

# International Capital Markets and Corporate Governance

May 6, 2017

# Tables of Content

1、	Corporate Governance - Primer	3
2、	Requirements of Corporate Governance	5
3、	Why Corporate Governance Matters?	16
4、	Practice Notes for Practicing Corporate Governance	18
5、	Participants in Establishing Corporate Governance	35

# (1) Corporate Governance - Primer

# Corporate Governance - Primer

## What is corporate governance?

“Corporate governance” is a system or process by which corporate entities are directed and controlled to achieve growth in shareholder value and adhere to sustainable development of the company for the benefit of shareowners and other stakeholders

## **A corporate governance model that meets the requirements of international investors is based on a number of basic principles:**

1. Respect for rights of shareholders, investors and other stakeholders
2. Clear separation of powers and responsibility between management units
3. Efficient supervisory board (structure of board of directors, operating committees, absence of conflict of interest etc.)
4. Well-established system of management accounting for supervisory board
5. Formalized and transparent policy and procedure of directors' election/reelection
6. Formalized and transparent policy and procedure of compensation for directors and company management
7. Information transparency for shareholders and other stakeholders, including social responsibility
8. Transparent dividend policy
9. Efficient internal control and internal audit systems

## (2) Requirements of Corporate Governance

# Requirements of Corporate Governance

**OECD, for example, has proposed a set of “Principals of Corporate Governance”**

## *I. Ensuring the Basis for an Effective Corporate Governance Framework*

***The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.***

- A.** The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.
- B.** The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.
- C.** The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.
- D.** Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner.

Moreover, their rulings should be timely, transparent and fully explained.

# Requirements of Corporate Governance (Cont.)

## *II. The Rights of Shareholders and Key Ownership Functions*

***The corporate governance framework should protect and facilitate the exercise of shareholders' rights.***

- A.** Basic shareholder rights should include the right to: (1) secure methods of ownership registration; (2) convey or transfer shares; (3) obtain relevant and material information on the corporation on a timely and regular basis; (4) participate and vote in general shareholder meetings; (5) elect and remove members of the board; and (6) share in the profits of the corporation.
- B.** Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: (1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; (2) the authorisation of additional shares; and (3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.
- C.** Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:
  - 1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.

# Requirements of Corporate Governance (Cont.)

2. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.
  3. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.
  4. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.
- D.** Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorisation of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.



# Requirements of Corporate Governance (Cont.)

**E.** Markets for corporate control should be allowed to function in an efficient and transparent manner.

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.
2. Anti-takeover devices should not be used to shield management and the board from accountability.

**F.** The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.

1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.
2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

**G.** Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

# Requirements of Corporate Governance (Cont.)

## *III. The Equitable Treatment of Shareholders*

***The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.***

**A.** All shareholders of the same series of a class should be treated equally.

1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected.
2. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.
3. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.
4. Impediments to cross border voting should be eliminated.
5. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

**B.** Insider trading and abusive self-dealing should be prohibited.

**C.** Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

# Requirements of Corporate Governance (Cont.)

## *IV. The Role of Stakeholders in Corporate Governance*

***The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.***

- A.** The rights of stakeholders that are established by law or through mutual agreements are to be respected.
- B.** Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.
- C.** Performance-enhancing mechanisms for employee participation should be permitted to develop.
- D.** Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.
- E.** Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.
- F.** The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

# Requirements of Corporate Governance (Cont.)

## *V. Disclosure and Transparency*

***The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.***

**A.** Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.
2. Company objectives.
3. Major share ownership and voting rights.
4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.
5. Related party transactions.
6. Foreseeable risk factors.
7. Issues regarding employees and other stakeholders.
8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

# Requirements of Corporate Governance (Cont.)

- B.** Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.
- C.** An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.
- D.** External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit. Channels for disseminating information should provide for equal, timely and cost efficient access to relevant information by users.
- F.** The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.

# Requirements of Corporate Governance (Cont.)

## *VI. The Responsibilities of the Board*

***The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.***

- A.** Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.
- B.** Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.
- C.** The board should apply high ethical standards. It should take into account the interests of stakeholders.
- D.** The board should fulfil certain key functions, including:
  - 1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
  - 2. Monitoring the effectiveness of the company's governance practices and making changes as needed.
  - 3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
  - 4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

# Requirements of Corporate Governance (Cont.)

5. Ensuring a formal and transparent board nomination and election process.
  6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transaction.
  7. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.
  8. Overseeing the process of disclosure and communications.
- E.** The board should be able to exercise objective independent judgement on corporate affairs.
1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.
  2. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.
  3. Board members should be able to commit themselves effectively to their responsibilities.
- F.** In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

# (3) Why Corporate Governance Matters?



# Why Corporate Governance Matters?

In order to get access to equity and debt markets, companies need to meet investor expectations with respect to corporate governance practices. They need to establish a formal structure of procedures, rights and responsibilities that make investors willing to provide money and make the original owners willing to share ownership with a new circle of outsiders.

Corporate governance standards are now often woven into listing requirements.

The results of independent empirical research have shown that corporate governance has a direct influence on investment decisions and capitalization. Companies act in compliance with corporate governance best practices when organizing the work of the board of directors and its committees, ensure a high level of disclosure, respect the rights of their shareholders and are committed to sustainable development practice.

When voting, institutional investors and minority shareholders are guided by the recommendations of specialized agencies such as the ISS, which pay close attention to the quality of the issuer's corporate governance. More and more institutional investors are creating portfolios based on sustainable development indexes or non-financial factors, including corporate governance.

# (4) Practice Notes for Practicing Corporate Governance

# Practice Notes for Practicing Corporate Governance

## Balance between the interests of original owners and new investors

Corporate governance practices often strike a balance between the expectations of outside investors on the one hand and the preferences of the original owner(s) on the other hand. If investors' demand and/or the regulatory burdens are considered excessive by the original owners, the company may decide to stay away from rising outside equity and perhaps even limit their ambitions to grow. The result will be that growth opportunities will not be realized and that investors will lose the opportunity to share in the future wealth creation of the company.

One particular example where the matching of expectations is important is when the original founder(s) and owner(s) want to retain strategic control of the company also after the IPO by using different classes of shares with different voting rights. One example is Google. When Google made their IPO in 2004, the public was offered shares with lower voting rights than the original owners and in the formal IPO letter the founders explicitly declared that: *“New investors will fully share in Google's long term economic future but will have little ability to influence its strategic decisions through their voting rights.”* When such control mechanisms are motivated and rational (investor may actually see control by the original entrepreneurs as an asset) they can, for example, be balanced by more demanding provisions with respect to minority protection and stricter voting rules on issues where minority shareholders may be negatively affected.

## Corporate governance evolves in a different stage of a company

# Practice Notes for Practicing Corporate Governance (Cont.)

	<b>Private Company Shareholders</b>	<b>Public Company Shareholders</b>	<b>Public Debt Holders</b>
Holder's rights	subject to shareholders' agreement	subject to listing requirements and market practice	subject to debt covenants, such as limitations on debt, sales of assets
Directors' rights	often requires consents of one or a number of directors for certain important matters	often requires the consent of a majority of board members	n/a

# Practice Notes for Practicing Corporate Governance (Cont.)

	<b>Private Company Shareholders</b>	<b>Public Company Shareholders</b>	<b>Public Debt Holders</b>
Board composition/ practice	subject to shareholders' agreement	subject to listing requirements, including INEDs	not required
Basis of Investment Decision	Reliance on investors' own due diligence and market intelligence	Reliance on disclosure documents	Reliance on disclosure documents and own credit reports

# Practice Notes for Practicing Corporate Governance (Cont.)

	<b>Private Company Shareholders</b>	<b>Public Company Shareholders</b>	<b>Public Debt Holders</b>
Information rights	periodical reporting, including audited or reviewed financial statements and management reports; visitation rights	periodical reporting, including audited or reviewed financial statements; public disclosures on reportable events	periodical reporting, including audited or reviewed financial statements; public disclosures on reportable events
Exit	Limited rights, thus requiring rights like tag, drag rights	reliance on mechanism of the public market	reliance on events of default mechanism

# Practice Notes for Practicing Corporate Governance (Cont.)

Concepts of “best practice” corporate governance have evolved over time

Impact of new technology	<p>Internet has changed regulators’ views on how to use information available in cyberspace</p> <p>Information overload has caused concerns over the disclosure regime, which is a cornerstone of the securities offering system in most of the developed countries</p> <p>Whether current disclosure regime is outdated, such as requirements to describe physical facilities, recent trading activities,</p>

# Practice Notes for Practicing Corporate Governance (Cont.)

one share, one vote?	true for companies in most of jurisdictions, but subject to constant challenges
same share, same price?	ESOP shares prior to IPO tend to be priced below “fair market” value
less or more financial reporting	For U.S. IPOs, EGCs are now allowed to include only two full year financial statements



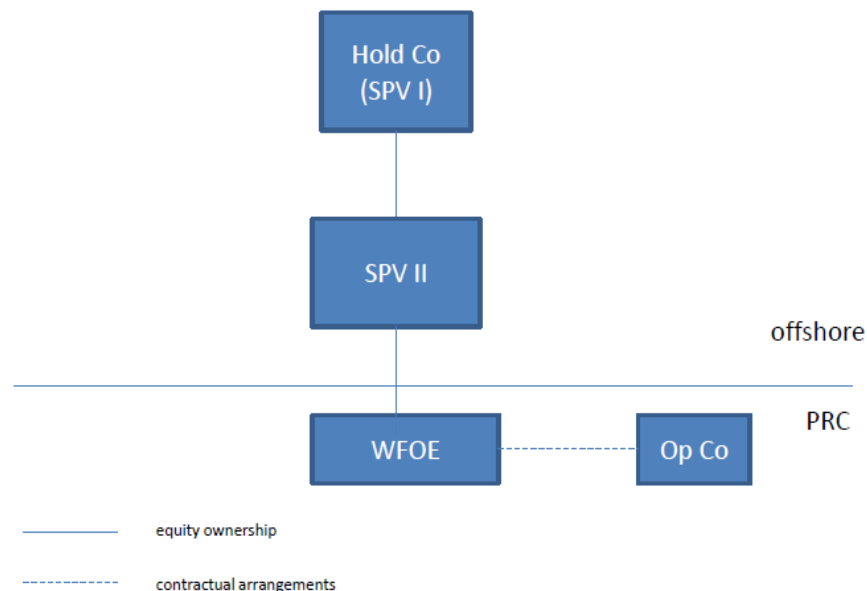
# Practice Notes for Practicing Corporate Governance (Cont.)

Anti-takeover	More sophisticated designs are afforded to defend takeover attempts
Competition	Competition among service providers have affected the formation of corporate governance

# Practice Notes for Practicing Corporate Governance (Cont.)

## Case Study #1 – VIE Structure

- The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.
- Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated.
- VIEs in China



### Widely accepted structure:

- Offshore SPV establishes WFOE in China
- WFOE enters into “VIE agreements” with Chinese operating company that give WFOE control and rights to economic benefit (licensing and services agreement, voting rights entrustment agreement, loan agreements; equity pledge agreement)

# Practice Notes for Practicing Corporate Governance (Cont.)

- “SINA Model”: VIE structure first employed back in late 1990’s by SINA and other Internet service companies in China to avoid restrictions on foreign ownership in restricted industries, such as telecom value-added services
- VIE structure has even been used by companies in non-foreign investment restricted industries, such as the advertising and education industry
- Issues relating to VIEs
  - Control
    - No direct ownership
    - Relies on contractual rights that would have to be enforced in China
  - Economic Benefit
    - Lacks shareholder’s right to dividends
    - Relies on contractual rights that would have to be enforced in China

# Practice Notes for Practicing Corporate Governance (Cont.)

## Case Study #2 - Disproportionate Voting Rights Given to Some but not All Shareholders

- Basic shareholder rights should include the right to elect and remove members of the board
- Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as including the transfer of all or substantially all assets
- Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings
- Disproportionate voting designs
  - For example, in the case of Alibaba:
    - Alibaba Partnership has the exclusive right to nominate/appoint a simple majority of Alibaba Group's directors. Such right may only be changed upon the vote of shareholders representing 95% of the votes.
    - The director nominees mentioned above are (i) proposed by the Partnership Committee of Alibaba Partnership and (ii) selected by Alibaba Partnership by vote of a simple majority of all of its partners.

- **Alibaba Partnership: 28 partners (22 company management, 6 related-party management). One partner has one vote on all matters.**
  - ☐ **Partner eligibility requirement: (i) continued service with Alibaba Group and/or related companies or affiliates for 5+ years; and (ii) a track record of contribution to the business of Alibaba Group.**
  - ☐ **Election: Election of new partners requires the approval of at least 75% of all of the partners.**
  - ☐ **Retirement: Partners retire when they cease employment with Alibaba Group or its related companies or affiliates, except Jack Ma and Joe Tsai may remain as partners until they elect to retire or are removed as partners**
  - ☐ **Removal: Any partner, including Jack and Joe, may be removed upon the vote of a simple majority of all partners.**
- **Partnership Committee: 5 partners.**
  - ☐ **Term: Three years and may serve multiple terms.**
  - ☐ **Elections: Held once every three years**
  - ☐ **Main roles: (i) Propose director nominee of Alibaba Group; and (ii) Determine annual bonuses to all partners.**

# Practice Notes for Practicing Corporate Governance (Cont.)

- In 2013-2016, U.S. IPOs in TMT and financial services comprised 57% of the IPOs with multiple classes of common stock.
- US listed companies with principal operations in China accounted for a large portion of US listed companies that have disproportionate voting arrangements. Take 2014 as example, 10 out of 12 companies adopted a disproportionate voting structure.
- Hong Kong Stock Exchange is weighing a dual-voting structure for new listing applicants
- It has become a receptive voting structure for investors in private companies

# Practice Notes for Practicing Corporate Governance (Cont.)

## Case Study #3 – How problems were discovered

- The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
- Irregular accounting practice and fraudulent disclosures
  - Regulators: In April 2011, the Chairman of the US SEC issued a letter that stated: “The number of issuers with their principal place of business in the PRC has undergone a marked increase in recent years, including those PRC-based companies that became domestic issuers through reverse mergers. The SEC’s Division of Enforcement has pursued securities violations by PRC-based issuers for a number of years, including investigating and filing its first accounting fraud case against a PRC-based issuer in early 2006. As will be described in more detail below, since then, the SEC has brought a number of cases, including market manipulations; accounting and disclosure violations; actions against auditors and accountants; trading suspensions; and administrative proceedings to revoke companies’ registration statements.”

# Practice Notes for Practicing Corporate Governance (Cont.)

- The Securities and Futures Commission in Hong Kong is seeking unspecified damages for minority shareholders related to alleged “market misconduct” by the defendants connected to China Forestry’s IPO prospectus, and the company’s financial statements for 2009 and for the first half of 2010, according to documents filed with Hong Kong’s High Court on Jan. 16.

- Accounting Firms: A letter issued by Deloitte in May 2011 on why they resigned as Longtop’s auditors :

“ . . [Deloitte visited Longtop’s banks to confirm some transactions]: statements by bank staff that their bank had no record of certain transactions; confirmation replies previously received were said to be false; significant differences in deposit balances reported by the bank staff compared with the amounts identified in previously received confirmations (and in the books and records of the Group. . . In the light of this, a formal second round of bank confirmation was initiated on 17 May, . . . seizure by the Company’s staff of second round bank confirmation documentation on bank premises; threats to stop our staff leaving the Company premises unless they allowed the Company to retain our audit files then on the premises; and then seizure by the Company of certain of our working papers. [In response to Deloitte’s inquiries, Longtop’s chairman of the Company,] did not answer when questioned as to the extent and duration of the discrepancies. When asked who was involved, [the Chairman] answered: “senior management”.



# Practice Notes for Practicing Corporate Governance (Cont.)

- Short sellers:
  - Muddy Waters said in November 2011 that Focus Media has been "fraudulently overstating" the number of screens in its LCD advertising display network by about 50 percent, and put a "strong sell" recommendation on the company's stock.
  - Muddy Water:" We are short China Huishan Dairy Holdings (6863 HK / "Huishan") because we believe it is worth close to Zero. We conclude Huishan is a fraud. In this first report on Huishan, we detail the following conclusions and supporting facts."

# Practice Notes for Practicing Corporate Governance (Cont.)

## Case Study #4 – Impact of Competition in the Service Industry on the Formation of Corporate Governance

### Lawyers as a gatekeeper?

- “We are committed to performing services for the Company to the best of our ability and with the independent professional judgment that an attorney owes to a client in accordance with The New York Rules of Professional Conduct, as currently effective (the “New York Rules”).”
- Tension between confidentiality concern and advocate for justice (such as a “whistle blower”)
- My hourly rates increased from US\$600 in 2001 (first year partner) to US\$1,375 in 2017.
- “Why should I hire a lawyer to tell me what I cannot do?”

## (5) Participants in Establishing Corporate Governance

# Participants in Establishing Corporate Governance

Corporate governance for a particular company is established by demand by and involvement of various parties, including:

## 1. Issuers

- Whose interests, original owners', minority shareholders', or other stakeholders?
- “Super-voting” shares or partnership arrangements.
- Functions of board of directors, board committees and INEDs
  - ❑ In a U.S. publicly traded company, an audit committee is an operating committee of the board of directors charged with oversight of financial reporting and disclosure. To qualify, the committee must be composed of INEDs with at least one qualifying as a financial expert.

# Participants in Establishing Corporate Governance

- ❑ Responsibilities of the audit committee typically include:
  - Overseeing the financial reporting and disclosure process.
  - Monitoring choice of accounting policies and principles.
  - Overseeing hiring, performance and independence of the external auditors.
  - Oversight of regulatory compliance, ethics, and whistleblower hotlines.
  - Monitoring the internal control process.
  - Overseeing the performance of the internal audit function.
  - Discussing risk management policies and practices with management.

# Participants in Establishing Corporate Governance (Cont.)

## 2. Investors

- “Angel” investors, late-stage venture capitalists or other types institutional investors have different investment thesis or expectations. For example, mutual funds and exchange traded funds tend to apply passive investment strategies based on a pre-defined set of criteria with respect to what companies to buy and help the investors to reduce transaction costs for trading and advisory fees for corporate analysis.
- By comparison, venture capitalists tend to exert high degree of control over the operations of the company

# Participants in Establishing Corporate Governance (Cont.)

## 3. Underwriters

- The underwriters are financial services professionals who advise the company on and the transaction and help execute all of the steps required to complete it. Underwriters will guide the company on how to market itself based on their knowledge of the industry, corporate finance and the capital markets more generally. They will assist with the preparation of disclosure materials, including in drafting sessions, and help organize the process to ensure that other working parties are involved and completing tasks in accordance to the company's timeline.
- In addition to advising the company, members of the investment banking team market the securities to the investment community. This is by helping position the company to be attractive to investors, through conduct of a marketing roadshow and through contacting investors with whom the underwriters have established relationships. The process of gathering commitments from investors to purchase the securities being offered is known as book-building.
- Various laws assign liability to underwriters in connection with any material misstatements or omissions in connection with the offering, and pre-marketing of securities before the offering has begun.

# Participants in Establishing Corporate Governance (Cont.)

## 4. Regulators

- Regulations are promulgated in respect of, among other things, the quality and access to market information, including fair and efficient price discovery, and standard setting, supervision and enforcement of corporate governance rules.
- In the US, the key regulator is the Securities Exchange Commission (SEC). In addition, the NYSE and NASDAQ securities exchanges have a pseudo-regulatory role over public companies (including those who are going public). In Hong Kong, the primary regulatory bodies are the Securities and Futures Commission (SFC) and the Stock Exchange of Hong Kong Limited (HKEX). These perform similar functions but have different regulations and practices. Given the prevalence of private securities litigation in the U.S., the SEC takes a comparatively hands-off approach and gives more discretion to issuers as they are subject to the risk of class-action litigation in the event they commit securities violations. The SEC also reserves the ability to bring enforcement actions against issuers. In comparison HKEX plays more of a gatekeeper role and may not permit an issuer to list if its requirements are not met, although perceived liabilities for securities violations after listing are lower than in the U.S.



# Participants in Establishing Corporate Governance (Cont.)

- In addition to enforcement of securities laws against violators, the SEC and HKEX review prospectuses prepared in connection with public offerings and issue comment letters with changes to be made to ensure compliance with applicable regulations and that the information is clear and complete for investors. For a major offering such as an IPO, a prospectus will undergo multiple rounds of comment and revision based on input from the regulator before a transaction is commenced.
- 5. “Gatekeepers”
  - a. Auditors
    - Auditors are responsible for preparation of the company’s financial statements included in the prospectus in order to ensure their accuracy and screen for any fraud. On major transactions the company is typically audited by a Big 4 firm (Deloitte, Ernst & Young, KPMG or PricewaterhouseCoopers), who generally will be experienced in the disclosures required for capital markets transactions. Auditors also review financial-related disclosures in the prospectus to ensure that it is accurate and matches or is based off of the information in the issuer’s financial statements. The auditors will negotiate and issue a comfort letter for the benefit of the underwriters, which confirms the accuracy of financial information in the prospectus.

# Participants in Establishing Corporate Governance (Cont.)

- In addition, the auditors participate in due diligence discussions with the underwriters and the attorneys to understand the process regarding the preparation of the company's financial statements and the company's internal financial reporting.
- Audit firms in the U.S. are regulated by the Public Company Accounting Oversight Board (PCAOB) which governs the professional conduct as well as the content of the financial statements prepared by auditors. A key focus of auditor representation is maintaining independence from the company so that it can objectively evaluate its financial statements and identify any weaknesses. As the information in the company's disclosure is governed by securities laws and regulations, including very specific requirements regarding financial information, the auditors assist the company in complying with these as well.

# Participants in Establishing Corporate Governance (Cont.)

## b. Attorneys

- Attorneys on a capital markets transaction are responsible for advising their clients (the issuer or the underwriters) on compliance with the applicable securities laws and other legal issues. This includes compliance with regulations regarding the conduct of an offering, as well as the information disclosed to investors. Attorneys also assist in conducting due diligence, both in terms of reviewing documents of the issuer, but also in preparing questions for telephonic due diligence discussion and leading relevant discussions.
- In connection with the disclosure, the attorneys are also heavily involved in preparing the prospectus to be used for the transaction and are involved in participating in drafting sessions, preparing and reviewing it. In addition to business, financial information and risk factors, the prospectus also contains legal disclosures and summaries of legal documents requiring input and review by attorneys. The attorneys may assist the company and underwriters in evaluating whether certain information needs to be included in the disclosure to investors. Experienced securities lawyers will have experience in preparing disclosure for companies of varying industries, sizes, and jurisdictions, and can provide advice that goes beyond simply compliance with applicable laws and regulations, such as corporate structures, marketing points, technical financial issues or risk areas specific to a given industry or jurisdiction. They can also advise on market practice to provide a point of comparison when issues arise in a transaction.
- agreements.

# Participants in Establishing Corporate Governance (Cont.)

- Attorneys advising on a securities offering are also responsible for negotiating and drafting the associated legal documentation, including the underwriting agreement, certificates, and opinions, as well as any other ancillary documents such as lock-ups or shareholders
- In an IPO context, issuers may not have substantial internal legal capability, so outside counsel may be involved in legal matters relating to a broad range of issues. In addition, attorneys take a leading role in negotiations with underwriters or shareholders.
- U.S.-licensed attorneys are subject to the rules of professional responsibility in their jurisdiction of admission, such as the New York Rules of Professional Conduct. These rules are applicable to attorneys in all areas of practice. The professional responsibility rules govern conflicts of interest, competence of representation, confidentiality and legal privilege, and related matters.

# Participants in Establishing Corporate Governance (Cont.)

## c. Securities Analysts

- Securities analysts are responsible for providing analysis of securities that are traded by investors. Research analysts are typically focused on an industry in which they are familiar with individual companies and overall trends. Based on the financial performance, industry, management and operations of a company, they will typically assign a “buy”, “hold” or “sell” recommendation to investors or price targets based on their valuation of a company. As employees of investment banks, they are involved in generating interest in a security in hopes that investors will purchase it through the firm, generating a brokerage commission.
- In the context of a securities offering, securities analysts will issue views on the offered securities, including the implied valuation, which investors will consider in making an investment decision. Accordingly, analyst views are very important for issuers and underwriters working on an offering.
- In addition to FINRA, securities analysts must comply with the Global Analyst Research Settlement entered into in 2002, which addresses conflicts of interest between research analysts, who are involved with potential purchases of securities and investment bankers, who are involved in marketing securities. Previously, investment bankers had exerted pressure on analysts to provide favorable views of securities they were selling. This decision resulted in the implementation of a “Chinese wall” which required separation between investment banking and investment research departments of investment banks, as well as rules regulating their interaction with companies who are marketing securities.

# Participants in Establishing Corporate Governance (Cont.)

d. Other equally important but less enchanted players

- Courts
- Plaintiff attorneys
- Short sellers

Thank you.