Although China appears on the front pages of U.S. newspapers more frequently now than ever before, the average U.S. investor still has much to learn about corruption risks, such as the following: (i) China, and in particular the industry in which an issuer operates, is susceptible to a high level of corruption risk;³² (ii) an issuer may face high corruption risk due to frequent contacts with government officials or business transactions with government bodies;³³ (iii) U.S.-incorporated issuers and foreign private issuers are subject to the FCPA if they list securities in the United States;³⁴ (iv) China-based issuers are also subject to PRC anti-corruption laws, and the PRC authority launches enforcement campaigns from time to time;³⁵ (v) being subject to the FCPA could render the issuer less competitive than its

29. *Id.*

30. *Id.*

31. (Item 503) Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges: Risk Factors, 17 C.F.R. § 229.503(c) (2013).

32. *See, e.g.*, Bohai Pharm. Grp., Inc., Annual Report (Form 10-K) 30 (Sept. 27, 2013) (noting that a series of corrupt practices occur from time to time in China as well as in the pharmaceutical industry); Sincere Pharm. Grp., Inc., Annual Report (Form 20-F) 16 (Apr. 25, 2012) (noting that there exists in the pharmaceutical industry a series of corrupt practices, such as the acceptance by hospitals and medical practitioners of kickbacks, bribes, or other illegal gains or benefits from pharmaceutical manufacturers and distributors); .

33. *See, e.g.*, 21Vianet Grp., Inc., Annual Report (Form 20-F) 18 (Apr. 18, 2012) (noting that doing business with state or government-owned enterprises or government ministries places the company in frequent contact with "foreign officials" under the FCPA).

34. *See* Bohai Pharm. Grp., Inc., *supra* note 32; *cf.* 21Vianet Grp., Inc., *supra* note 33 (acknowledging that the company is subject to the FCPA although it is a foreign private issuer).

35. *See, e.g.*, Sincere Pharm. Grp., Inc., *supra* note 32.

competitors in China that are not U.S.-listed companies;³⁶ (vi) the issuer's compliance system, whether already in place or still being implemented or improved, may nevertheless fail to ensure the compliance of employees or of third parties with which the issuer deals;³⁷ (vii) some issuers, while not having the intent to bribe, gave gifts to government officials prior to becoming public companies in the United States;³⁸ (viii) failure to comply with anti-corruption laws will expose the issuer to significant liabilities and will harm its reputation, operations, and prospects.³⁹

Not all companies discuss every item in this list in their risk factor disclosures—if they even include one in their documents—since each could be more appropriate for some issuers than others. Nevertheless, if the securities laws could ensure that all China-based issuers assess the foregoing aspects of corruption risks as applied to them and consider disclosing accordingly, the overall information made available to investors (especially information specific to an issuer's industry and private knowledge subtly revealed “between the lines,” such as “prior gifting”) might be very rich. Not only would investors learn about each China-based company's corruption risks in the handy format of SEC filings, but they could also more easily compare corruption risk profiles across companies. Although further empirical evidence is wanting, risk disclosure requirements in securities regulations should be seriously considered by the SEC in order to protect investors from the corruption risks of China-based securities.

II. THE STANDARD-BASED DISCLOSURE REQUIREMENT FOR CORRUPTION RISKS

The current legal requirement for corruption risk disclosures can be viewed as a standard rather than a rule. A rule typically provides clear and specific guidance *ex ante* regarding permissible behavior; a standard, in comparison, looks mushy and flexible before the act and is often given content specific to the relevant factual circumstances by the adjudicator *ex post*.⁴⁰ As a result, in choosing a course of action *ex ante* under a standard-

36. See, e.g., Bohai Pharm. Grp., Inc., *supra* note 32; China Kanghui Holdings, Annual Report (Form 20-F) 19 (June 3, 2011).

37. See e.g., 21Vianet Grp., Inc., *supra* note 33; Sincere Pharm. Grp., Inc., *supra* note 32.

38. See, e.g., Keyuan Petrochemicals, Inc., Annual Report (Form 10-K) 38 (Apr. 13, 2012) (disclosing that the company had, prior to going public in the United States, given small gifts to government officials during spring festivals, which it believed would not trigger criminal liability under the PRC law).

39. See, e.g., *supra* notes 32–38.

40. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559 (1992) (“Arguments about and definitions of rules and standards commonly emphasize the distinction

based legal norm, an agent could face considerable uncertainty and, therefore, can be expected to exercise a greater amount of judgment than when acting under a rule.

The disclosure requirement for corruption risk under U.S. securities regulations is standard-based: there is no specific directive applicable to this issue. As previously noted, risk factor disclosures are a required component of registration statements under the Securities Act of 1933 (the Securities Act)⁴¹ and of annual and quarterly filings under the Securities and Exchange Act of 1934 (the Exchange Act).⁴² The SEC adopted separate but similar risk factor disclosure requirements, which are applicable to domestic issuers and to foreign private issuers in Item 503(c) of Regulation S-K and Item 3.D. of Form 20-F, respectively.⁴³ Aside from the general requirements that the most significant risks should be disclosed and that generic risks, or “risks that could apply to any issuer or any offering,” should be avoided,⁴⁴ Regulation S-K and Form 20-F offer very limited concrete guidance about which risks to disclose. Each does provide a few examples of possible risks that issuers “may” consider including,⁴⁵

between whether the law is given content *ex ante* or *ex post*.”). For a good summary of the “rule versus standard” debate in the constitutional law context, see generally Kathleen M. Sullivan, *Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 57–69 (1992).

41. See (Item 503) Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges: Risk Factors, 17 C.F.R. § 229.503(c) (2013); U.S. SEC. & EXCH. COMM’N, SEC 1852, FORM 20-F: REGISTRATION FORM/ANNUAL REPORT/TRANSITION REPORT Item 3.D (2012) [hereinafter FORM 20-F]; see also U.S. SEC. & EXCH. COMM’N, SEC 1981, FORM F-1: REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933 (2008) [hereinafter FORM F-1] (requiring disclosure in accordance with Form 20-F); U.S. SEC. & EXCH. COMM’N, SEC 870, FORM S-1: REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933 (2008) [hereinafter FORM S-1] (requiring disclosure in accordance with Regulation S-K).

42. See 17 C.F.R. § 229.503(c), Item 3.D; U.S. SEC. & EXCH. COMM’N, SEC 1673, FORM 10-K: ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 (2012) [hereinafter FORM 10-K] (requiring disclosure per Item 503(c)); U.S. SEC. & EXCH. COMM’N, SEC 1296, FORM 10-Q: GENERAL FORM FOR QUARTERLY REPORTS UNDER SECTION 13 OR 15(D) (2012) [hereinafter FORM 10-Q] (also requiring such disclosure); FORM 20-F, *supra* note 41.

43. See § 229.503(c); FORM 20-F, *supra* note 41.

44. § 229.503(c). The instruction for Item 3.D. of Form 20-F also requires that “[r]isk factors should be concise and explain clearly how the risk affects the issuer or the securities.” FORM 20-F, *supra* note 41.

45. See § 229.503(c) (suggesting that risk factors may include the issuer’s “lack of an operating history,” its “lack of profitable operations in recent periods,” its “financial position,” its “business or proposed business,” and its “lack of a market for [its] common equity securities or securities convertible into or exercisable for common equity securities”); FORM 20-F, *supra* note 41 (instructing a foreign private issuer to consider disclosing risks such as “the nature of the business in which it is engaged or proposes to engage; factors relating to the countries in which it operates; the absence of profitable operations in recent periods; the financial position of the company; the possible absence of a liquid trading market for the company’s securities; reliance on the expertise of management; potential dilution; unusual competitive conditions; pending expiration of material patents, trademarks or

but corruption risk is not mentioned in those examples.⁴⁶

Consequently, whether an issuer should disclose corruption risks turns on materiality: the classic standard-based norm in securities regulation that is generally applicable to disclosure issues.⁴⁷ Factual information is material if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁴⁸ Where the SEC has stopped short of using its rulemaking power to predetermine for issuers which information is important and relevant to investors and therefore worth disclosing, issuers are left with the materiality analysis, which is often open-ended and highly fact-specific.⁴⁹ So far there has not been any court decision on the specific topic of corruption risk disclosure.⁵⁰

While issuers’ discretion is limited by the potential liabilities they face if they omit material information, there is considerable room for them to decide *ex ante* about whether corruption risks are material enough for disclosure and to argue that determination *ex post*. By analogizing to similar judicial decisions and other authorities, sound arguments that corruption risk factors are material can be made.⁵¹ Counterarguments may

contracts; or dependence on a limited number of customers or suppliers”).

46. See § 229.503(c); FORM 20-F, *supra* note 41, Item 3.D.

47. 4 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.9 (6th ed. 2009).

48. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S.Ct. 1309, 1318 (2011) (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988)). The SEC also affirmed this standard. See Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,151 (Aug. 19, 1999) (to be codified at 17 C.F.R. pt. 211).

49. See, e.g., Additional Information, 17 C.F.R. § 230.408(a) (2013) (“In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.”); Additional Information, 17 C.F.R. § 240.12b–20 (2013) (“In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made not misleading.”).

50. For a doctrinal analysis of the viability of securities fraud claims over the disclosure of China’s country risks in general, see Peter M. Friedman, Note, *Risky Business: Can Faulty Country Risk Factors in the Prospectuses of U.S. Listed Chinese Companies Raise Violations of U.S. Securities Law?*, 44 COLUM. J. TRANSNAT’L L. 241, 264–73 (2005) (“[A] strong case can be made that in certain cases, Chinese issuers, their officers, their underwriters, and their lawyers could face civil liability under the Securities Act’s Section 11.”).

51. For example, the court has previously decided that facts pertaining to management integrity are likely to be deemed material. See HAZEN, *supra* note 47, § 12.9[3][B]. Also, according to the United States Court of Appeals for the Second Circuit’s formulation, which is also accepted by some other courts, material facts may “include . . . those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company’s securities.” *E.g.*, *Kronfeld v. Trans World Airlines, Inc.*, 832 F.2d 726, 732 (2d Cir. 1987); *SEC v. Mize*, 615 F.2d 1046, 1051 (5th Cir. 1980); *Northway, Inc. v. TSC Industries, Inc.*, 512 F.2d 324, 331 (7th Cir. 1975); *Sargent v. Genesco, Inc.*, 492 F.2d 750, 764 (5th Cir. 1974); *SEC v. Texas Gulf*

nevertheless point out that the SEC's materiality standard focuses much more on the disclosure of quantifiable information rather than non-quantifiable factors, such as corruption risks.⁵² Moreover, issuers have long been advised that they do not have a *per se* obligation to disclose even a material fact absent affirmative regulatory requirement.⁵³

Thinking in relatively abstract terms, allowing issuers discretion on corruption risk disclosures under the materiality standard could produce a "signaling game."⁵⁴ As issuers have different corruption risk profiles, the efficient equilibrium in such a signaling game, at which high-risk issuers disclose a greater amount of risk information and low-risk issuers disclose less or no risk information, could be reached. Assuming that securities regulations use risk factors to make riskier securities less attractive to investors than less risky ones,⁵⁵ achieving such a "separating equilibrium" would attest to the efficacy of securities law and in particular to the materiality standard. In reality, however, there is no evidence of honest signaling in this context. Potential liabilities for faulty disclosures may render honest signaling costly and thus may create incentives for it. As mentioned, however, liabilities for omitting corruption risks are far from certain. Moreover, as Part IV will describe, there may be other incentives that could counter the incentives created by legal liabilities. Consequently, as the next Part shows, in reality, not all China-based companies are disclosing corruption risks upon careful assessment of their respective

Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968). Information typically included in corruption risk factors does appear to be material according to such jurisprudence. See *supra* Part I. Furthermore, since 1976, the SEC has taken the position that "even if questionable or illegal payments are not quantitatively material, disclosure of such payments may be required because of their bearing on management's competency or integrity." Ralph C. Ferrara et al., *Disclosure of Information Bearing on Management Integrity and Competency*, 76 NW. U. L. REV. 555, 581 (1981). In addition, while some may argue that China's corruption issues are widely reported and that whether corruption risk disclosure may really alter the "total mix" of information available to investors is an open question, the United States District Court for the Southern District of New York has, in fact, in a recent case rejected a similar argument for immateriality. See *In re Fuwei Films Sec. Litig.*, 634 F. Supp. 2d 419, 438 (S.D.N.Y. 2009) (noting that pre-IPO disclosures in a Chinese language news article did not render subsequent non-disclosure immaterial).

52. See Amy Deen Westbrook, *Sunlight on Iran: How Reductive Standards of Materiality Excuse Incomplete Disclosure Under the Securities Laws*, 7 HASTINGS BUS. L.J. 13, 24–25 (2011).

53. HAZEN, *supra* note 47, § 12.9[1]; see also STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 45 (2d ed. 2008) ("[T]here is no general duty to disclose all material information . . .").

54. For a classic description of the signaling game, including the concepts of separating equilibrium, semi-pooling equilibrium, and pooling equilibrium referenced in this Article, see generally A. MICHAEL SPENCE, *MARKET SIGNALING: INFORMATIONAL TRANSFER IN HIRING AND RELATED SCREENING PROCESSES* 92–97 (1974).

55. THOMAS LEE HAZEN & DAVID L. RATNER, *SECURITIES REGULATION: CASES AND MATERIALS* 110–11 (6th ed. 2003).

exposure. From the perspective of investor protection, that can be quite problematic.

III. DEFICIENT DISCLOSURE

This Part presents some general observations on the disclosure practices adopted by China-based companies with respect to corruption risks. Public filing searches, which can be inherently crude and incomplete, were used to observe patterns in available disclosures that are sufficiently revealing for the mission of this Article.⁵⁶ As the following shows, the standard-based disclosure requirement has instead resulted in a “semi-pooling” equilibrium.

A. Who Discloses?

There are a number of China-based companies that have made corruption risk disclosures. These disclosing companies mainly include pharmaceutical companies, “backdoor-listed” companies, and a small number of companies that went public through a conventional IPO process.

Pharmaceutical and medical service companies are more likely to include a corruption risk factor in their IPO and periodic filings.⁵⁷ The disclosure is likely driven by the widely-held perception that China's pharmaceutical industry is subject to rampant corrupt practices and persistent government scrutiny and crackdown.⁵⁸

56. Specifically, Westlaw's EDGAR Filing search tool was used to perform searches for filings on Form F-1, Form 20-F, Form S-1, and Form 10-K, with alternative search terms of “China /20 corrupt!” and China /20 brib!” As of the latest search date of December 21, 2013, the first search yielded 1324 documents and the second 766 documents. Those results are expected to include at least the vast majority of SEC filings by both China-based companies and multinationals that may have mentioned China's corruption issues. To confirm negative findings (i.e., firms that have not disclosed corruption risks), EDGAR pages for the relevant companies on the SEC website have also been double-checked.

57. See, e.g., China Kanghui Holdings, Prospectus (Form 424B4) 26–27 (Aug. 11, 2010); China Nuokang Bio-Pharm. Inc., Prospectus (Form 424B4) 28 (Dec. 10, 2009); Simcere Pharm. Grp., Prospectus (Form 424B4) 18–19 (Apr. 20, 2007); Mindray Med. Int'l Ltd., Prospectus (Form 424B4) 10 (Sept. 27, 2006). But see ShangPharma Corp., Prospectus (Form 424B4) (Oct. 19, 2010) (neglecting to mention corruption anywhere in its filings).

58. See Mindray Med. Int'l Ltd., Annual Report (Form 20-F) (Apr. 8, 2013) (“Due to the conditions of competition in the markets for medical devices in China . . . [Mindray] believe[s] that corrupt practices may still occur . . . [including] inappropriate and unlawful payments or favors to influence procurement decision of customers, regulatory approval decisions of the China Food and Drug Administration, or CFDA, and clinical trials conducted by Chinese hospitals and medical institutions. . . . [Despite the company's compliance efforts, it or its distributors may still violate anti-bribery laws in various jurisdictions, for which it] could be required to pay damages or fines, which could materially and adversely affect [its] financial condition and results of operations. In addition, [its] brand and reputation, [its] sales activities or the price of [its] ADSs could be adversely affected if [the] company becomes the target of any negative publicity as a result of actions taken by [the company] or

Many smaller and more obscure companies that obtained their U.S. listings through so-called “reverse mergers” instead of a conventional IPO process⁵⁹ also disclose corruption risks. Companies in this group span a wide range of industries.⁶⁰ Consistent with empirical studies linking greater risk disclosures with higher litigation risks, such “backdoor-listed” companies may be advised to include corruption risk factors as protection against the growing hostility towards such companies since 2011.⁶¹

Finally, a few better-known companies that went public through underwritten IPOs have disclosed or have just started to disclose corruption risks in filings. For example, two hardware solution providers in the information technology sector, 21Vianet Group, Inc. and ChinaCache International Holdings Ltd., have included corruption risk factor disclosures in their documents.⁶² The disclosures of both companies are almost identical,⁶³ and the language suggests that substantial government contracting by each of the companies is the major concern driving the disclosure.⁶⁴ It is less clear why in 2013 Xinyuan Real Estate Co., Ltd., a China-based real estate company listed in New York, added a corruption

[its] distributors.”).

59. For a general introduction to these Chinese reverse merger companies, see generally Janelle A. McCarty, Note, *Mergers & Accusations: Chinese Auditing and Corporate Disclosure Standards Indirectly on Trial in the United States*, 21 MINN. J. INT’L L. 347 (2012).

60. Such companies are in the pharmaceutical, food, manufacturing, petrochemical, and waste recycling industries, among others. See e.g., Bohai Pharm. Grp., Inc., *supra* note 32; China Advanced Constr. Materials Grp., Annual Report (Form 10-K) 20 (Sept. 25, 2013); China Xuefeng Envtl. Eng’g Inc., Annual Report (Form 10-K) 21 (Sept. 11, 2013); Keyuan Petrochemicals Inc., Annual Report (Form 10-K) 38 (June 5, 2013); Asia Green Agric. Corp., Annual Report (Form 10-K) 20 (Mar. 29, 2013).

61. For background on the hostility against such companies, see McCarty, *supra* note 59, at 354–55; see also David M. Katz, *Chinese Reverse Mergers Spawned U.S. Class Actions, Report Says*, CFO, May 22, 2012, http://www3.cfo.com/article/2012/5/m-a_reverse-mergers-china-firms-class-action-cornerstone-research-heli-electronics.

62. See 21Vianet Grp., Inc., *supra* note 33; ChinaCache Int’l Holdings Ltd., Annual Report (Form 20–F) 14 (Apr. 26, 2013).

63. ChinaCache apparently modeled its risk factor disclosure on 21Vianet Group’s after ChinaCache decided to include such a risk factor in its 2012 annual report filing. 21Vianet has had such a risk factor since its IPO prospectus in 2011. See 21Vianet Grp., Inc., Prospectus (Form 424B4) 22 (Apr. 21, 2011); ChinaCache Int’l Holdings Ltd., *supra* note 62.

64. See 21Vianet Grp., *supra* note 33, at 16 (“[21Vianet] operate[s] in the data center services industry in China and generally purchase[s] [its] hosting facilities and telecommunications resources from state or government-owned enterprises and sell[s] [its] services domestically to customers that include state or government-owned enterprises or government ministries, departments and agencies. This puts [it] in frequent contact with persons who may be considered ‘foreign officials’ under the FCPA, resulting in an elevated risk of potential FCPA violations.”); see also ChinaCache Int’l Holdings Ltd., *supra* note 62 (acknowledging similar issues in the content and application delivery services industry).

risk disclosure to both its 2012 annual report⁶⁵ and a prospectus filed on Form F-3.⁶⁶ In addition, China Commercial Credit, Inc., a small credit firm incorporated in Delaware that went public in August 2013, disclosed a risk factor that only concerns FCPA.⁶⁷

The reasons China-based companies choose to disclose corruption risks can be further speculated upon, but that is not the focus of this Article. It suffices to say that the above information suggests that at least some China-based companies signal their higher corruption risk exposure to investors.

B. Who Does Not Disclose?

Many well-known China-based companies have never disclosed corruption risk factors. Such non-disclosing companies include, for example, large state-controlled enterprises (SCEs) in heavily regulated sectors such as oil and gas, energy, telecommunications, railroads, and airlines.⁶⁸ PetroChina Co. Ltd. (PetroChina), the New York- and Hong Kong-cross-listed unit of China's state-owned oil and gas giant, China National Petroleum Corp., is a good example of an SCE that faces exceptionally high risks of corruption. Not only does PetroChina operate in the highly regulated oil and gas industry, which involves frequent contacts with domestic and foreign government authorities and other state-backed counterparties, but its management and employees may also be deemed government officials under both the PRC Criminal Law⁶⁹ and the FCPA.⁷⁰ Despite PetroChina's potentially significant exposure, it has never warned investors in its filings about the corruption risks inherent in its operations.⁷¹ This potential disclosure deficiency is more significant since late August 2013, when Chinese authorities initiated corruption investigations against several former and then-incumbent senior executives

65. See Xinyuan Real Estate Co., Ltd., Annual Report (Form 20-F) 30 (Apr. 15, 2013).

66. See Xinyuan Real Estate Co., Ltd., Prospectus (Form 424B3) 19 (Nov. 18, 2013).

67. See China Commercial Credit, Inc., Prospectus (Form 424B4) 24 (Aug. 14, 2013).

68. See, e.g., China Mobile Ltd., Annual Report (Form 20-F) (Apr. 25, 2013); China Unicom (Hong Kong) Ltd., Annual Report (Form 20-F) (Apr. 25, 2013); Guangshen Ry. Co. Ltd., Annual Report (Form 20-F) (Apr. 24, 2013); China Petroleum & Chem. Corp., Annual Report (Form 20-F) (Apr. 11, 2013); Huaneng Power Int'l Inc., Annual Report (Form 20-F) (Apr. 17, 2013).

69. Article 93 of the PRC Criminal Law provides that state officials include persons carrying out public functions in state-owned companies. Zhonghua Renmin Gongheguo Xing Fa (中华人民共和国刑法) [Criminal Law of the People's Republic of China] art. 93 (promulgated by Order No. 83 of the President of the People's Republic of China, Mar. 14, 1997, effective Mar. 14, 1997), 1997 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 138.

70. The FCPA's definition of "foreign officials" has been interpreted liberally to cover employees of state-owned companies. Warin et al., *supra* note 1, at 44.

71. See, e.g., PetroChina Co. Ltd., Annual Report (Form 20-F) (Apr. 26, 2013).

of PetroChina, leading to declines in share prices in both New York and Hong Kong.⁷² In September 2013, investors filed two securities class action complaints against PetroChina in the United States District Court for the Southern District of New York, alleging that PetroChina had made false and misleading statements and had failed to disclose material facts with respect to its corruption issues.⁷³ Other New York-listed large Chinese SCEs such as Sinopec⁷⁴ and China Mobile,⁷⁵ which have also experienced turmoil in recent years due to corruption investigations, have not disclosed any corruption risks either.

SCEs are not alone in adopting a non-disclosure approach for corruption risks. Many privately owned companies that went public through conventional IPOs do not mention either general or specific corruption risks facing their operations in China.⁷⁶ Many of these companies operate in the high-tech sector,⁷⁷ which may be perceived as

72. On the day the news broke, PetroChina's NYSE-traded American depository declined by 4%. *PetroChina Falls as Corruption Probe Expanded*, BLOOMBERG BUSINESSWEEK NEWS, Aug. 28, 2013, <http://www.businessweek.com/ap/2013-08-28/petrochina-falls-as-corruption-probe-expanded>. PetroChina's Hong Kong-listed shares dropped by 4.4% following a one-day suspension. Isabella Steger & Mia Lamar, *PetroChina Loses \$1 Billion in Market Value*, WALL ST. J., Aug. 28, 2013, 5:16 AM ET, <http://online.wsj.com/news/articles/SB10001424127887323324904579040200172694292>.

73. See Class Action Complaint for Violations of the Federal Securities Laws at 2–6, *Hsu v. Petrochina Co.*, No. 13 Civ. 6274 (S.D.N.Y. Sept. 6, 2013); Class Action Complaint for Violations of the Federal Securities Laws at 2–4, *Broux v. Petrochina Co.*, No. 13 CV 6180 (S.D.N.Y. Sept. 3, 2013) [hereinafter *Broux Complaint*].

74. In 2009, Sinopec's former chairman was convicted of bribery. Shai Oster, *Sinopec Ex-chief Convicted of Graft*, WALL ST. J., July 16, 2009, at A.8, available at <http://online.wsj.com/news/articles/SB124764264846943917>.

75. Since 2010, China Mobile, the largest state-owned telecommunications operator, has counted 14 senior executives prosecuted or convicted for corruption-related crimes, including one in a recent investigation initiated around the same time as the PetroChina probe. Liao Zhijie, Chen Yong & Wu Qiaofa (廖志杰, 陈勇, 吴侨发), *Zhong Yi Dong Fan Fu Si Nian Shi Si Ren Luo Ma: Chuan Nei Bu Ming Dan Shang Wei Zhua Wan* (中移动反腐四年14人落马: 传内部名单尚未抓完) [Four Years of Anti-corruption Campaign Counted 14 Fallen Executives in China Mobile: The Prosecution Is Likely to Continue] *Xin Lang Ke Ji* (新浪科技) [SINA TECH.] (Aug. 24, 2013, 05:27), <http://tech.sina.com.cn/t/2013-08-24/05278671558.shtml>.

76. For example, only one of the eight companies that completed an IPO in 2013 included a corruption risk factor in its prospectus. See *China Commercial Credit, Inc.*, *supra* note 67. None of the others included similar disclosure language. See *Autohome Inc.*, Prospectus (Form 424B4) (Dec. 11, 2013); *500.com Ltd.*, Prospectus (Form 424B4) (Nov. 22, 2013); *Sungy Mobile Ltd.*, Prospectus (Form 424B4) (Nov. 22, 2013); *Qunar Cayman Is. Ltd.*, Prospectus (Form 424B4) (Nov. 1, 2013); *58.com Inc.*, Prospectus (Form 424B4) (Oct. 31, 2013); *Montage Tech. Grp. Ltd.*, Prospectus (Form 424B4) (Sept. 26, 2013); *LightInTheBox Holding Co., Ltd.*, Prospectus (Form 424B4) (June 6, 2013).

77. One account done in April 2012 shows that the largest group of China-based companies listed in the United States were from the technology sector. See Yingjie Zhang, *The Study on the Entry Mechanisms by Chinese Companies to the U.S. Market 15* (May 17, 2012) (unpublished B.S. thesis, State University of New York at Albany), available at http://www.albany.edu/honorscollege/files/Zhang_Thesis_Final.pdf.

relatively less susceptible to corruption. But some of these companies operate in more vulnerable industries, including resources and mining,⁷⁸ renewable energy,⁷⁹ insurance,⁸⁰ machinery and equipment,⁸¹ education,⁸² media,⁸³ and state-sponsored lotteries,⁸⁴ which are highly regulated and involve considerable government contacts in daily operations. There is a strong case for the latter group to disclose corruption risks.

C. A “Semi-Pooling” Equilibrium

As the preceding sections suggest, it is possible that quite a number of China-based companies with high corruption risks, including both SCEs and privately owned companies, have chosen not to warn their investors about such risks. Therefore, the equilibrium for the signaling game of risk disclosure under the materiality standard seems to be “semi-pooling,” at which some high-risk issuers are sending the same messages to investors as low-risk issuers. Normally, an investor may expect to be able to differentiate the corruption risk exposure of, for example, a large SCE such as PetroChina from that of an online social network operator by comparing risk disclosures. But at this equilibrium, the investors may not find this a straightforward task since neither company includes any corruption risk disclosures.

This is, of course, not to say that reasonable investors would be unduly naïve to think it plausible that the SCE and the internet company hold the same good faith belief that they face immaterial corruption issues. Instead, non-disclosure by otherwise high-risk companies could be interpreted by investors as a signal of such companies’ private knowledge that even visibly serious corruption risks in their industry are unlikely to have any quantifiably significant impact on them. From the perspective of outside investors, those companies, by not disclosing risk factors, could be signaling their “inside assessment” about how China’s anti-corruption campaigns work and their justifiable confidence in their capability of managing the process without damages. In hindsight, however, signals as such are most often misleading for the investors. The failure of high-risk China-based companies to disclose corruption risks and the presence of the

78. See, e.g., Yanzhou Coal Mining Co. Ltd., Annual Report (Form 20-F) (Apr. 27, 2012).

79. See, e.g., China Ming Yang Wind Power Grp. Ltd., Annual Report (Form 20-F) (Apr. 30, 2012); Yingli Green Energy Holding Co. Ltd., Annual Report (Form 20-F) (Apr. 26, 2012).

80. See, e.g., CNINSURE Inc., Annual Report (Form 20-F) (Apr. 24, 2012).

81. See, e.g., WSP Holdings Ltd., Annual Report (Form 20-F) (Apr. 30, 2012).

82. See, e.g., New Oriental Educ. & Tech. Grp. Inc., Annual Report (Form 20-F) (Oct. 12, 2012).

83. See, e.g., Phoenix New Media Ltd., Annual Report (Form 20-F) (Apr. 27, 2012).

84. See, e.g., 500.com Ltd., *supra* note 76.

semi-pooling equilibrium suggest that the standard-based requirement is not effective for the disclosure of corruption risks.

IV. PRACTICAL CHALLENGES IN DISCLOSURE DRAFTING

Practitioners have debated whether it is necessary or prudent for U.S. public companies with international operations to include risk factor language on FCPA compliance issues.⁸⁵ While some believe that the regulatory burdens and liability risks that the FCPA imposes on companies are significant enough to merit a risk factor,⁸⁶ others are skeptical about the benefits.⁸⁷ The PetroChina case described earlier seems to support the more cautious stance. In one complaint, plaintiffs alleged that PetroChina “made false and/or misleading statements and/or failed to disclose that: (1) the Company’s senior officials were in non-compliance with the Company’s corporate governance directives and code of ethics . . . (4) the Company lacked adequate internal and financial controls”⁸⁸ If PetroChina had even included a general risk factor to balance its disclosure about compliance, it may have at least benefitted from having an easier argument against the plaintiffs.

Commentators speculate that China’s ongoing anti-corruption campaign could place the securities disclosures of many more China-based companies under close scrutiny like that of PetroChina.⁸⁹ Until that actually happens, however, the perceived benefits of easier risk management may not provide adequate incentive for better corruption risk disclosure due to the challenges in the practical process of disclosure drafting discussed above, which lead many companies to avoid mentioning corruption in their disclosure documents.

This Part discusses such challenges, drawing primarily from observations on the ground.⁹⁰ Two useful preliminary notes should be made here to clarify some definitional issues. First, although securities information is primarily required to be disclosed by corporate issuers, the typical process of disclosure drafting often involves professional

85. See Di Schino, *supra* note 27, at 6 (noting that the necessity and prudence of disclosing in filings that a company is subject to the FCPA is unsettled).

86. *Id.* at 7.

87. *Id.* at 8 (quoting Claudius Sokenu, a partner at Shearman & Sterling LLP (“[I]f [a] company has an FCPA problem down the road, I’m not really sure what pointing to that general risk factor gets the company.”)).

88. Broux Complaint, *supra* note 73, at 4.

89. LaCroix, *supra* note 16.

90. These observations are based on the author’s previous practice experience and discussions with other lawyers specializing in capital markets transactions and securities compliance work.

intermediaries, such as outside lawyers and independent accountants. Where disclosure documents are being prepared for offering transactions, disclosure decisions also reflect significant inputs from investment banks that serve as underwriters of the relevant offerings and thus can be held liable for statements made in the disclosure documents. Due to the lack of both knowledge and language proficiency, most China-based companies have relied on professional intermediaries for disclosure drafting to a much greater extent than U.S.-based public companies typically do. As a result, disclosure decisions need to be understood in the context of the incentives and behavior of both the issuers and the professional intermediaries involved in the drafting process.

Second, while companies draft securities disclosures, including risk disclosures, for both offering transactions and periodic filings, this Part focuses on examining the dynamics of disclosure drafting in the former context, mainly for the purpose of economizing the discussion, since all important factors can be found in the transactional context but not necessarily in the periodic filing context. For example, the disclosure incentives for underwriters can be observed only in transactions. In addition, as a practical matter, China-based companies review disclosure issues much more closely in the transactional context. Risk factors drafted during the transactional process are also likely to be adopted and to remain “sticky” (i.e., virtually unchanged, even where language adjustment is appropriate) in periodic filings, especially for many China-based issuers that have short listing histories.⁹¹

A. Issuer Disincentives

China-based issuers typically face considerable disincentives to mention corruption risks in their public disclosure documents, especially in securities offering documents. Both corporate issuers and underwriters want the best possible pricing in offering transactions. Issuers, as advised by many investment banking professionals in China, still believe that the negative connotations of risks could hamper marketing efforts⁹² and should be avoided absent clear legal mandates. Furthermore, many Chinese

91. The stickiness of risk factor information in China-based company filings has also been analyzed as it relates to country risks in general. *See* Friedman, *supra* note 50, at 245–55 (finding that many China-based issuers made little change to country risk languages in their filings between mid-1990 and 2005 despite significant changes in underlying circumstances in China).

92. Although many practicing lawyers tend to dismiss such concerns when raised by issuers and underwriters in transactions, recent empirical evidence suggests that a negative disclosure tone indeed affects cost of capital and firm value. *See* Campbell et al., *supra* note 24, at 399 (“[N]egative/pessimistic disclosure increases cost of capital when a combined set of information sources is analyzed . . .”).

issuers, including but definitely not limited to SCEs, are reluctant to disclose corruption risks due to the fear of such disclosure's potential practical ramifications within China. Many companies see no point in inviting the Chinese government's closer scrutiny by putting on record that their business faces high corruption risks. Companies that conduct business or otherwise interact frequently with government bodies also raise concerns at drafting meetings that valuable or critical business relationships could be risked if they imply or even insinuate in public documents that corrupt practices may exist in their dealings with government counterparties.

B. Lack of Due Diligence Opportunities

Corporate and securities law scholarship has extensively discussed the supposed "gatekeeper" role that professional intermediaries play in complex business transactions such as securities offerings.⁹³ Typically, the negative consequences of potential legal liabilities and loss of reputation should make intermediaries more risk-averse than their clients on compliance matters such as disclosure. Nevertheless, in China-based securities transactions, professional intermediaries involved in the disclosure drafting process, such as underwriters and lawyers, also face weighty practical considerations against disclosing corruption risks. Generally, investment banks' internal policies place considerable emphasis on controlling anti-corruption compliance risks in connection with their securities underwriting business.⁹⁴ Bankers and the lawyers running transactions on the ground, however, have extremely limited means to conduct meaningful anti-corruption due diligence with China-based issuer clients. Market-accepted diligence practice usually consists of no more than one highly formalistic Q&A session with the issuer's management, which is unlikely to catch any "red flags."⁹⁵ Basic background checks are routinely performed through web searches, which usually reveal few

93. See generally John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986); Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583 (2010).

94. See, e.g., Wendy Wysong, *Why, Whether and When the FCPA Matters in Capital Market Transactions: The Asian Perspective*, CORP. COMPLIANCE INSIGHTS (Mar. 5, 2014), available at <http://www.corporatecomplianceinsights.com/why-whether-and-when-the-fcpa-matters-in-capital-market-transactions-the-asian-perspective/> (noting that investment banks' concern about FCPA risks has been rising in Asian capital markets transactions).

95. Typically, questions are framed in a "yes or no" fashion, seeking the knowledge of the management about potential compliance issues. Management expectedly answers "no" to all questions without explaining much further.

notable prior issues on the record. More thorough independent investigations are believed to be performed much less often than before, as such investigations have become increasingly risky in China.⁹⁶ Without the benefit of adequate and meaningful due diligence opportunities, the underwriters and lawyers have little basis on which to advise in favor of disclosure.

Over the years, the transactional dynamic has become increasingly issuer-dominated due to intensified competition for securities underwriting business in China's market.⁹⁷ Transactions underwritten by more than two lead banks have become the norm, and issuers are often not hesitant to fire or change underwriters even just before their deals launch. Although Chinese issuers still rely heavily on professionals to put together the necessary paperwork, they tend to treat underwriters and lawyers as functionaries rather than "gatekeepers," and they are not inclined to concede to the professionals on sensitive diligence and disclosure issues.⁹⁸ These dynamics are particularly unfavorable for corruption risk diligence and disclosure. Any underwriter in the syndicate will certainly find it silly to push the issuer "too hard" on corruption risk diligence and disclosure while letting its competitor win the client's favor by being "reasonable."⁹⁹

As diligence and disclosure have become much harder to obtain from the issuers, the investment banks have tended to fall back on other conventional risk management tools available to underwriters, such as issuer representations and warranties in the underwriting agreement and the "10b-5/disclosure letter" provided by lawyers. These tools, however, are not a perfect substitute for due diligence, as they afford no direct protection

96. See, e.g., Jane Perlez, *In China, the Dangers of Due Diligence*, N.Y. TIMES, Sept. 13, 2013, http://www.nytimes.com/2013/09/14/business/global/china-hems-in-private-sleuths-seeking-fraud.html?_r=0 (reporting incidents illustrating challenges and dangers, including the risk of criminal prosecutions, facing business investigators in China).

97. As the recent media report on and SEC investigations of J.P. Morgan's hiring practices in China revealed, competition has even driven the international investment banks to engage in questionable conduct themselves. Ben Protess & Jessica Silver-Greenberg, *On Defensive, JPMorgan Hired China's Elite*, N.Y. TIMES DEALBOOK (Dec. 29, 2013, 9:22 PM), <http://dealbook.nytimes.com/2013/12/29/on-defensive-jpmorgan-hired-chinas-elite/> (documenting J.P. Morgan's internal communications, which revealed its program to hire children of government officials for the purpose of competing with other investment banks for mandates).

98. Similar phenomenon and the negative consequences thereof have been noticed in general in business transactions with multiple "gatekeepers." See Tuch, *supra* note 93, at 1604 (describing the troubling prospect that a corporate issuer may interpose itself between the various professional gatekeepers so that none of them can effectively monitor such issuer).

99. Cf. *supra* Part III.A (noting that the filings of many "backdoor-listed" China-based companies and of tiny IPO companies such as China Commercial Credit often include corruption risk language, probably because such smaller companies have much less leverage over their financial and legal advisors and tend to largely defer to them on disclosure issues).

to the investors that are not parties to the documents. In addition, negative assurance provided in a law firm's 10b-5 letter is based on the relevant lawyers' actual subjective belief, which is inherently limited by the scope of their substantive inquiries.¹⁰⁰ Furthermore, also as a result of competition, China-based issuers have become much less receptive to terms contained in investment banks' allegedly "form" underwriting agreements, and many have attempted to cut back the more robust representations and warranties contained in the underwriting agreement.¹⁰¹

C. Market Norm and Group Think

Disclosure drafting practice has a highly conformist aspect. In particular, where the standard-based disclosure requirement offers little specific guidance, disclosure drafters often reference market practices.¹⁰² Although some have noted that "group think" seems to steer U.S.-based issuers towards including FCPA risk language in filings,¹⁰³ for China-based companies, the collective force has moved in the opposite direction. As a good number of non-disclosing issuers can be found on the market, non-disclosure has become the market norm, the deviation from which is generally discouraged. This norm makes it easier for the issuers to rationalize their preference for non-disclosure and makes it harder for underwriters and lawyers to request that issuers cooperate with enhanced corruption risk due diligence and disclosure where appropriate. China-based issuers often take such a pro-disclosure stance by the professional intermediaries as a lack of trust, especially if those parties have a prior record of working for other China-based companies that do not disclose

100. Subcommittee on Securities Law Opinions, Committee on Federal Regulation of Securities, ABA Section of Business Law, Report, *Negative Assurance in Securities Offerings (2008 Revision)*, 64 BUS. LAW. 395, 403 (2009); see also Tuch, *supra* note 93, at 1657 (noting an "apparent gap in liability . . . concern[ing] the basis of knowledge on which lawyers' negative assurance [in the 10b-5 letters] rests.").

101. See Youku.com Inc., Form of Underwriting Agreement (Form F-1/A, Ex-1.1) § 1(a)(lxviii) (Dec. 3, 2010) (illustrating "clean" representation language, without a knowledge qualifier, in the issuer's representation on anti-corruption law in a securities underwriting/purchase agreement, which is rare); see also Sungy Mobile Ltd., Underwriting Agreement (Form F-1/A, Ex.-1.1) § 2(1)(xliv) (Nov. 20, 2013) (illustrating that the knowledge qualifier can sometimes expand to apply to directors and officers, which is arguably not "market"); Baidu.com, Inc., Underwriting Agreement (Form F-1/A, Ex-1.1) § 1(a)(lxviii) (Aug. 4, 2005) (illustrating that the knowledge qualifier can sometimes expand to apply to the issuer itself, which is arguably not "market"). More aggressive cutbacks on anti-corruption representation language by the issuers have been seen in non-registered deals, but the underwriting/purchase agreements are not publicly available.

102. See Stephen J. Choi & G. Mitu Gulati, *An Empirical Study of Securities Disclosure Practice*, 80 TUL. L. REV. 1023, 1024–25 (describing certain network effects in disclosure practices that involve attorneys looking to the market standard disclosure practices as an indicator of the required disclosures).

103. Di Schino, *supra* note 27, at 5–6.

corruption risks. They also think that much of the requested diligence and disclosure is greater than the market standard and not legally required and that it simply serves the professional intermediaries' interest in managing their own exposure. Issuers are unlikely to be sympathetic to such disclosure advice, especially if any additional diligence or disclosure puts strains on the often ultra-tight transaction timeline or if it potentially affects the deal's marketing prospects.

V. CUTTING THE GORDIAN KNOT WITH A RULE-BASED DISCLOSURE REQUIREMENT

The practical dynamics in the disclosure drafting process create considerable counterforces to the interest of issuers and intermediaries in due diligence and a more adequate disclosure of corruption risks. Consequently, investors have lost the benefit of not only accurate information with which to evaluate risk but also potentially better risk management that might result from greater attention and from measures adopted as a result of adequate due diligence and disclosure analysis.

This Article proposes to replace the materiality standard with a rule-based requirement for the disclosure of corruption risks. Unlike the standard-based requirement, a rule-based disclosure requirement would remove much of the discretion of the issuer, as advised by professional intermediaries, over the disclosure of specified information.

The "rule versus standard" dichotomy, however, consists of possible middle points between the "pure" forms at the two extremes. Some disclosure requirements in the form of a rule may nevertheless have a materiality component. For example, Item 5.A. of Form 20-F requires foreign private issuers to "[d]escribe the impact of inflation, if material."¹⁰⁴ Similarly, a standard-based requirement can also incorporate rule-like components. Item 3.D. of Form 20-F, which documents the general standard for risk factor disclosures by foreign private issuers, nevertheless makes the disclosure of risks mentioned in a few examples similar to being regulated by rule-based requirements.¹⁰⁵ Legal norms in such intermediary, blended forms do not eliminate the issuer's judgment in producing disclosures as much as a pure rule. For disclosure of corruption risks, an alternative disclosure requirement might take the form of a brightline rule, requiring any issuers having significant operations (perhaps over a defined threshold) in high-corruption-risk jurisdictions to prominently disclose a risk factor. Alternatively, the rule might adopt a softer form by asking

104. FORM 20-F, *supra* note 41, Item 5.A.

105. *See supra* note 45 (quoting the risk factors that Item 3.D. suggests that issuers disclose).

issuers to describe their exposure to corruption risk in high-risk jurisdictions “if material.” The SEC might even look beyond risk factors and consider requiring issuers to specifically describe their anti-corruption compliance programs in prominent parts of their filings, such as the “Business” section; state their subjective evaluation of such programs’ effectiveness; and then allow them to include accompanying risk factor language.

These alternative approaches might create different incentives for corruption risk disclosure, and the SEC might choose among them based on policy considerations. But here it suffices to note that any of these approaches would be more effective than the current materiality standard at promoting informative disclosure of corruption risk based on more careful due diligence and analysis. By giving unequivocal notice to issuers that the Commission views corruption risk as one area of regulatory focus, the alternative requirements could elevate deliberation and diligence on corruption risks to a much higher priority in the disclosure drafting process. An explicit legal requirement should greatly reduce the incentive of issuers and intermediaries to take chances by remaining willfully ignorant. Even where issuers find the corruption topic sensitive and prefer avoiding it as much as possible, underwriters and legal advisors could feel much less stress when raising it with clients by pointing to legal requirements expressly referencing corruption risks. Especially for underwriters, requesting with a straight face additional diligence information and disclosure discussion time from the issuer would be much easier if the matter were a legal requirement rather than simply the bank’s internal policy. For China-based issuers, explicit regulatory requirements should also alleviate their concerns about risk disclosure’s potential ramifications at home. They could relatively easily explain to their government counterparties that the disclosure is made mostly to fulfill explicit regulatory requirements in connection with their overseas financing activities. If the rule-based requirement could incentivize China-based companies to generally more often include corruption risk language in filings, issuers would also worry less about drawing unwanted attention from Chinese anti-bribery authorities simply for making such disclosure.

Overall, a rule-based requirement should counter much of the challenges present in the disclosure drafting process under the materiality standard. Increased disclosure because of changed incentives in the drafting process might provide the market with more adequate information. With greater issuer cooperation, higher quality due diligence would also afford investors further protection by increasing the chance of uncovering issues and taking feasible remedial measures before launching the

transaction in the market.

VI. POSSIBLE OBJECTIONS TO THE RULE-BASED APPROACH

This Part offers a preliminary discussion of a few possible objections to the adoption of rule-based disclosure requirements for corruption risks. Rather than preempting such objections, the major goal here is to explore angles for further consideration of using disclosures effectively to regulate corruption risks in securities investment.

A. Just Another Example of Lawyers Asking for Useless Additional Disclosures?

A rule-based disclosure requirement should induce a greater number of corruption risk disclosures by China-based issuers. Some suggest that disclosure is “at worst, harmless”¹⁰⁶ and can provide no more than “too much information.”¹⁰⁷ Others, in contrast, worry that too much disclosure does more harm than good, as it may cause information overload.¹⁰⁸ Moreover, some argue that the pervasive mandated disclosure is a failure as the disclosed information is often wastefully under-utilized by the group that the disclosure requirements are intended to inform and protect.¹⁰⁹

The SEC has looked to enhance risk disclosures in recent years.¹¹⁰ In October 2013, current Chair of the SEC Mary Jo White noted that the lengthy risk factor sections in filings may suggest a problem of information overload to which the Commission needs to attend in considering a potential overhaul of disclosure requirements.¹¹¹ Without disputing in principle the concern of information overload, this Article has argued that more clearly stipulated disclosure mandates in the specific context of corruption risks of China-based securities may enhance investor protection.

106. Robert A. Hillman & Maureen O'Rourke, *Defending Disclosure in Software Licensing*, 78 U. CHI. L. REV. 95, 107 (2011).

107. STEPHEN BREYER, *REGULATION AND ITS REFORM* 163 (1982).

108. See WESLEY A. MAGAT & W. KIP VISCUSI, *INFORMATIONAL APPROACHES TO REGULATION* 90 (1992) (“Some authors have theorized that . . . consumers may become overloaded with information and respond to the additional information by making worse decisions.”); OMRI BEN-SHAHAR & CARL E. SCHNEIDER, *MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE* 169-82 (2014) (arguing that mandated disclosures can have perverse effects).

109. See generally BEN-SHAHAR & SCHNEIDER, *supra* note 108, at 33–54 (describing various documented failures of mandated disclosure).

110. Sarah Johnson, *SEC Pushes Companies for More Risk Information*, CFO MAG., Sept. 1, 2010, at 16, available at <http://ww2.cfo.com/risk-compliance/2010/09/sec-pushes-companies-for-more-risk-info/>.

111. Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Speech at the National Association of Corporate Directors Leadership Conference 2013: The Path Forward on Disclosure (Oct. 15, 2013), available at <http://www.sec.gov/News/Speech/DetailSpeech/1370539878806#.UrhZgbThfHY>.

As opposed to average consumers, securities investors unsurprisingly are found to actually consider and respond to such information.¹¹² The presence of a savvy investment community that constantly studies and digests company disclosures also makes it much more likely that securities disclosure will have an impact. Moreover, as Parts IV and V discussed, enhanced disclosure requirements for corruption risks could respond to challenges posed by practical social dynamics that hamper good due diligence and deliberation during the disclosure drafting process; improvement in the due diligence and deliberation process would provide greater protection to investors than disclosed information itself.

Under the rule-based requirement, all China-based companies might simply include a corruption risk in their filings so that a “semi-pooling” equilibrium would again prevent investors from distinguishing low-corruption-risk companies from high-risk ones. Even if that is the case, however, such pooling would be superior to the current equilibrium, at which investors can mistakenly interpret the non-disclosure by high-risk companies as signaling insignificant risk.¹¹³ Nevertheless, since low-risk issuers would still have incentives to achieve better pricing, the rule-based disclosure requirements could be designed to better promote differentiated signals. For example, a rule might incorporate a materiality component requiring all China-based companies to disclose corruption risk factors “unless they do not have material exposure” to such risk. Such rule would prevent issuers and underwriters from ignoring corruption risks but would allow non-disclosure if they were to conclude after careful evaluation that they had immaterial risk. In addition, the SEC should tolerate, as it in fact very often does, mitigating language¹¹⁴ in corruption risk factors, such as statements about the issuer’s industry being less susceptible to corruption than other sectors in China. Furthermore, as noted earlier, China-based issuers might be required to describe their anti-corruption compliance programs affirmatively in prominent sections of the filings. Where risk factor language used by different issuers might be reduced to boilerplates, disclosure of risk control would offer some issuers another opportunity to signal their relatively low corruption risks.

112. See Campbell et al., *supra* note 24.

113. See *supra* Part III.C.

114. The Staff generally advises against using mitigating language, such as clauses that begin with “while,” “although,” or “however,” in risk factors. See, e.g., *Staff Observations in the Review of Smaller Reporting Company IPOs*, U.S. SEC. & EXCHANGE COMMISSION (Mar. 4, 2009), <http://www.sec.gov/divisions/corpfin/guidance/cfsmallcompanyregistration.htm>.

B. Cost Matters?

Although implementing a rule-based requirement might generate benefits currently unavailable under the materiality standard, one may wonder if such benefits would be worth the associated cost.¹¹⁵ Without engaging in a more rigorous cost-benefit analysis, intuitively, incremental cost incurred by a rule-based requirement is unlikely to be excessive. The cost of additional drafting will be *per se* minimal given the existence of decent precedent disclosure language on the market.¹¹⁶ Greater cost might arise if issuers and underwriters are motivated by the disclosure requirement to conduct enhanced anti-corruption due diligence and spend greater time deliberating risk issues. But a large part of such cost can be deemed private because the enhanced diligence work often enhances firm value through improved governance and risk control.

C. Isn't the Current Requirement for Reporting on Internal Controls Sufficient?

The Exchange Act Rules require that registered companies maintain internal controls over financial reporting and include in their annual shareholder reports both management and auditor attestations on internal controls.¹¹⁷ Devising and maintaining effective internal controls can indeed overlap with a company's effort to control corruption risk. But the compliance reality in China suggests that even companies with formal internal controls attested to by auditors in accordance with the applicable standard may still be susceptible to systemic corruption risks.¹¹⁸ Moreover, the internal control report requirement is often less stringent on China-based companies, as many of them, being smaller or newly public, qualify for an exemption.¹¹⁹ An enhanced requirement for the disclosure of

115. Even the SOX burden is actually less than usually claimed, however. See Erica Fung, *Regulatory Competition in International Capital Markets: Evidence from China in 2004–2005*, 3 N.Y.U. J.L. & BUS. 243, 264 (2006) (noting a remark made by a financial/legal advisor in China that the frequently complained-of financial disclosure standards under the Sarbanes-Oxley Act of 2002 are not “difficult to meet” and that foreign issuers often “exaggerate the burden”).

116. See *supra* Part I.

117. See (Item 308) Internal Control over Financial Reporting, 17 C.F.R. § 229.308 (2013); Controls and Procedures, 17 C.F.R. § 240.13a-15 (2013); Controls and Procedures, 17 C.F.R. § 240.15d-15 (2013).

118. See, e.g., PetroChina Co. Ltd., *supra* note 71, at 98 (concluding that PetroChina's internal controls were effective, which was attested to by its auditor PricewaterhouseCoopers).

119. See, e.g., 15 U.S.C. § 7262(b)–(c) (2012) (requiring domestic and foreign registrants that are non-accelerated filers or “emerging growth companies” to include the management report but not the auditor attestation report on internal control); 17 C.F.R. § 229.308 (exempting a company that has newly conducted an IPO from complying with the internal control reporting requirements until its second annual report filed with the SEC).

corruption risk factors might be useful for duly warning investors and for reminding issuers about the inherent limit on standard internal control. This additional incentive would be particularly favorable if the incremental cost is limited.

D. Is a Chinese Problem Worth a General Rule of U.S. Securities Regulation?

It is nothing novel for U.S. securities laws to impose heightened disclosure requirements relating to specific countries.¹²⁰ In the vaguely drafted Item 3.D. of Form 20-F, the SEC suggested that an issuer consider disclosing risks “relating to the country where it operates.”¹²¹ Although this Article discusses corruption risks relating to China-based securities, however, corruption risks are definitely not special to China. As they are beyond the scope of this Article, further studies may look into whether securities disclosures by issuers from such other jurisdictions as India and Latin America face similar deficiencies in disclosing corruption risks. Conceptually, designing a rule-based disclosure requirement to cover countries with high corruption risks in general would not be too difficult. The scope of such a rule’s application might be defined, for example, by referring to third-party corruption research, such as the Corruption Perception Index published by Transparency International.¹²²

CONCLUSION

Corruption poses multifaceted risks to securities investors who look for protection provided by securities regulation. Some have argued that it may have been an over-stretch for the SEC to deviate from its core institutional mission by engaging in the battle against overseas corruption by actively enforcing the FCPA.¹²³ This Article serves as a reminder that there is still potential room to improve the regulation of corruption risks through enhanced risk disclosure requirements and that such regulatory effort would fall squarely within the parameters of the U.S. securities laws’ core mission of protecting investors by promoting full disclosure of information. Drawing upon filing searches and practical observations, this Article calls for attention to the practical challenges present in the securities

120. A recent example is the addition of Section 13(r) to the Exchange Act, requiring issuers to disclose dealings with Iran. *Notice Required by the Iran Threat Reduction and Syria Human Rights Act of 2012 to Be Filed Through EDGAR*, U.S. SEC. & EXCHANGE COMMISSION (Dec. 19, 2012), <http://www.sec.gov/divisions/corpfin/cfannouncements/itr-act2012.htm>.

121. FORM 20-F, *supra* note 41, Item 3.D.

122. See TRANSPARENCY INT’L, *supra* note 2.

123. See, e.g., Black, *supra* note 18, at 1095.

disclosure drafting process, which are understood to contribute to deficient corruption risk disclosures by China-based companies. By replacing the current disclosure requirement based on the materiality standard with a rule-based requirement, both disclosures of and underlying due diligence on corruption risks should more effectively inform and protect investors in China-based securities.

As the SEC is conducting its latest round of reviews of the securities disclosure regime, the announced regulatory preferences seem to be streamlining risk disclosures and eliminating boilerplates.¹²⁴ Even though improvement is due, this Article suggests that ideas for reform should not be anchored to only reducing disclosure. Instead, the Commission should remain open to different options and carefully analyze the behavioral impacts of different forms of disclosure requirements.¹²⁵ While the findings and observations in this Article are inherently qualified by its limited methodology,¹²⁶ future studies may employ more rigorous empirical analytical tools to shed further light on how disclosures may be more effectively used as a relatively inexpensive way to regulate investment risks.

124. See White, *supra* note 111 (using risk factors disclosure as an example for disclosure language that might have grown more lengthy than really needed).

125. For an interesting proposal to reform risk factor disclosures based on the insights from behavioral law and economics, see Tom C. W. Lin, *A Behavioral Framework for Securities Risk*, 34 SEATTLE U. L. REV. 325 (2011).

126. See *supra* notes 56 and 90.