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Institutional Arbitrage: China's Economic Power Projection and International Capital Markets

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Abstract

How has China been able to offset its institutional weaknesses at home while achieving impressive economic results worldwide without having had to move closer to the existing models of western countries? This article examines international capital market practices and explains why in just a decade, China and its firms have transformed from inexperienced conformists, to sophisitcated players, to finally game-changers dominating today's headlines.

By proposing the idea of "institutional arbitrage," this article argues that China compensates for its internal institutional deficits by leveraging the complexity of regulatory regimes across various countries, and thereby pursues its development strategy with unprecedented speed. With Rule 144A and Regulation S of the U.S. Securities Act serving as a platform for such approach, obscure domestic regulations in China further set a firewall between domestic and global markets to minimize risk exposure. Consequently, risks are transferred across borders and flow into less-regulated markets overseas, as evidenced by the recent outbreak of corporate frauds surrounding Chinese firms in major global stock exchanges. The proliferation of activities of Chinese firm overseas will foster more political and regulatory clashes between Chinese and foreign regulators in the foreseeable future.

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INTRODUCTION

China's aggressive participation in global capital markets dominates today's headlines, leaving informed observers with mixed feelings. Not only are there landmark transactions, such as the Agriculture Bank of China recording the biggest initial public offering ("IPO") in financial history at the time, statistics tell the larger story: China has become the world's biggest IPO market despite the global downturn and Chinese company listings on global exchanges set a record in 2010, with 129 IPOs, up from 77 in 2009.[1] Moreover, since January 2008, Chinese firms have disclosed 1,414 overseas acquisitions, valued at about $235 billion; of those deals, 198, valued at about $40.6 billion, occurred in 2012.[2] In the U.S. alone, 2012 is also a record year for Chinese outbound direct investment, with completed deals worth $6.5 billion, a 17% increase from the previous record of $5.5 billion in 2010.[3]

At the same time, the substantial Chinese presence in the market has fueled international controversies about alleged accounting frauds, national security consequences of Chinese companies acquiring foreign assets, and disputes between Chinese and foreign regulators.

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1 Gillian Zhang, Zero2IPO Research Center, *324 Chinese IPOs Raised US$53.8B in Jan-Nov 2011 with 154 VC/PE-backed IPOs Down 20.0% YoY* (Jan. 6, 2012, 4:21 PM), http://www.pedaily.cn/Item.aspx?id=218355; Samuel Shen & Jacqueline Wong, *China's IPO Market the World's Biggest Despite Slump*, REUTERS (Jan. 4, 2012, 1:48 PM), http://www.reuters.com/article/2012/01/04/us-china-ipo-idUSTRE8030IP20120104.

2 Simon Hall et al., *China Push in Canada Is Biggest Foreign Buy*, WALL ST. J. (July 24, 2012), http://online.wsj.com/article/SB10000872396390443437504577544470741886332.html.

3 Thilo Hanemann, *Chinese FDI in the United States: Q4 2012 Update*, Rhodium Group (Jan 16, 2013), http://rhg.com/notes/chinese-fdi-in-the-united-states-q4-2012-update.

China's sovereign wealth fund and mighty state-owned enterprises have also challenged the conventional thinking of corporate governance and global regulatory structure.

How can we interpret this phenomenon from a theoretical perspective? In particular, how has China been able to offset its institutional weaknesses at home while achieving such impressive results without moving further toward the existing models of western countries? Political scientists label this economic supremacy as "Chinese state capitalism",[4] while economists emphasize the strength of "latecomer advantage."[5] Resonating the two schools of thought from an institutional perspective in law and development, this paper uses international capital market practices to illustrate how the Chinese developmental state compensates for its domestic institutional deficits by leveraging institutions across various jurisdictions, and thereby pursues its development strategy at an unprecedented speed. I call this approach "institutional arbitrage."[6]

In finance, arbitrage is a speculative practice that takes advantage of price differences between multiple markets, pursuing an almost guaranteed profit by buying low at one market and selling high at the other. The flip side of price and profit is risk. In theory, arbitrage is risk-free as it is an exchange where the profits are known beforehand; in practice, however, arbitrage may incur enormous risks simply because the betting is carried out not in a perfect market, but in a real world where unforeseen variables, drastic changes of market

[4] See, e.g., The Economist, The Rise of State Capitalism (Jan. 21, 2012); Philip C. C. Huang, Profit-Making State Firms and China's Development Experience: "State Capitalism" or "Socialist Market Economy"?, 38 MODERN CHINA 591 (2012).

[5] For a representative discussion, Lin Yifu (林毅夫) et al., Zhong Guo de Qi Ji: Fa Zhan Zhan Lüe yu Jing Ji Gai Ge (中国的奇迹发展战略与经济改革) [The Chinese Miracle: Development Strategy and Economic Reform] (Shanghai Renmin, 2nd ed., 2002); Justin Yifu Lin, *Development 3.0*, THE STRAITS TIMES (June 27, 2012), http://www.straitstimes.com/microsites/global-perspectives/story/justin-yifu-lin-development-30.

[6] "Institutional arbitrage" was initially constructed by strategic business management literature that aim to analyze the situation where a firm exploits the differences between two institutional environments of two countries, usually the home country and a host country where the firm invests in, to maximize its profits and advantages. Ajai S. Gaur & Jane W. Lu, *Ownership Strategies and Survival of Foreign Subsidiaries: Impacts of Institutional Distance and Experience*, 33 J. MGMT. 84 (2007); Max Boisot & Marshall W. Meyer, *Which Way through the Open Door? Reflections on the Internationalization of Chinese Firms*, 4(3) MGMT. & ORG. REV. 349 (2008).

conditions, or the complexity of different rules across markets often catch the arbitrageur off guard.

This paper uses arbitrage as a metaphor to describe an approach adopted by the Chinese state and companies of making up flawed institutions at home, and thereby borrowing time and acquiring managerial expertise for reforms while accessing foreign capital to achieve development goals. Like arbitrage, however, this strategy isn't risk-free, either for Chinese firms or the global capital markets, in that the risks from the domestic institutional weakness are not dissolved but rather diffused globally.

I will begin with a brief discussion about Chinese state capitalism and its interaction with international capital markets (Part I), followed by an analysis of institutional arbitrage (Part II), its impacts on global regulatory regimes (Part III), and a number of identified patterns (Part IV) before concluding.

I. CHINESE STATE CAPITALISM AND INTERNATIONAL CAPITAL MARKETS

Scholars of law and development stress that institutions matter, but how they matter and which institutions matter most remain hotly contested questions.[7] In the Asian context particularly, activist developmental states usually undermine conventional assumptions regarding legal regulations. The classic liberal model emphasizes government constraint rather than empowerment, whereas public-private capitalistic coalitions in East Asia require a government that is both constrained and, more importantly, empowered.[8]

[7] For an excellent symposium discussion about the challenges for current law and development thinking, see, e.g.,Tom Ginsburg, *The Future of Law and Development*; Katharina Pistor, *There Is No Single Field of Law and Development*; Mariana Prado, *Should We Adopt a "What Works" Approach in Law and Development?*; D. Daniel Sokol, *Law and Development—The Way Forward or Just Stuck in the Same Place? in Symposium: The Future of Law and Development,* NW. U. L. REV. COLLOQUY, Vol.104, at 164 (2009), http://colloquy.law.northwestern.edu/.

[8] Tom Ginsburg, *Does Law Matter for Economic Development? Evidence From East Asia,* 34 LAW & SOC'Y REV. 829, 836-37 (2000) (discussing how the accounts of public-private coalitions in East Asia challenge the conventional theory about the role of law).

A. Why is Chinese State Capitalism Unique?

State capitalism is hardly new in Asia, but Chinese state capitalism is unique and is distinguished by two characteristics. First, it relies on foreign investment, with a high degree of dependence on international capital markets.[9] Second, it is directly led by state-owned enterprises ("SOEs") and state-controlled firms.[10] Since 2007 when the sovereign wealth fund China Investment Corporation ("CIC") was incorporated, big SOEs have been receiving further financial support from the CIC to expand globally and invest actively in international financial institutions and the natural resources sector.[11] These two characteristics sharply contrast the Chinese model with its predecessors in East Asia.

Compared to its Chinese counterpart, state capitalism in Japan, Korea and Taiwan relies more on domestic capital and largely is led by private enterprises, with guidance and strong support from developmental state institutions.[12] A recent cross-country study of state capitalism also indicates more complex and dynamic patterns of corporate structure---a hybrid of majority and minority shareholding in various forms of business entities---that Chinese state capitalism has developed and relied upon compared to those of its counterparts in the old days.[13] In the following sections, I look at how Chinese state capitalism has been adapted to global capital markets regulations while continues to adapt domestically through institutional designs.

[9] *See, e.g*. Barry Naughton, The Chinese Economy: Transitions and Growth, at 401-06 (2007) (discussing the predominance of foreign investment in China); Yasheng Hunag, Selling China: Foreign Direct Investment During the Reform Era, at 6-14 (2005) (discussing China's substantial reliance on foreign direct investment).

[10] SOEs dominated the 2010 list of China's top 500 companies, with 329 SOEs earning more than 80 percent of the total revenue. *SOEs Dominates Top 500 List*, PEOPLE'S DAILY ONLINE (Sept. 06, 2010), http://english.people.com.cn/90001/90778/90862/7130352.html; Also, YASHENG HUANG, CAPITALISM WITH CHINESE CHARACTERISTICS, at 278-81(2008) (discussing the state-led capitalism in China compared with other East Asian countries).

[11] Jianfei Zhao, *Overseas Acquisitions: A Chorus Without a Conductor*, CAIJING (Feb 25, 2009), http://english.caijing.com.cn/2009-02-25/1 10074133.html. For a general discussion, for example, Mariana Pargendler, *State Ownership and Corporate Governance*, 80 FORDHAM L. REV. 2917 (2012); Souvik Saha, *CFIUS Now Made in China: Dueling National Security Review Frameworks as a Countermeasure to Economic Espionage in the Age of Globalization*, 33 NW. J. INT'L L. & BUS. 199 (2012).

[12] Huang, *supra* note 10, at 280 (noting the insignificant role of foreign direct investment in the successful export production model of the East Asian economies except for Singapore).

[13] Aldo Musacchio & Sérgio G., Lazzarini, *Leviathan in Business: Varieties of State Capitalism and Their Implications for Economic Performance*, working paper (May 30, 2012), available at SSRN: http://ssrn.com/abstract=2070942.

B. How Does Chinese State Capitalism Shape Market Institutions at Home and Worldwide?

The Chinese government has adopted an approach of "institutional bypass" domestically.[14] This involves creating favorable rules and institutions that attract inward foreign investments and encouraging big SOEs and state-controlled firms to go abroad,[15] thereby circumventing institutional weakness or barriers pertaining to the SOEs, banking system, and corporate governance.[16] For instance, China's domestic capital markets have so far not proven effective in either providing sizable amounts of capital to firms or in disciplining the management of listed companies.[17] The problems of corporate governance in China have also been well-documented, including concentration of state ownership, lack of independence among board directors, false financial disclosure, insider trading, and limited

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[14] For a general discussion of institutional bypass, Mariana Mota Prado, *Institutional Bypass: An Alternative for Development Reform* (University of Toronto, working paper, Apr. 19, 2011), *available at* http://ssrn.com/abstract=1815442.

[15] Historically the Chinese government is very cautious about foreign listings because greater concentration of foreign control over Chinese companies may affect central planning of economy, such as money supply in the economy. However, exceptions have been made for big SOEs since the early 1990s when the Deng Xiaoping/Zhu Rongi administration decided to take advantage of limitless capitals available overseas. Since then, Beijing has encouraged its "national champion" SOEs to pursue overseas listings by providing favorable credit and tax policies and by actively assisting in the investment process. By contrast, private firms that intend to pursue overseas listings have to circumvent a handful of legal restrictions by, for instance, reverse merger, overseas holding company structure, joint venture structure, or variable interest equity ("VIE") structure. Such legal restrictions on foreign listings can be seen in the Notice on Issues Concerning Overseas Listing Application of Enterprises (1999) ("1999 Notice") and the Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors (2006), both of which set high thresholds and tough preconditions for Chinese firms pursuing overseas listings. However, the Chinese regulators have lifted some of such restrictions recently. In December 2012, the China Securities Regulatory Commission abolished and replaced the 1999 Notice with the Regulatory Guidance on Application Documents and Examination Procedures of Issuing Shares Abroad and Overseas Listing by Company Limited by Shares (effective on 1 Jan 2013). For general discussion, *see* I.A. TOKLEY & TINA RAVN, COMPANY AND SECURITIES LAW IN CHINA, 85 (1998); CARL E. WALTER & FRASER J. T. HOWIE, RED CAPITALISM: THE FRAGILE FINANCIAL FOUNDATION OF CHINA'S EXTRAORDINARY RISE (2011).

[16] *See, e.g,* Naughton, *supra* note 9, at 406-13 (discussing a generally favorable regime for foreign investments in China); Yasheng Huang, *One Country, Two Systems: Foreign-invested Enterprises and Domestic Firms in China*, 14 CHINA ECON. REV. 404 (2003); Weitseng Chen, *WTO: Time's Up for Chinese Banks-China's Banking Reform and Non-Performing Loan Disposal,* 7 CHI J. INT'L L. 239 (2006).

[17] See, e.g., Lay-Hong Tan & Jiangyu Wang, Modeling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy, J. CORP. L. STUD., Vol. 7, No. 1, Apr. 2007, at 143 (discussing the issues of China's corporate governance regime and overall institutional weakness regarding the domestic capital markets); SATYANANDA J. GABRIEL, CHINESE CAPITALISM AND THE MODERNIST VISION, at 147 (2006) (noting that Chinese firms usually raise money only once through domestic stock markets in the form of an IPO and rarely dip back into the stock market for additional funding through secondary offerings).

private enforcement through litigation.[18] The institutional bypass approach confers an instant advantage and provides big SOEs a short cut to foreign capital, albeit with foregoing structural problems at home.

Furthermore, the fact that Chinese state capitalism is led by the SOEs has given rise to a corporate governance regime that allows state intervention. Many international lawyers involved in SOE global securities offerings report not to a board of directors but to a decision-making party committee, the members of which are usually appointed under political consideration.[19] This institutional design lets the government guide SOEs and extract immense revenues from them. In 2010, 121 SOEs directly overseen by the State-Owned Assets Supervision and Administration Commission posted a combined profit of 1.13 trillion yuan (US$182 billion) and handed over about 60 billion yuan (US$9,639 million) to the government.[20] The state can, in turn, reallocate resources within the public-private coalition in a strategic manner by, for example, establishing and expanding the sovereign wealth fund, which has played a crucial role in global capital markets.[21]

Unsurprisingly, the immense scale of Chinese state capitalism has long-term implications for international capital markets. Along with increasing their economic power, the Chinese

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[18] See, e.g., Donald C. Clarke, Law Without Order in Chinese Corporate Governance Institutions, 30 NW. J. INT'L L. & BUS. 131 (2010); Yong Kang et al., The Rand Corporation, Chinese Corporate Governance: History and Institutional Framework (2008), http://www.rand.org/pubs/technical_reports/TR618.html.

[19] Katharina Pistor has used the concept of "human resource management" to illustrate how the CCP has been able to implement a relatively coherent policy through its control of the human resource of SOEs without greatly compromising market efficiency. See Katharina Pistor, *The Governance of China's Finance*, *in* CAPITALIZING CHINA (Joseph P. H. Fan & Randall Morck eds., 2012) (discussing the pros and cons of the CCP's human resource management within SOEs as an alternative corporate governance model in China).

[20] Since 2011 China has begun collecting profits from more SOEs (approximately 1,631 SOEs, up from about 120 previously), with a higher proportion of their profits to be paid to the state. *More State Companies' Profit For Social Welfare*, PEOPLE'S DAILY ONLINE (Feb. 23, 2011, 8:28 AM), http://english.people.com.cn/90001/90778/7296669.html; *Why China collects earnings from more SOEs?* PEOPLE'S DAILY ONLINE (Nov. 4, 2010, 11:59 PM), http://english.people.com.cn/90001/90778/90862/7188893.html.

[21] For a description, *Larry Cata Backer, Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State-Owned Enterprises, and the Chinese Experience*, 19 TRANSNAT'L L. & CONTEMP. PROBS. 3 (2010); SCOTT B. MACDONALD & JONATHAN LEMCO, ASIA'S RISE IN THE 21ST CENTURY, at 103 (2011) (noting the background and formation of the China Investment Corporation in 2007); China's Sovereign Wealth Fund Received $30 Billion New Capital Last Year, BLOOMBERG NEWS (Mar. 4, 2012, 3:24 PM), http://www.bloomberg.com/news/2012-03-04/china-s-sovereign-wealth-fund-received-30-billion-new-capital-last-year.html.

government and SOEs are leveraging their market status to better position themselves in globalized capital markets, and gradually are changing their attitude toward existing regulations and practices and becoming more visionary in a bid to re-shape the rules of the game.

Thanks to globalization of capital markets, China is able to adopt an "institutional arbitrage" approach to compensate for its own institutional deficits at home by reaping comparative institutional advantages worldwide, across different jurisdictions and varying regulatory regimes. Other developing countries and firms may adopt the same approach, but they barely bring about as great impact as China has. Size matters; for example, Chinese high-yield offerings have dominated global bond issuances the past few years as numerous PRC issuers from various industry sectors have taken turns executing deals. Furthermore, Beijing's policy to internationalize renminbi (RMB) as a rival to the U.S Dollar has gradually and systematically changed the configuration and practices of international capital markets, as manifested by the boom of RMB-denominated bonds beginning in 2010 and the establishment of offshore settlement centers for RMB business recently in Hong Kong, Singapore, Macau, London, Taiwan, and potentially, Luxemburg in the near future. In just 10 years, China and its SOEs have transformed themselves with unprecedented speed from students learning and adapting to existing capital market practices, to savvy players enjoying being part of the establishment, to, finally, game-changers.

II. CHINA'S INSTITUTIONAL ARBITRAGE IN INTERNATIONAL CAPITAL MARKETS

A. Institutional Arbitrage and Chinese State Capitalism

Chinese state capitalism represents a coalition consisting of the developmental state and its affiliates in the market, namely, SOEs and state–controlled companies. Contrasting with the orthodox view of institutions as humanly devised *constraints* that structure human interactions,[22] I emphasize institutions as *resources* that China and its firms strategically utilize for solving problems of cooperation, risk distribution, and implementation of development strategies.[23]

Whereas traditional arbitrage is about individual market players taking advantage of information asymmetry and price differences between multiple markets, institutional arbitrage focuses on the way in which the developmental state and its affiliates leverage the complexity and differences between multiple systems of regulations across countries to pursue their development goals and/or carry out long-term strategies. Consequently, risks and costs caused by institutional deficiencies may cross borders and flow into less-regulated markets, as exemplified by current global market practices examined below.

B. Putting New Wine in Old Bottles: Platforms for Institutional Arbitrage

China's institutional deficits relating to capital markets and corporate governance have barely disadvantaged Chinese firms in the global capital and financial arena; yet this would not have been possible but for a crucial regulatory platform structured by Rule 144A and Regulation S under the U.S. Securities Act of 1933, as amended (the "Securities Act"). Rule 144A and Regulation S are two exemptions granted by the U.S Securities Exchange Commission ("SEC") in 1990 to exempt securities issuers from full compliance with the Securities Act, thereby allowing these issuers to access the global and American capital markets without going through a time–consuming registration process.[24] Without these two exemptions, the past decade would not have seen a skyrocketing number of global securities offerings by Chinese firms.

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[22] Douglass C. North, *The New Institutional Economics and Third World Development, in* THE NEW INSTITUTIONAL ECONOMICS AND THIRD WORLD DEVELOPMENT (John Harriss et al. eds., 1995) at 23.

[23] This view resonates with a developing literature of international business that focuses on how market players view institutions as resources for solving problems of economic coordination based on firm-specific resources. *See, e.g.*, Gregory Jackson & Richard Deeg, *Comparing Capitalism: Understanding Institutional Diversity and Its Implications for International Business*, 39 J. INTE'L BUS. STUD. 540 (2008); W.P. Wan, *Country Resource Environments, Firm Capabilities and Corporate Diversification Strategies*, 42 J. MGMT. STUD. 161 (2005).

[24] 17 C.F.R. § 230.144A (2012). Rules 901 through 905 of the Securities Act form the body of Regulation S. *See* 17 C.F.R. §§ 230.901-.905 (2012).

In contrast, Chinese law only has to play a very limited role in PRC firms' international capital market transactions.[25] First of all, the governing law of each transaction is made not by the PRC but by foreign jurisdictions, usually New York State. Second, PRC firms' financial advisors and U.S. lawyers are mainly concerned about potential liability should their clients fail to comply with U.S. securities laws; hence PRC laws are less of a focus in the execution of exempted transactions. Third, as far as the PRC laws are concerned, Chinese issuers often will not hesitate to represent no compliance issue under PRC law in order to fulfill the requirement by the exemptions that allow foreign issuers to follow their home state regulations regarding corporate governance, disclosure and accounting standards, instead of those of the host state. As a result, the two exemptions greatly relieve the compliance burdens for PRC firms and their professional advisors and similarly reduce their potential liability.

Prior to the adoption of Rule 144A, foreign borrowers wishing to raise large-scale capital in the U.S. were forced to use the New York market by structuring their cross-border offerings as domestic U.S. securities offerings, which required a lengthy and expensive registration process.[26] This is now not the case, as Rule 144A provides an exemption for foreign issuers intending to sell their securities in the U.S. if their securities are sold only to qualified institutional buyers, such as banks and savings associations. Thanks to Rule 144A, U.S. institutional investors have also gained a quick channel to foreign investment opportunities and hence can benefit from higher rates of return globally.[27] Similarly, regulation S provides issuers an exemption from registration if the offer and sale of securities

[25] It is worth noting that various domestic regulations still put strict restrictions on foreign listing applications made by Chinese companies, especially private firms. Nevertheless, once a foreign listing approval has been granted, like most international offerings, home state laws play a very limited role during the execution of a global transaction. *See supra* note 15.

[26] GEOFFREY FULLER, THE LAW AND PRACTICE OF INTERNATIONAL CAPITAL MARKETS, at 92-98 (2007) (discussing the international capital market practices prior to the adoption of Rule 144A and Regulation S).

[27] Kellye Y. Testy, *Comity and Cooperation: Securities Regulation in a Global Marketplace*, 45 ALA. L. REV. 927, 930-32 (1994) (noting that US companies may benefit from the adoption of Rule 144A given the rock-bottom interest rates and sluggish corporate earnings growth found domestically at the time).

are made outside the U.S. and no "directed selling efforts" are made in the . This way, American companies can foster their fund-raising overseas without compromising the protection of U.S. investors.[28] To be eligible for the exemptions, issuers can only sell securities through private placements, instead of public offerings that still require registrations with the SEC.

Regardless the importance of the exemptions for Chinese issuers, Chinese firms were not part of the equation when the two exemptions were created. Most Chinese SOEs and private enterprises were still struggling to survive in the late 1980s when the amendments were under consideration. The original purpose of Regulation S and Rule 144A was mainly to benefit European and American firms that wanted more efficient capital flows across the Atlantic Ocean.[29] To protect American investors, U.S. securities laws are meant to apply to any onshore or offshore transaction that employs U.S. jurisdictional means, requiring the registration with the SEC of any offer or sale of securities involving the use of interstate commerce unless specifically exempted.[30] Given the strong presence of American investors worldwide, the extraterritorial reach of the Securities Act has defined global capital market practices and potentially imposes huge compliance costs on any foreign company making its securities available for American investors.

A decade later after the two exemptions were created in 1990, Chinese firms injected a new dynamic into this regulatory structure that had benefited European and American companies, whose corporate governance and regulatory regime at home are very different

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[28] U.S. borrowers have become one of the largest borrowers in the international bond markets since late 1980s. Prior to the adoption of Regulation S, offshore transactions were governed by Securities Act Release No. 4708 and a sprawling body of no-action letters issued by SEC's staff as most companies were compelled to seek an individualized determination by the SEC that their particular offerings would not be deemed to occur in the U.S. *See* Securities Act Release No.33-6779, *supra* note 29; Testy, *supra* note 27, at 939.

[29] *See generally,* Securities Act Release No.33-6779, 41 SEC-Docket 126 (June 10, 1988); Kellye Y. Testy, *The Capital Markets in Transition: A Response to New SEC Rule 144A*, 66 INDIANA LAW JOURNAL 233 (1990).

[30] Section 5 of the Securities Act serves as the focal point for the Securities Act's registration requirement for offers and sales of securities. "Intestate commerce" is defined widely to include trade or commerce in securities between the U.S. and any foreign country. The registration process results in the creation of an information disclosure document known as the registration statement, or prospectus, to be delivered to investors. *See* 15 U.S.C. § 77e (2012), 15 U.S.C. § 77(a)(7) (2012).

from their Chinese counterparts. With the exemptions, private placements are mainly governed by market practices standards rather than any formal system of securities regulation.[31] To take advantage of the foregoing exemptions, most global IPO schemes structured by Chinese issuers have adopted a commonly referenced "global offering structure." As any foreign issuer relying upon the exemption from registration can sell securities only by private placements, this structure consists of a public offering in the issuer's home market, plus a series of private placements in reliance on Rule 144A and/or Regulation S. While the former part of this structure makes the shares to be registered and circulated in the home state, the latter part enables issuers to sell their shares globally and access to the U.S capital market with much less stringent regulations.

The IPOs of China's "big four" banks between 2005 and 2010 are cases in point. All four banks adopted the "global offering structure," which constituted public offerings of shares in Hong Kong and/or Shanghai and private placements of shares internationally as allowed by Regulation S and Rule 144A. In fact, shares sold through private placements in all four IPOs are nearly ten times greater than those sold through public offering.[32] Only a tiny portion of shares were sold and distributed through channels that fit the conventional IPO definition. This has become the common practice today.[33]

Private placements serve equally well the other forms of international securities offerings that constitute most of capital market activity by Chinese firms today. Offerings of convertible bonds, high-yield bonds, RMB-denominated bonds, global depository receipts or straight debt in the greater China markets are always structured, if not entirely, as exempted deals per Rule 144A and Regulation S, including global notes issued by the PRC government that has

[31] See Howell E. Jackson & Eric J. Pan, Regulatory Competition in International Securities Markets: Evidence from Europe in 1999-Part I, 56 BUS. LAW. 653, 655 and 684-85 (2000-2001).

[32] Shares sold through private placement represent approximately 95% of all H shares offered in the IPOs of all the big four banks, as indicated in respective prospectuses.

[33] In Hong Kong market, it is not uncommon that issuers would have sold their shares entirely though private placements but for the minimum public float requirement by the Listing Rules of the Hong Kong Exchange.

been active as a private issuer with the assistance of investment banks and consulting firms.[34] Private placements have not earned much attention from academic observers in part because the placements are perceived as a postscript to normal regulations.[35] In practice, they have become the dominating mechanism for Chinese firms and the Chinese government to gain access to U.S. capital.

C. Regulatory Leverage Among International Stock Exchanges

Unlike public offerings, foreign issuers do not have to publicly list their securities before selling them through private placements, which are not subject to any formal system of securities regulation. However, this approach may not be beneficial for issuers from emerging markets because investors generally perceive such issuers to be less creditworthy. Investors usually prefer securities that are listed so as to rely on reputable stock exchanges that formally address their concerns by listing rules that require greater transparency and accountability from issuers. In theory, by subjecting themselves through a listing to a thorough legal regime, foreign firms legally bond themselves and their insiders to responsive corporate governance and protection of investors' rights, which increases the value of their securities.[36] Chinese firms and their advisors are aware of the legal bonding effect but always investigate respective listing and disclosure requirements of various global stock exchanges

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[34] For example, in 2004 PRC issued global notes in the amount of US$500 million and global bonds in the amount of €1 billion in reliance on Regulation S and Rule 144A, with Goldman Sachs, JP Morgan, Morgan Stanley, Merrill Lynch, UBS, Deutsche Bank and PNB Paribas as underwriters. Also, Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L L. 243, 249-250 (2010) (discussing the necessity of shifting the focus of the international regulatory framework to reflect governments' engagement in private markets today).

[35] *See* Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 31-32 (1999) (noting the rationale of the private placement exemptions that wealthy investors, whether individuals or institutions, can absorb greater risk and replicate the protection of full-blown registration).

[36] John C. Jr. Coffee, Racing Toward The Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance, 102 COLUM. L. REV. 1757, 1780-83 (2002); The Future of History: The Prospects For Global Convergence in Corporate Governance and Its Implication, 93 NW U. L. REV. 673-76 (1999) (both discussing that foreign issuers may increase their share value by migrating to US markets and agreeing to comply with higher governance systems, disclosure standards and accounting rules that prevail in the US); Rene Stulz, Globalization, Corporate Finance, and The Cost of Capital, JOURNAL OF APPLIED CORPORATE FINANCE, Vol. 12, No.3, at 8, 15 (1999) (suggesting that globalization reduces capital costs and foreign companies can make fund raising less expensive by seeking additional listing on exchanges and committing to higher disclosure standards).

before making private placements in the hope of gaining both listing status and minimally intrusive obligations post-listing.[37]

Today, the Luxembourg Stock Exchange and Singapore Exchange are the two most convenient venues for Chinese firms, places where they often go to reap the benefits of the legal bonding effect. Both stock exchanges have created alternative listing platforms geared toward foreign issuers selling securities through private placements.[38] Not only is the review of disclosure documents by respective regulators minimal, it takes just one month to complete the listing process.[39] At the same time, although they still prefer listed securities, U.S. investors have become increasingly indifferent to where a company is listed, and large mutual funds have changed their charters to allow their fund managers to invest in non-U.S. stocks such that they can obtain more investment opportunities in emerging markets. [40]

Furthermore, the current U.S. regime also offers choices to those who have chosen public access in the past, but now prefer a different approach (e.g. private access) or other markets (e.g. Hong Kong), aiming to create an incentive to foreign issuers to initially register their securities with the SEC. [41] One pronounced post-financial crisis phenomenon is the increasing number of delistings and deregistrations by Chinese firms that had listed their securities in the U.S. but have chosen to migrate back to Asia where abundant capital is available.[42] This

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[37] Stulz also suggests a "thin" version of such legal bonding effect, indicating that the mere accouchement that a foreign company intends to list on a stricter exchange tends to be interpreted by the market as good news. Stulz, *supra* note 36 at 15.

[38] London and Japan are two other alternative venues but have appeared less popular than they once were. Erica Fung, *Regulatory Competition in International Capital Markets: Evidence From China in 2004-2005*, 3 NYU J. L. & Bus. 243, 292-96 (2006) (discussing why London and Japan, together with Singapore, are attractive to Chinese firms)

[39] For example, the Luxembourg Stock Exchange created Euro MTF (Multilateral Trading Facility) in 2005 to provide an easy listing procedure that falls out of the scope of a European "regulated" market under European Directives 2004-39-EC.

[40] Fung, *supra* note 38, at 296-97.

[41] The SEC has adopted new rules in 2007 to make it easier for foreign companies to terminate their registration of securities and reporting obligations. *See Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty To File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*, Release No. 34-55540; 17 C.F.R. §§ 200, 232, 240, and 249 (2012).

[42] Interviews with U.S. lawyers and practitioners based in Hong Kong. Also see *More Chinese Firms Seek Delisting from US Market,* CHINA DAILY (July 4, 2012), http://www.chinadaily.com.cn/bizchina/2012-07/04/content_15547675.htm; *23 Chinese Companies Delisted in US Since Last Year*, CHINA TIMES (Aug 14, 2012), http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20120814000039&cid=1102.

has coincided with the SEC's recent increased scrutiny of Chinese firms, especially those that have obtained listing status in the U.S. through reverse mergers.[43] A substantial number of Chinese firms have completed, or are in the process of, delisting and deregistering their securities from U.S. stock exchanges and have made plans for re-listing in Hong Kong or Shanghai.

D. Risk Management by the State

To defend its companies from exposure to market risk and potential liability as a result of global securities offerings, the Chinese government will intervene and alter market practices if necessary. Such policies usually would not discourage international investors who have mainly been driven by potentially high profits that may offset remote risks or transaction costs caused by such protective measure. One prominent example is that Chinese regulators, contradicting international practice, forbid foreign issuers of debt securities to require any onshore PRC company to provide guarantees or pledges for offshore issuers.[44] It is worth noting that the foreign issuers in question usually are Chinese-owned parent holding companies incorporated overseas only for financing purposes, and the onshore PRC companies are usually their subsidiaries that conduct actual business operations and own valuable corporate assets in China. Consequently, because the Chinese borrower's guarantees are substantially outlawed, international creditors who purchase Chinese debt securities issued overseas are not sufficiently protected in a fashion commensurate with international market practices that treat foreign and domestic creditors equally. In short, foreign creditors

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[43] *SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies* (Nov. 9, 2011), *available at* http://www.sec.gov/news/press/2011/2011-235.htm; Jamila Trindle, *SEC Tightens Rules for 'Reverse Merger' Listings*, WALL ST. J. (Nov. 10, 2011, 4:17 AM), http://online.wsj.com/article/SB10001424052970204358004577028381460208046.html

[44] It requires an approval from the State Administration of Foreign Exchange ("SAFE") for a PRC company to provide a guarantee in favor of any foreign company. Recently SAFE issued the *Circular on Relevant Issues Concerning Foreign Exchange Administration Relating to Encouraging and Guiding a Healthy Development of Private Investment* (国家外汇管理局关于鼓励和引导民间投资健康发展有关外汇管理问题的通知) (June 15, 2012) to slightly relax this restriction on a case-by-case basis, but this has not changed market practices as SAFE gives its approval only to strategic key SOEs.

are made subordinated to onshore PRC subsidiaries' creditors, such as state-owned banks or local companies.

This rule is essentially a firewall set by the Chinese government between international and domestic capital markets in favor of PRC companies and creditors. It has changed capital market practices regarding Chinese debt securities in that Chinese companies pay very high interest while giving their foreign lenders limited rights in the event the companies fail. Generally, this firewall effectively protects Chinese firms and domestic creditors without discouraging keen international investors who are willing to take the risk in exchange for potentially high profits.[45] Sometimes this doesn't work out well for investors when the risk is materialized. In a bankruptcy case filed in Hong Kong court in 2009 by Asia Aluminum Holdings Ltd, PRC creditors were given priority and U.S. investment bank Merrill Lynch and institutional investors received less than one cent for every dollar the company owed them in the form of high-yield bonds.[46]

E. Chinese Latecomer Advantage

Chinese firms that successfully leverage the complexity of different regulatory systems are also benefited by their latecomer advantage in the market. Compared to their European and American counterparts, who called for the adoption of Regulation S and Rule 144A in the 1980s, Chinese firms have been able to access an array of institutional resources from the moment they entered this competitive market.[47]

First, internationalized legal services have greatly eliminated the high compliance costs that used to burden foreign issuers and led to the adoption of Rule 144A and Regulation S in

[45] Foreign investors in fact are informed of such risks, which Chinese issuers always disclose as a risk factor in their prospectuses.

[46] Tom Kohn & Andrea Tan, *Asia Aluminum Needs 'Urgent Action' from Investors*, BLOOMBERG (June 15, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aBvJJh4WwYl0; *Investors Lose Battle For Asia Aluminum*, INTELLASIA EAST ASIA NEWS (June 29, 2009, 7:01AM), http://www.intellasia.net/investors-lose-battle-for-asia-aluminum-102364.

[47] *See, e.g.*, WALTER & HOWIE, *supra* note 15, at 156-64 (suggesting the crucial role of Goldman Sachs in China Telecom's US$4.2 billion IPO in 1997 and stating "The New China of the twenty-first century is a creation of the Goldman Sachs and Linklaters & Paines of the world").

1990. Today, top-notch lawyers and bankers from international law firms and investment banks are local and provide seamless services through regional offices for their Chinese clients.[48] It is not uncommon that the working language within American law firms and banks based in Beijing, Shanghai or Hong Kong is Mandarin, because many of their lawyers and bankers are trained in both China and the or elsewhere. Difficult legal compliance issues—except perhaps in fees paid to Wall Street lawyers—no longer exist.[49] Their professional expertise and skills put Beijing and SOEs in the driver's seat for a strategic piece of the Chinese economy.[50]

Second, the economic system today is buoyed by financial innovations that produce many benefits, such as reduced risk, enhanced transactional efficiency, expanded scope of services and better utilized professional knowledge. Hedging mechanisms—such as credit default swaps, securitization, and future and options contracts—spread risk, minimize potential liability, and protect against loss from financial volatility. Chinese firms have greatly benefited from these financial innovations, international accounting and financial rules, new deal structure, and pricing methodology, which increasingly make their securities acceptable worldwide because the inherent risks resulting from the quality of their corporate governance and emerging market status can be defused by distributing widely.

Furthermore, the Internet, smart phones, digital databases and other telecommunication technologies have transformed time differences and geographic distances, turning them from transaction costs into operational efficiencies. Lawyers and bankers from different time zones can coordinate to provide their Chinese clients far more efficient services globally, 24 hours a day, 7 days a week. The once cumbersome clearing and settlement system has been

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[48] Unlike in the 1980s, most major American and British law firms have branch offices in Hong Kong, Shanghai and Beijing today, as do most reputable accounting firms and international investment banks.

[49] *Also, see,* Fung, *supra* note 38, at 264 (noting a remark made by a financial/legal advisor in China that the frequently complained financial disclosure standards under Sarbanes-Oxley Act of 2002 are not difficult to meet and that foreign issuers often exaggerate the burden).

[50] WALTER & HOWIE, *supra* note 15, at 161-164.

digitalized too; with SWIFT codes, the proceeds of offerings can swiftly be wired to Chinese issuers around the world. Book-entries have replaced physical certificates issued by foreign issuers, and investors' titles to securities purchased appear on their accounts as quickly as issuers instruct the transfers on the other side of the globe. No longer is distance or geography a barrier to China deal-making.

III. IMPACTS OF INSTITUTIONAL ARBITRAGE ON INTERNATIONAL CAPITAL MARKETS

A. Global Regulatory Competition

China's institutional arbitrage in the international capital markets may shed light on a policy debate about issuer-choice under U.S. securities laws—whether foreign issuers should be allowed to choose foreign securities regulation when accessing U.S. capital markets. Proponents assert that providing exemptions under U.S. securities laws is an incentive for foreign issuers to reach U.S investors and for the SEC to make its regulations more cost-efficient.[51] Meanwhile, critics of issuer-choice warn that it would encourage regulatory competition between various jurisdictions, and eventually, lead to a destructive "race to the bottom," in which issuers migrate to a least demanding regulatory regime with the lowest level of investor protections, causing the overall quality of global securities regulation to deteriorate.[52]

In the current global capital markets, Chinese firms often gravitate to light-touch regulation systems, such as platforms offered by the Luxembourg Stock Exchange or the Singapore Exchange for private placement issuers. The Hong Kong Exchange where an increasing number of PRC firms have listed their shares is in the process of changing listing

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[51] See, e.g., Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L. J. 2359 (1998); Stephen J. Choi & Andrew T. Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulations, 71 S. CAL. L. REV. 903 (1998).

[52] See, e.g., Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment, 85 VA. L. REV. 1335 (1999).

rules to make listings easier too.[53] The issuer-choice theory assumes that good governance of an issuer will be reflected by a higher price of the securities to be offered because the price system is a mechanism for communicating information; hence the issuer as well as home regulators have incentives to pursue good corporate governance instead of engaging in regulatory competition to lower a regulatory standard.[54] Empirical studies of European capital markets and companies generally support this assumption and find no compelling evidence of a race to the bottom; the gap distinguishing U.S. and European disclosure standards has in fact become narrower over time.[55] This assumption, however, does not seem to apply to behavior of Chinese firms. Other factors, such as an issuer's monopolistic market status, often outweigh the quality of corporate governance as major pricing factors for Chinese securities.[56]

Chinese firms particularly disfavor certain foreign regulations that might challenge their overseas operations in certain areas, especially those that have been labeled as Chinese state capitalism. For example, the SEC has required Chinese firms that list their shares in the U.S. to disclose detailed information pertaining to not just companies themselves but also their beneficial shareholders, subsidiaries and affiliates.[57] In its comments on the 2006 annual report of China National Offshore Oil Cooperation ("CNOOC"), one of the major PRC national oil companies, the SEC asked for details of CNOOC's current, past and anticipated activities

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[53] Among 1,358 companies listed in the Main Board of Hong Kong Exchanges and Clearing Limited (HKEx) as of Oct. 31, 2012, 640 are Mainland Chinese firms and 622 are HK companies, with the remaining 96 companies from worldwide. (Data source, HKEx, Oct. 31, 2012). *See also* Paul J Davies, *HK Moves to Make Foreign Listings Easier*, FIN. TIMES (Nov. 25, 2012, 10:40 PM), http://www.ft.com/intl/cms/s/0/eb4d88cc-3549-11e2-bf77-00144feabdc0.html.

[54] Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Market,* 38 VA. J. INT'L L. 563, 565 and 609 (1998) (noting that conventional finance theory argues that the impact the law has on listed companies is quick to be reflected in stock prices as the price system is a "mechanism for communicating information," and hence better laws mean higher stock prices and vice versa).

[55] Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence From Europe-Part II*, 3 VA. L. & BUS. REV. 207 (2008); Jackson & Pan, *supra* note 31.

[56] In fact, it is reported that the Chinese high-yield issuers have largely avoided corporate governance risk premium commonly born by their Indonesian counterparts. HSBC, THE VIEW: ASIA'S BOND MARKETS, at 7 (Feb. 8, 2011) (on file with the author).

[57] The SEC may impose substantial pressure on foreign private issuers to make comprehensive disclosure by commenting on their annual reports in Form 20-F.

associated with Iran, Syria and Sudan, including through affiliates and other direct and indirect arrangements.[58] This strikes a nerve with Chinese regulators and firms because such information might trigger enforcement of trade sanctions decisions made by the Office of Foreign Assets Control ("OFAC").

In general, the threat of enforcement actions against foreign issuers, including the Foreign Corruption Practices Act ("FCPA"), has proven to be quite real recently. The Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) has also strengthened the enforcement by setting up a securities whistleblower program, creating monetary awards as much as thirty percent of the monetary sanctions so collected to whistleblowers providing information that leads to successful enforcement actions against various corporate frauds.[59] According to the SEC report, China has been one of the largest sources of whistleblower tips received overseas, ranked number one in 2011 and fourth in 2012.[60] When regulatory regimes like those of the U.S. are laden with increasing moral obligations, Chinese firms and regulators may opt for a classical laissez-faire regulatory regime elsewhere.[61]

Furthermore, at a time when global capital markets are more volatile than before, Chinese firms are particularly attracted to light-touch regulations.[62] To capture investment windows that have become much shorter, especially exacerbated after the 2008 global financial crisis, issuers need to avoid any delay in the registration process. Today, once an investment

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[58] CNOOC correspondence dated 12 Feb 2007, in response to the SEC comment letter dated 11 Jan 2007, available at the SEC filing archive: http://www.sec.gov/Archives/edgar/data/1095595/000114554907000225/filename1.txt. The SEC's requirement ended up with additional disclosure in CNOOC's annual report in the following year, albeit with CNOOC's fierce push-back.

[59] Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the Securities Exchange Act of 1934 by, among other things, adding Section 21F entitled "Securities Whistleblower Incentives and Protection." Pub. L. No. 111-203, § 922(a), 124 Stat 1841 (2010).

[60] U.S. Securities and Exchange Commission, Annual Reports on the Dodd-Frank Whistleblower Program Fiscal Year 2011 and 2012, available: http://www.sec.gov/whistleblower.

[61] Andrew Brady Spalding, The Irony of International Business Law: U.S. Progressivism and China's New Laissez Faire, 59 UCLA L. REV. 354 (2011).

[62] The overall regulatory environment would also cause a firm migration from one country to another. China's largest state-owned banks have begun moving big chunks of their European business to Luxembourg to escape tougher regulation in the City of London. Daniel Schäfer, *Chinese Banks Flee London's Tough Rules,* FIN. TIMES (Oct. 28, 2012, 9:27 PM), http://www.ft.com/intl/cms/s/0/3cabad56-2105-11e2-9720-00144feabdc0.html#axzz2FU38Z8LI.

window is identified, a Chinese high-yield bonds issuer is able to mobilize their lawyers and financial advisors to complete an offering within two to three months through private placements in reliance on Regulation S and/or Rule 144A exemptions. This is in contrast to the years prior to the financial crisis when it used to take a significantly longer period to execute a similar private placement transaction, not to mention the six months or longer required to register a public offering. However, a quick execution may further compromise due diligence and disclosure standards, which have been lowered for private placement transactions.

B. Distribution of Regulatory Deficiency

Through institutional arbitrage, Chinese firms can piggyback on foreign institutions and regulatory systems to access capital before resolving institutional deficits at home; consequently, risk can go across borders to be distributed to investors worldwide. At the same time, financial innovations that defuse risk, such as securitization and credit default swaps, may paradoxically tempt market players to take more risk because of the improved capability to bear risk.

Since 2009 there has been an outbreak of corporate scandals surrounding Chinese companies listed overseas. In Canada in 2011, Sino-Forest Corporation, a once well-regarded Chinese timber company listed in Toronto, was accused of a massive accounting fraud. This was followed by an investors class-action claim against the company, as well as its big-name underwriters and auditors. Sino-Forest has filed bankruptcy in March 2012.[63]

In the U.S. since late 2010, alleged financial frauds and accounting issues have been revealed at a number of Chinese companies. Nasdaq and NYSE halted trading in the shares of

[63] For a description, Madhavi Acharya-Tom Yew, *Sino-Forest Investigation: OSC Accuses Ernst & Young of 'Failure to Perform Sufficient Audit'* (Dec. 3, 2012), http://www.thestar.com/business/article/1296809--osc-accuses-ernst-young-of-failure-to-perform-sufficient-audit-on-sino-forest.

at least 21 Chinese companies in 2010 alone and delisted five of them from the exchanges.[64] As of September 2012, 67 China-based public companies have had their auditors resign.[65]

Likewise, on the Singapore Exchange, since early in 2008, there have been nineteen corporate scandals involving Chinese companies.[66] In Hong Kong, at least six disputes were reported in the first four months of 2012 and the Hong Kong Financial Reporting Council has announced that 13 Chinese firms require close monitoring.[67]

C. Political and Regulatory Clashes

Wary of regulatory deficiencies surrounding China-based companies, regulators of the U.S. and elsewhere have started tightening enforcement on all fronts. As evidenced by the CNOOC annual report incident in 2007, the SEC, through its review of annual reports and other company disclosures, has strengthened its scrutiny of Chinese firms as well as their shareholders, subsidiaries and affiliates.[68] Various compliance issues now routinely scrutinized include FCPA or economic sanctions enforced by OFAC against terrorists or other targeted foreign countries such as Iran where Chinese oil companies have a presence.

In response, Chinese regulators fiercely defend the current practices of institutional arbitrage on the grounds of national sovereignty. For example, the China Securities Regulatory Commission ("CSRC") has rejected a continuing request by the Public Company Accounting Oversight Board ("PCAOB"), a watchdog agency created by the Sarbanes–Oxley Act (2002) to oversee the auditors of public companies.[69] PCAOB wants to directly inspect

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[64] Robert Cookson, *China Foreign Listings Dogged by Scandal,* FIN. TIMES (June 5, 2011, 11:37 PM), http://www.ft.com/intl/cms/s/0/9b70a976-8f8a-11e0-954d-00144feab49a.html#axzz2FpkoJosz.

[65] Many of these companies are small Chinese companies that obtained US listing status through reverse mergers. Michael Cohn, *PCAOB Makes Tentative Progress on Chinese Audit Firm Inspections,* ACCOUNTING TODAY (Sept. 24, 2012), http://www.accountingtoday.com/news/pcaob-china-audit-firm-inspections-64051-1.html.

[66] For a general discussion, *see, e.g.,* Qian Meijun, *Why S-chip Fraud Cases Keep Cropping Up* (Press release, RMI of National University of Singapore, Feb. 17, 2012), *available at* http://*www.rmi.nus.edu.sg.*

[67] Fox Hu, *Investor Distrust of Chinese Listings Hits IPOs Prices*, BLOOMBERG (Apr. 19, 2012, 6:00 AM), http://www.bloomberg.com/news/2012-04-18/investor-distrust-of-chinese-listings-hits-ipos-prices.html

[68] *Supra* note 58.

[69] *SEC and CSRC Wrestle Over Cross-Border Financial Supervision*, CAIJING (Jan, 08, 2013, 15:45PM), http://english.caijing.com.cn/2013-01-08/112419091.html.

Chinese auditing firms involving U.S.-listed companies in the wake of increasing accusations of accounting irregularities at a number of Chinese companies.[70]

Recently the tension between Chinese and foreign regulators has increased. The CSRC, for instance, has ruled out the possibility of allowing SEC staff to conduct on-site reviews of the records and books of Chinese rating agencies applying for the status of Nationally Recognized Statistical Rating Organizations ("NRSROs") under the Securities Exchange Act of 1934. The CSRC insists that the SEC should entrust the CSRC to implement the SEC's oversight of Chinese agencies.[71] Consequently, when the SEC denied an NRSRO application by Dagong Global Credit Rating Co., China's largest rating agency that works closely with China's Commerce Ministry on ratings projects in connection with SOEs, the decision aroused strong criticism of the SEC for intruding on national sovereignty and discriminating against Chinese applicants.[72]

The most recent dispute is the SEC's proceeding against five big international accounting firms that have a strong presence in China. In December 2012, the SEC brought an administrative proceeding against Deloitte Touche Tohmatsu Certified Public Accountants Ltd., Ernst & Young Hua Ming LLP, KPMG Huazhen, PricewaterhouseCoopers Zhong Tian CPAs Ltd., and BDO China Dahua CPA Co., Ltd, alleging they failed to submit documents sought in the SEC's investigations and thus violated the Securities Exchange Act and the

[70] PCAOB seeks to inspect these China-based audit firms because they are registered with the PCAOB and audit approximately one fourth of the Chinese firms that have obtained listing status in the US through reverse mergers. Cohn, *supra* note 65.

[71] Securities Exchange Act of 1934 Release No. 62968, Admin. Proc. File No. 3-13860 (Sept. 22, 2010) (stating that it did not appear possible for the Chinese applicant to comply with the recordkeeping, production, and examination requirements of the U.S. securities laws); Neil Gough, *Rating Agency Dagong's Profile on the Rise*, SOUTH CHINA MORNING POST (Aug. 15, 2011) http://gochina.scmp.com/beijing/news/rating-agency-dagongs-profile-rise.

[72] Joy C. Shaw, *Dagong Fires Back at SEC,* WALL ST. J. (Sept. 27, 2010), http://online.wsj.com/article/SB10001424052748704082104575515470951666514.html

Sarbanes-Oxley Act.[73] The five firms refused to comply with the SEC's order for fear of violating PRC secrecy laws.[74]

Disputes have also arisen in the context of the national security review of foreign investment by recipient nations of Chinese foreign investment. Early in 2012, Huawei, the world's second largest telecom equipment supplier based in China, was barred by the Australian government from a A$42bn tender to build a national broadband network. The Australian government expressed concern about the alleged links between Huawei and the Chinese military.[75]

Similar tensions between China and the U.S. were manifested in a lawsuit against President Barack Obama by Ralls, a company owned by two Chinese executives, in October 2012.[76] Ralls believes the president violated constitutional protections on property ownership and has challenged the decision of the Committee on Foreign Investment in the U.S. ("CFIUS") to determine the negative effect on the US national security that would be brought about by Rolls' acquisition plan. The committee's decision prompted the president to issue an order blocking Rolls' investment in wind farms within or in the vicinity of restricted air space in Oregon because of national security concerns.[77] The then PRC vice-

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[73] SEC Release No. 34-68335 (Dec. 3, 2012), http://www.sec.gov/litigation/admin/adminarchive/adminarc2012.shtml.

[74] Michael Rapoport & Ben Dummett, *U.S. Sues Big Firms Over China Audits*, WALL ST. J. (Dec. 3, 2012, 9:08 PM), http://online.wsj.com/article/SB10001424127887324355904578157252180759338.html.
As far as the PRC secrecy laws are concerned, two legislations have been cited and discussed. First, The Law of PRC on Guarding State Secrets (1988) which broadly defines "state secrets" as "matters that have a vital bearing on state security and national interests and, as specified by legal procedure, are entrusted to a limited number of people for a given period of time." This law provides seven categories of state secrets, including a catch-all provision to cover "other matters that are classified as state secrets by the state secret-guarding department." Second, the Provisions on Strengthening Confidentiality and Archives Administration of Overseas Issuance and Listing of Securities enacted by the CSRC, the State Secrecy Bureau and the State Archives Bureau in 2009. The provisions provide that if work papers created in China by securities services institutions during the process of overseas issuance of securities involve state secrets, national security or other vital interests, they shall not be exported out of China via any method without the authorities' approval.

[75] The Financial Times Editorial, *Huawei's Woes-- Beijing's Export Ambitions Held Back by Cyber Crime Fears*, FIN. TIMES (Mar. 28, 2012, 7:28 PM), http://www.ft.com/intl/cms/s/0/cfb969b4-78e8-11e1-88c5-00144feab49a.html.

[76] CFIUS, Statement from the Treasury Department on the President's Decision Regarding Ralls Corporation (Sept. 28, 2012), http://www.treasury.gov/press-center/press-releases/Pages/tg1724.aspx.

[77] Ralls was seeking to acquire the ownership of four wind farm project companies and place wind turbines made by its Chinese affiliate in Oregon near restricted Navy airspace. Sara Forden, *Chinese-Owned Company Sues Obama Over*

premier Wang Qishan subsequently chastised U.S. cabinet members for performing "political background checks", adding that Americans were not asked about politics when investing abroad.[78]

IV. PATTERNS OF INSTITUTIONAL ARBITRAGE

Institutional arbitrage is different from mere forum shopping, although the latter conveys a similar but narrower sense of calculations. While forum shopping mainly refers to a choice of jurisdiction that maximizes the benefits of plaintiff or defendant in dispute, institutional arbitrage goes beyond to entail more dynamic arrangements across multiple jurisdictions and/or systems of regulation to maximize one's institutional advantages (or minimize disadvantages).

The globalized and complex capital markets make institutional arbitrage even more commercially and legally viable. For instance, it is not uncommon to see an offering made by a Chinese company incorporated in Hong Kong, with major operations in the mainland China and Taiwan through its subsidiaries listed in Singapore, that is to issue bonds to be listed on the Luxembourg Stock Exchange in reliance upon the exemptions under the U.S. Securities Act of 1933, with the New York state law as the governing law. As multiple jurisdictions and systems of regulation are often involved in one single transaction, there is plenty of room for the market players, such as the state, to leverage the complexity of cross-border regulations for their benefits. Institutional arbitrage is based on a function of various factors, including compliance and transaction costs, commercial or institutional strengths and weaknesses, targeted markets, development strategies, business alliances with certain market players, or any other political economy consideration.

Wind Farm Project, BLOOMBERG (Oct. 02, 2012, 11:45 PM), http://www.bloomberg.com/news/2012-10-02/obama-bars-chinese-owned-company-from-building-wind-farm.html.

[78] Richard McGregor, *Beijing Attacks US Investor Checks*, FIN. TIMES (Dec. 21, 2012), at 2.

A few patterns of institutional arbitrage can be identified.[79] First, the Chinese state seeks to *compensate* for its institutional deficits at home by encouraging SOEs and state-controlled companies to bypass institutional obstacles (e.g., immature domestic capital markets) and policies (e.g., the capital account control) in accessing international capital markets. In numerous transactions, the state and its affiliates have appeared to be willing to pay a premium to learn and to sacrifice higher valuations for foreign expertise in order to strengthen its corporate sector.[80] Although they have been willing to conform to international regulatory standards, especially in the early years, Chinese firms act strategically, usually choosing the least intrusive regulations that would not undermine their public-private coalition. As Carl Walter and Fraser Howie indicated in their research, after China Life Insurance Company's IPO in 2003 on the New York Stock Exchange was investigated for financial irregularities, its fellow SOEs from the "national champion" team opt for Hong Kong as the venue of choice, while many overseas returnees are moving back directly to Shanghai where things are "a bit easier to manage," as one SOE chairman put it.[81]

Second, the Chinese government and companies may *ignore or defect* from current international market practices and regulations. This pattern has been evident in recent disputes between Chinese and U.S. regulators. In regard to the SEC's proceeding against the top five accounting firms in December 2012, it was reported that Chinese officials warned the accounting firms about releasing information about Chinese SOEs and private companies to outside parties, considering it a possible violation of Chinese secrecy laws.[82]

Third, the state may *defend* international standards by preserving core competencies centered on home institutions and rules. The party-state maintains its strong presence in the

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[79] I borrowed the patterns examined in the context of international business studies and collectively discussed by Gregory Jackson and Richard Deeg. Jackson & Deed, *supra* note 23.

[80] For instance, the Chinese government granted substantial discounts to Bank of America and Royal Bank of Scotland for their share purchases in IPOs of China Construction Bank and Bank of China, respectively.

[81] Walter & Howie, *supra* note 15, at 193.

[82] Stanley Lubman, *Unpacking the Law Around the Chinese Reverse Takeover Mess*, WALL ST. J. (Jan. 24, 2012), http://blogs.wsj.com/chinarealtime/2012/01/24/unpacking-the-law-around-the-chinese-reverse-takeover-mess/.

corporate governance structure of SOEs, despite the fact that many of these firms have become seasoned players in global capital markets.[83] The other example of this is the legal firewall between global and domestic capital markets erected by Chinese regulators to protect PRC firms and their creditors from foreign creditors' claims. The regulators refuse to follow international practices that treat overseas and domestic creditors equally and disallow overseas creditors to protect their credits by asking for pledges or guarantees against issuing companies' assets under their effective control in China (as discussed in Part II). In this regard, China has made advantageous use of market enthusiasm for investment opportunities in China and leveraged a favorable regulatory environment for PRC firms.

Furthermore, Chinese firms may seek better evaluation and greater access to international capital markets by *symbolically adapting* to international regulations. As discussed previously, although a listing status is not legally needed for private placements, Chinese issuers bond themselves with a reputable foreign stock exchange by obtaining a nominal listing status that requires minimal obligations.[84] Regulatory competition between international stock exchanges may facilitate such regulatory leverage by Chinese issuers.

Ultimately, the Chinese government and Chinese firms may *change, or reform* existing practices as prescribed by various countries' regulatory regimes and market standards. This intention to change comes at a time when architects of Chinese state capitalism are altering their attitude towards international regulation, becoming more visionary and setting their own agenda. The resulting institutional changes may be accomplished by "layering"—not by eliminating existing institutions but by creating new alternatives that may or may not be fundamentally different from the existing ones. The internationalization of renminbi ("RMB")

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[83] *See* Pistor, supra note 19 (arguing that the dominant form of governance in China is a network of financial party cadres and that this regime has been strengthened over the past decade in response to perceived threats to the stability of China's financial and political system).

[84] Likewise, many Chinese firms voluntarily follow U.S. disclosure practices when executing private placements of their securities for commercial reasons—to approach U.S. investors easily and to keep the option for U.S. market open.

in global capital markets is a case in point and is at the top of China's agenda. This change of status for RMB will very likely provide new momentum to critical institutional changes in global capital markets in the near future.

The recent boom in "dim sum" bonds, the RMB-denominated bonds traded outside China, illustrates these institutional changes by layering. Perceiving the internationalization of RMB as a critical long-term development strategy, the Chinese government has allowed such bonds to be issued in 2007 and the market took off significantly in 2010 following further deregulation.[85] As a result, the dim sum bonds market has rapidly changed practices across the board—from the character of clearing and settlement institutions (i.e., a shift from American to Chinese banks and institutions), to the credentials of banking and legal professionals (i.e., greater knowledge of PRC and HK regulations and more fluency in Mandarin), and to the creation of new RMB-denominated financial products and trading markets (i.e., a stronger demand by RMB holders for investment opportunities). To achieve these breakthroughs that may fundamentally reshape the U.S. dollars-denominated capital world, China has simply replicated an existing capital market model and created an alternative platform with a Chinese currency touch.[86]

CONCLUSION

An institutional perspective on development issues has become increasingly prominent in the field of development theory and practice, leading to a proliferation of research exploring not just why but how institutions matter. Meanwhile, the rise of China has posed even more challenges to conventional development thinking, as captured in the fashionable term

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[85] Michael Schuman, *Is the Chinese Yuan Becoming a Rival to the Dollar?* TIME (Feb. 15, 2011), http://business.time.com/2011/02/15/is-the-chinese-yuan-becoming-a-rival-to-the-dollar/.

[86] China has repeated this approach and created its first domestic high-yield bond market in June 2012, opening a new funding channel that by some estimates will see as much as $50 billion in capital flow to cash-starved small and medium-sized private firms within a few years. *China Opens Its First Junk Bond Market,* N.Y. TIMES (June 8, 2012), http://www.nytimes.com/2012/06/09/business/global/china-opens-its-first-junk-bond-market.html?_r=0.

"Beijing Consensus."[87] While the current literature tends to focus on the institutional evolution taking place within jurisdictional boundaries, with the state as a major *supplier* of institutional reforms, Chinese state capitalism shifts such discussion to a global level among multiple jurisdictions, with its developmental state and affiliates as *consumers* of good institutions worldwide.

In light of the widely recognized relationship between economic growth and good institutions regarding financing, banking and corporate governance,[88] how has the Chinese system been able to compensate for its institutional weaknesses at home without having had moved closer to the existing models and practices of developed countries? This paper uses the concept "institutional arbitrage" to explain China's strategy and its impressive performance in international capital markets for the past decade. Institutional arbitrage allows the Chinese government and its firms to compensate for its domestic institutional deficits by piggybacking on foreign institutions, regulatory regimes and managerial expertise to tap foreign capital and facilitate domestic institutional reforms. The Chinese developmental state in turn extracts revenues from SOEs and reallocates resources strategically within the state capitalism system, and thereby further projects the state's economic power and institutional changes worldwide.

China's institutional arbitrage model posts various challenges to conventional thinking. Bernard Black once argued that big individual companies may partially escape weak home-country institutions by listing shares overseas, but it is much harder for an entire country to piggyback on foreign institutions due to the complexity of securities regulation and law

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[87] *See, e.g.,* Joshua Cooper Ramo, *The Beijing Consensus*, The Foreign Policy Centre, (2004), available at http://fpc.org.uk/publications/; Yasheng Huang, *Debating China's Economic Growth: The Beijing Consensus or The Washington Consensus,* ACADEMY OF MANAGEMENT PERSPECTIVES, Vol. 24 (2), at 31 (2010); John Ohnesorge, *"Beijing Consensus" Anyone?, in Symposium: The Future of Law and Development, Part V,* NW. U. L. REV. COLLOQUY, Vol.104, at 257 (2009), http://colloquy.law.northwestern.edu/.

[88] *See, e.g.,* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439 (2001), and the widely cited and debated "LLSV" literature, such as Rafael La Porta, et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

enforcement.[89] However, the Chinese experience shows that it is the very complexity of regulations that makes China's institutional arbitrage possible. The connection between Chinese firms and the developmental state adds a new dimension challenging traditional thinking that treats the firm and the government separately.

While this paper has shown patterns of institutional arbitrage, the consequence of it all remains to be observed. Economic historians point to the invention of bonds markets as a key to understanding why the United Kingdom replaced France in the 19th century as the world's strongest power as the French in general did not appreciate the logic and power of bonds market then.[90] Does China's institutional arbitrage in capital markets illustrate a parallel? For certain, Chinese firms as a whole have quickly transformed themselves from inexperienced conformists, to sophisticated players, and finally to game-changers, all within a decade. With the proliferation of their overseas activities that may lead to more clashes between Chinese and foreign regulators, the future is rocky at best.

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[89] Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 816-831 (2001).

[90] FERNAND BRAUDEL, THE WHEELS OF COMMERCE---CIVILIZATION AND CAPITALISM: 15TH-18TH CENTURY, VOL. II (1992), at 385, 389, 400, and 525-28 (discussing the advantage of England over France in terms of credit system, fiscal institutions, and the usage of government bonds); NIALL FERGUSON, THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD, at 70-92 (2009) (discussing the advantage of the British financial system in the 19th century that is based on bond markets over the French one based on conventional taxation);