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Preprint

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Suggested Citation: Michael, Bryane; Goo, Say-Hak (2017) : The Case for the Extra-Territorial Application of Corporate Governance Standards in China, ZBW - Deutsche Zentralbibliothek für Wirtschaftswissenschaften, Leibniz-Informationszentrum Wirtschaft, Kiel, Hamburg

This Version is available at:

<https://hdl.handle.net/10419/173678>

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The Case for the Extra-Territorial Application of Corporate Governance Standards in China

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Abstract

What rule might an international financial centre like Hong Kong play in incentivizing corporate governance reform in China? Or any foreign jurisdiction? In this article, we describe theoretical application of extra-territoriality to corporate governance related law in Hong Kong. We describe why and how such extra-territoriality (following the US's lead) could encourage Mainland firms to adopt better corporate governance practices (and even implement them). Changes to the Companies Ordinance and the Hong Kong Stock Exchange's Listing Rules can, in theory, provide for such extra-territorial reach. The results of such an experiment would help us understand the role an international financial centre can play in creating value across borders, as well as make Hong Kong's rules and markets more relevant in/to the Mainland.

Keywords: Chinese corporate governance, extra-territoriality, Hong Kong, Listing Rules.

Acknowledgement: We gratefully acknowledge the Hong Kong Theme-Based Research Grant Scheme for support. Faults with the paper belong to us alone. Errors of course remain our own.

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Introduction

We know that countries' laws and policies exhibit 'lock in' and 'path dependence.'¹ Such phenomenon make reform extreme politically expensive.² Only external impetus can cause a country or group of people to change a way of acting – or at least represents the cheapest way to effect some desired change.³ What if that change consists of changing the corporate governance of a country like China?⁴ As a thought experiment, let's imagine that such a change could occur. What role could a foreign jurisdiction play in changing corporate governance in China? If China would never accept the influence of a state like the US, what about a closer and less "foreign" jurisdiction like Hong Kong?⁵ As a thought experiment, how might a foreign jurisdiction's corporate governance laws and practices influence Mainland ones – of course only with the consent of the government of the People's Republic and its Communist Party.⁶ We conduct that thought experiment in this article.

We argue that Hong Kong could – in theory – exercise extra-territorial jurisdiction over its corporate governance policies in China (and particularly over Mainland firms listed in Hong Kong). The mere potential to exercise such jurisdiction (and thus hopefully our article) teaches us about the expanding, and fascinating, use of international law. The first section explains why large-scale reform (if it comes) should have an external impetus. In simpler (though less accurate) language, reform must come from outside. The current system relies on – and provides incentives for – poor corporate governance (corporate governance which maximises returns for all

¹ Even as early as 1994, Berglof presciently wrote extensively about the problems of changing corporate governance in China. As lagging reform in even Eastern Europe and the Former Soviet Union show, lock in and path dependence represent almost insurmountable problems in most formerly planned economies. See Berglof, Erik, Corporate governance in transition economies : the theory and its policy implications, *World Bank Institute Working Paper 16284*, 1994, available [online](#).

² Some authors argue that China's regular programme of experiments – such as experimenting with enterprise reform, price liberalisation, special economic zones, and so forth, -- represent one way allowing leaders to change systems in the presence of these costs. See Heilmann, Sebastian, Policy Experimentation in China's Economic Rise, *Studies in Comparative International Development* 43(1), 2008, available [online](#).

³ We do not argue for external change always. Historians still debate about whether some foreign-imposed external corporate governance changes, from those in post-war Japan and German, to those in post-conflict Iraq, represent the best solution to perceived corporate governance problems of the time. For a brilliant analysis, see Dignam, Alan and Michael Galanis, *The Globalization of Corporate Governance*, Ashgate, 2009.

⁴ We refer to the People's Republic of China throughout this paper as China, or more conveniently the Mainland – as we contrast much of our discussion with Hong Kong.

⁵ We put foreign in quotation marks as Hong Kong technically does not represent a foreign jurisdiction at all (as a special administrative region of China). Yet, its historical independence, and its on-going autonomy to govern by its own laws until 2047, make the jurisdiction at once foreign and domestic – the perfect case for our thought experiment.

⁶ No serious treatment of political acceptability could omit mention of the Communist Party's role in deciding policy. For a readable treatment of the Party's role, see McGregor, Richard, *The Party: The Secret World of China's Communist Rulers*, 2012.

shareholders and more broadly other stakeholders). The second section describes how Hong Kong's lawmakers might place extra-territorial provisions into existing black letter law. Hong Kong has not exercised its law extra-territorially – and would unlikely do so in the future. Yet, even the possibility of cross-border enforcement of corporate governance laws might give corrupt and self-serving managers/investors north of the border pause. The third section describes options for encouraging the Mainland's cooperation with these extra-territorial laws. Any extra-territorial law needs the foreign government's sovereign agreement to assist with enforcement. The final section concludes.

Such a politically, if not academically, divisive juridical thought-experiment comes with several caveats. First, we do not argue for such extra-territorial influence. We only seek to describe a theoretical possibility, an extreme which might inspire less radical change in China and other jurisdictions struggling with corporate governance reform. We have no stake in Chinese companies, their reform (or lack thereof), or need to see any kind of change on the Mainland. Second, we do not describe the Mainland's or Hong Kong's interest in – or benefit from -- supporting such extra-territorial effect in this paper. We discuss the costs and benefits of such a regime in a larger working paper from which we draw this article.⁷ In that article, we also show how Hong Kong contributes to poor corporate governance on the Mainland – and thus may wish to contribute to remedying it. Third, we follow the usual distinction between 'good' and 'bad' corporate governance as policies which do (or do not) increase returns for minority shareholders and other corporate stakeholders. We understand that 'good' corporate governance rules in the US might result in bad governance in China (and visa versa). Yet, the evidence over-whelmingly shows that certain policies advocated by the OECD as good practices do increase shareholder value and returns to broader sections of Chinese stakeholders.⁸ We do not talk about specific corporate governance rules in this article that lawmakers should apply extra-territorially...only whether such extra-territoriality they can/should apply. Fourth, we draw heavily on US law and practice to see how far a jurisdiction has been able to push the envelope in the past. We do not advocate these policies – only use them as measures for the possible. Countries increasingly resort to the extra-territorial application of numerous branches of law.⁹ Instead of debating the pros and cons of such extra-territoriality, we only treat it as a *fait accompli* and look at applications up until now as the limits of such extra-territoriality.

⁷ See Bryane Michael and Say-Hak Goo, The Role of Hong Kong's Financial Regulations in Improving Corporate Governance Standards in China: Lessons from the Panama Papers for Hong Kong, *University of Hong Kong Faculty of Law Research Paper No. 2016/048*, 2016, available [online](#).

⁸ Cheung and co-authors show the evidence. Readers should consult Leng for a discussion of how China's politics of gradual reform make our proposals harder than we make them seem. See Cheung, Yan-Leung, Ping Jiang, Piman Limpaphayom, and Tong Lu, Corporate Governance in China: A Step Forward. *European Financial Management* 16, 2010, available [online](#). See also Leng, Jing, *Corporate Governance and Financial Reform in China's Transition Economy*, HKU Press, 2009.

⁹ Calls for increased extra-territorial enforcement of corporate governance have increased in recent years. Maybe someday, jurisdictions will apply corporate governance rules' extra-territorially as ubiquitously as such application in anti-trust and anti-corruption law. See Kirshner, Jodie, A Call for the EU to Assume Jurisdiction over Extraterritorial Corporate Human Rights Abuses, *Northwestern Journal of International Human Rights* 13(1), 2015, available [online](#).

Why China's Reform Can't Come from the Inside

Many authors implicitly argue that Chinese companies, if left to their own devices, will not reform their own corporate governance. Authors like Wang have outlined in detail why Chinese companies do not want to improve corporate governance.¹⁰ He – and authors like him – outline the ways that Chinese companies use profits and funds raised from investors to implement Communist Party and government policies, rather than maximise profits. State-owned enterprises particularly reflect this problem – where the Party controls hiring and other decisions far removed from the use of funds. Recent cases of CEO swapping at China Telecom and China Unicom as well as at CNOOC and PetroChina illustrate the Party's role in SOEs most clearly.¹¹ For Wang (Zhao-Feng and not Jiang-Yu cited above), as well as a large number of corporate governance experts on the Mainland, their concept of improving corporate governance only consists of figuring out how to improve SOEs' abilities to cheaply and effectively fulfil their Party-mandated social objectives.¹² Figure 1 shows the way that Chinese SOEs in particular have kept less performing corporate governance institutions (like Communist Party firm secretaries working at the company) alive while constraining shareholder returns.¹³ As the authors show, Mainland firms without party secretaries (as senior level persons who influence managers based on Party priorities), tend to do better than those that have them. Their Tobin's q values, sales, employment, even valuations-to-shareholder equity values exceed those of their party-secretary-line-totting brethren. In brief, such political control has led to reduced share price appreciation.¹⁴ The Chinese government thus has very weak incentives to improve corporate governance.

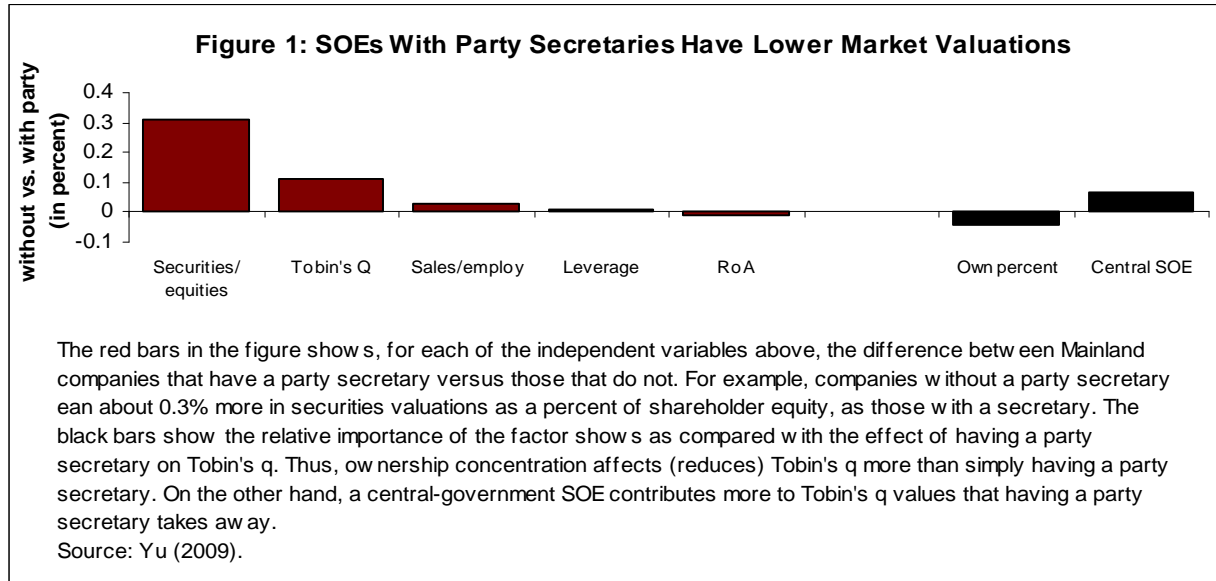
¹⁰ See Wang, Jiang-Yu, The Political Logic of Corporate Governance in China's State-Owned Enterprises, *Cornell International Law Journal* 47(3), available [online](#).

¹¹ See Kawase, Kenji, Corporate governance has a distinctly different meaning in China, *Nikkei Asian Review* July, 2016, available [online](#).

¹² He cites an old SOE law which requires Party representatives in the SOE to support the objectives of the Party and state. In our own reading of the revised Law (at least the one talking about state-owned assets), these requirements disappeared. Yet, SOEs are not forbidden from considering these factors either. Gu argues that the long hand of political influence continues to work in China's SOEs. See Zhao-Feng Wang, Corporate Governance under State Control: The Chinese Experience, *Theoretical Inquiries in Law* 13(2), 2012, available [online](#). See also Gu, Bin, Corporate governance pivotal part of State-owned enterprise reforms, *Global Times*, 2013, available [online](#). See also Law of the People's Republic of China on the State-Owned Assets of Enterprises, *Presidential Order* 5, 2009, available [online](#).

¹³ See Yu, Wei, Party Control in China's Listed Firms, Doctoral dissertation, Chinese University of Hong Kong, available [online](#).

¹⁴ The conclusion seems relatively robust and stable across time. For an earlier study showing the same effects, see Chang, Eric and Sonia Wong, Corporate Governance, Political Interference, and Corporate Performance of China's Listed Companies, 2002, available [online](#).



Does lack of interest by the central government, or by boards themselves, explain why Chinese companies will not – if left to their own devices – adopt better corporate governance practices? Chen et al., for example, find that – using data on corporate fraud committed by Chinese firms – that poor corporate governance practices can increase the probability of fraud.¹⁵ Specifically, companies with large proportions of inside directors have an 18% probability of prosecution for fraud for each inside director added.¹⁶ Each year the chairman stays reduces the probability of a fraud prosecution by 42%. Every extra board meeting decreases the probability of discovering fraud by 52%. The effectiveness of Chinese supervisory boards provides another excellent example. Jia and co-authors' econometric analysis shows that supervisory boards engage more actively in company affairs when their listed companies face investigation by securities regulators (the exchange or The China Security Regulatory Commission).¹⁷ Larger supervisory boards typically attract more severe sanctions, presumably because they should have known better. In line with such stepped-up punishment, supervisory board meetings generally increase when the company faces such an investigation.¹⁸ In another example of Chinese institutions stymieing reforms, Wang and Campbell show econometrically that Chinese firms implementing International Financial Reporting Standards (IFRS) have the same amount of earnings

¹⁵ Chen, Gong-meng, Michael Firth, Daniel Gao, and Oliver Rui, Ownership structure, corporate governance, and fraud: Evidence from China, *Journal of Corporate Finance* 12(3), 2006, available [online](#).

¹⁶ We converted the original data (regression coefficients from probit regression into probabilities).

¹⁷ Jia, Chun-Xin, Shu-Jun Ding, Yuan-Shun Li, and Zhen-Yu Wu, Fraud, Enforcement Action, and the Role of Corporate Governance: Evidence from China, *Journal of Business Ethics* 90(4), 2009, available [online](#).

¹⁸ Readers unfamiliar with Chinese boards should not confuse supervisory boards and the management board (or board of directors). In theory, supervisory boards should mostly look after (supervise) corporate governance matters. Yet, as we have previously cited, the board of directors plays a much bigger role in pushing good corporate governance. Authors like Cho and Rui demonstrate a positive correlation between firm performance and the proportion of independent board of directors members and the frequency of supervisory committee meetings. They also show a positive correlation between earnings informativeness and the proportions of independent directors on the company board and supervisory committee. See Cho, Stella, and Oliver Rui, Exploring the Effects of China's Two-tier Board System and Ownership Structure on Firm Performance and Earnings Informativeness, *Asia-Pacific Journal of Accounting & Economics* 16(1), 2012, available [online](#).

manipulation as non-IFES firms.¹⁹ They similarly find that earnings manipulation decreases with more independent directors on the board of private (non-SOE) firms. Yu and Razaee similarly find that good governance makes the transition to IFES standards easier.²⁰ Yet, Mainland firms still do not adopt the better corporate governance practices that makes IFES and other reforms easier. Even if the Mainland government wanted to push better corporate governance, entrenched incentives prevent such reform.

Worse still, institutions on the Mainland could nullify the beneficial impacts of corporate governance policies which have typically helped improve shareholder value in Hong Kong and the West. Lai has relatively recently shown how rules encouraging the appointment of independent directors on Chinese boards led to more earnings management as their corporate governance rules became institutionalized.²¹ Lai places the blame for the failure of these independent directors to restrain earnings management specifically on regulation designed seemingly to thwart, rather than encourage, independent directors' independence. Ting and co-authors similarly find that audit committees tend to correspond with more earnings management, when combined with ownership concentration and the presence of government officials on audit committees.²² In other words, some might argue that simply adopting Western/Hong Kong style corporate rules on the Mainland will not work without some form of *deus ex machina* able to identify and solve problems outside the existing system.

Changing such institutions would require far more than simply importing rules from a place like Hong Kong. Miao shows the need, using several case studies, for a complete overhaul of China's public governance for corporate governance reform to succeed.²³ Tomasic argues that Chinese law does not recognise many of the legal principles – and therefore provisions -- allowing for Western-style corporate governance practices in the Middle Kingdom.²⁴ Authors like Bin *et al.* find that changes – like the famous 2005 split-share structure reform -- had no impact on the way that corporate governance affects Chinese firm performance. In other words, corporate governance remains unmoved by, and indifferent to, different policies.²⁵ Ma and Khanna find that independent directors' dissent does not have the same returns as in the West.²⁶ Tan and Wong, in their overview piece, lament the futility of trying to implement corporate governance

¹⁹ Wang, Ying and Michael Campbell, Corporate governance, earnings management, and IFRS: Empirical evidence from Chinese domestically listed companies, *Advances in Accounting* 28(1), 2012, available [online](#).

²⁰ Yu, Chen and Zabihollah Rezaee, The role of corporate governance in convergence with IFRS: evidence from China", *International Journal of Accounting & Information Management* 20(2), 2012, available [online](#).

²¹ Lai, Liona, Monitoring of earnings management by independent directors and the impact of regulation: evidence from the People's Republic of China, *International Journal of Accounting, Auditing and Performance Evaluation* 7(1/2), 2011, available [online](#).

²² See Lin, Teng, Marion Hutchinson, and Majella Percy, The Role of the Audit Committee and Institutional Investors in Constraining Earnings Management : Evidence from Chinese Firms, *Proceedings of Accounting and Finance Association of Australia and New Zealand Annual Conference*, 2009, available [online](#).

²³ See Miao, Yin-Zhi, Overseas Listing and State-Owned-Enterprise Governance in China: The Role of the State, 2012, available [online](#).

²⁴ See Tomasic, Roman, Corporate Governance in Chinese Companies Going Global, *The Chinese Journal of Comparative Law* 2(1), 2014, available [online](#).

²⁵ See Leo Bin, Leo, Dar-Hsin Chen and Kun-Yan Chan, Chinese Corporate Profitability Performance Following The Split-Share Structure Reform, *Journal of Finance and Accountancy* 19(1), 2015, available [online](#).

²⁶ See Ma, Juan and Tarun Khanna, Independent Directors' Dissent on Boards: Evidence from Listed Companies in China, *Harvard Business School Working Paper 13-089*, 2013, available [online](#).

reforms in Mainland companies.²⁷ The only out, for them, consists of creating a Temasek-style method of corporate governance in SOEs reformed as state-asset management companies. In other words, force foreign management practices and rules on to Chinese managers. The authors had such a poetically beautiful description of the current problems which prevent reform-from-the-inside, we uncharacteristically reprint it in its full:

Having seen the politico-cultural traditions of China, one can easily understand why the independent director and supervisory board system does not work in China at all. The majority of supervisory board members are cadres who occupy a secure and well-defined position within the Party hierarchy and ranks of officialdom. He is constrained by and also loathes to upset the network of relationships existing within the listed SOE and between the SOE and its department-in-charge. Thus he sees himself as the government's apparatus to supervise the directors for violations of law or any acts that threatened the political interests of the Party. His loyalty is to his superior and more distantly the Chinese Communist Party as personified by Deng and his factions of successors such as Jiang Zemin and Hu Jintao. He belongs unquestionably to the side of authority. He does not understand that in modern China the state's interest has become pluralistic for he grew up under the all-pervading influence of the powerful monolithic bureaucracy. Hence, he is ineffectual as a supervisory board member for the simple reason that he has not been taught and do [*sic*] not understand that there are other interests of the state to be protected besides its political and power interests. Put simply, he does not understand the Western dynamics of checks and balances between the supervisory board and management board in their bid to protect the economic interests of the shareholder as owners of capital.

Tan & Wang (2007)

The lack of enforcement of all securities rules – not just those related to corporate governance – also shows that the Mainland authorities can not offer a sufficient enough deterrent on poor corporate governance practices to change corporate governance standards at a national level. In 2010, Professor Clark documented almost non-existent enforcement of Mainland securities rules – noting less than 1% of all companies censured.²⁸ By 2016, publicly available information from 2014 showed little improvement – with only 74 cases referred to the police.²⁹ If the CSRC started 488 investigations in 2014, the Commission closed only 163 cases in that same year – with the backlog of cases rising.³⁰ Even having government officials sit on Mainland companies' boards does not seem to improve corporate governance practices and enforcement. As Tin and co-authors show in their econometric study, more government officials on Mainland boards correlate with more earnings management and ineffective (even if they are independent) audit committees.³¹ Corporate governance enforcement (and thus compliance) on the Mainland will

²⁷ See Tan, Lay-Hong and Yu-Wang Jiang, Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy, *Journal of Corporate Law Studies*, August 2007, available [online](#).

²⁸ Clarke, Donald, Law without Order in Chinese Corporate Governance Institutions, *Northwest Journal of International Law and Business* 30(131), 2010, at p. 185, available [online](#).

²⁹ China Securities Regulatory Commission, 2014 Annual Report, at p. 3, available [online](#).

³⁰ Id at p. 30.

³¹ Lin, Teng, Marion Hutchinson and Majella Percy, Earnings management and the role of the audit committee: an investigation of the influence of cross-listing and government officials on the audit committee, *Journal of Management & Governance* 19(1), 2015, available [online](#).

not occur often, unless a credible, outside actor engages in enforcement effort with the full-backing of the government of the People's Republic.³²

Experts calling for the Mainland to import foreign corporate governance rules (either directly or through foreign listings) thus miss the point. Dai in particular illustrates the futility of making these kinds of recommendations.³³ He argues for stronger disclosure rules in the US for Chinese firms (and others) listing there – specifically disclosing corruption risks. Because Chinese firms deal with much higher corruption risks than US and other firms, such a rule would help Chinese issuers disclose information they would be unable to disclose at home. Yet, recommendations like this ignore the enforcement issue. Why should Mainland companies comply? An external force, though, might encourage compliance.³⁴ In contrast, extra-territorially applied rules from jurisdictions like the US have demonstrated their ability to affect change abroad.³⁵ Only rules which give the explicit mandate to securities law enforcement officials from a jurisdiction with high levels of corporate governance to work with foreign governments (and especially the Mainland) will likely move corporate governance forward in China.

If the US experience holds, other jurisdictions will likely not resist extra-territorial application of such corporate governance rules. Vagts, as early as 2003, noted in his discussion of Sarbanes-Oxley Act (the first law to theoretically apply extra-territorial corporate governance rules), that the EU and other countries did not formally object to such application.³⁶ Individual academics and social crusaders may grumble – but most see reasoned and moderate extra-territorial application in good taste. Indeed, he further notes that securities and other business increased over-seas as a result of such extra-territorial application.³⁷ As US companies had to comply with the same rules at home or abroad, they found they could exploit the benefits afforded to them by the law, without costly managing multiple regulations. International experience supports the assertion that limited extra-territorial application of corporate governance law thus increases a country's corporate activity outside of its borders.³⁸

³² We can not provide a taxonomy of the cases where such outside influence changed enforcement and compliance norms in a jurisdiction. US “cooperation” by sending experts to reform foreign laws represents one obvious – and futile – way of encouraging reform from the outside. The EU's latest accession provides much interesting fodder for readers interested in seeing a historical case of a jurisdiction importing rules and enforcement from abroad. For the first perspective, see De Lisle, Jacques, *Lex Americana?: United States Legal Assistance, American Legal Models, and Legal Change in the Post-Communist World and Beyond*, *University of Pennsylvania Journal of International Economic Law* 20, 1999. For the second perspective, see Ialnazov, Dimiter, *The Impact Of EU Accession on Corporate Governance Reform in Bulgaria*, *Acta Oeconomica* 57(2), 2007, available [online](#).

³³ Dai, Xin, *Disclosing China's Corruption Risks: A Securities Regulation Perspective*, *Duke Journal of Comparative & International Law* 24, available [online](#).

³⁴ We stopped summarizing Dai in the previous sentence. Extra-territoriality thus follows – in our analysis – as a possible implication from Dai's analysis.

³⁵ Anti-corruption law represents the most obvious example. See Lippitt, Anne, *An Empirical Analysis of the Foreign Corrupt Practices Act*, *Virginia Law Review* 99(8), 2013, 2013, available [online](#).

³⁶ Vagts, Detlev Extraterritoriality and the Corporate Governance Law, *American Journal of International Law* 97(2), 2003, available [online](#).

³⁷ *Id* at p. 293.

³⁸ The author further rightly notes that such rulemaking may over-burden regulators who must survey activity abroad as well as at home. In cases where foreign regulators or courts have an interest in the case, they must similarly use resources in negotiating with these parties.

The Rationale for Extra-Territorial Corporate Governance Law and Rules

The Legislative Council clearly has arguably the power to enact extra-territorial legislation. In a 2003 brief looking at the extra-territorial application of national security laws, the Hong Kong Department of Justice considered more generally the question of whether the LegCo had the competence to enact legislation applying beyond Hong Kong's borders.³⁹ As a result of two orders, Hong Kong Order of 1986 and later 1989, under the Hong Kong Act, Hong Kong may apply laws agreed by international treaty extra-territorially.⁴⁰ Citing law professor Peter Wesley-Smith, who finds a possible rationale under existing law if the "nexus" between Hong Kong and the foreign act bears a "real or substantial relation" to Hong Kong.⁴¹

Yet, such a rationale relies on two legal artifices. First, most arguments in support of extra-territoriality apply to rulemaking under the British Empire. Second, citing the supposed Piggott Doctrine, the Queen of that time did not strike down the extra-territorial application of law -- in a historical version of silence-equal-consent.⁴² For Judge Power JA, any law promoting the "peace, order and good government" of Hong Kong which applies in Hong Kong may receive extra-territorial treatment. Arguments from lawyers like Mok clearly suggest that Hong Kong's legal community considers extra-territorial application of corporate governance not only possible, but necessary.⁴³

The Hong Kong (Legislative Powers) Order 1986 clearly intended for the LegCo to have the competence to rule extra-territorially.⁴⁴ Confusion shortly surfaced as to whether such powers extended only to civil aviation, merchant shipping and admiralty. Or whether the powers applied more generally. Wesley-Smith cites a tax case, which attracted extra-territorial jurisdiction as per British imperial rulings of the time.⁴⁵ The Companies Ordinance imposes several requirements on companies not in Hong Kong.⁴⁶ Yet, in the case of the extra-territorial application of Hong Kong's anti-corruption law, courts have pushed back against attempts to interpret the Prevention of Bribery Ordinance extra-territorially.⁴⁷ The Legislative Council needs to expressly write extra-territorial provisions, given the uncertainty and vagueness around the extent to which laws can apply extra-territorially. Violations of Hong Kong's corporate governance rules by Hong Kong

³⁹ Department of Justice, National Security (Legislative Provisions) Bill: Extraterritoriality, Paper 50, 2003, available [online](#).

⁴⁰ Id at Annex I, p.5.

⁴¹ Id, citing Peter Wesley-Smith, Constitutional and Administrative Law, at p. 207.

⁴² Id at sec. 752.

⁴³ Id. at sec. 5.

⁴⁴ Id at sec. 7.5.3.

⁴⁵ Id at Annex 2, 3rd to the last sentence.

⁴⁶ See Companies Ordinance, Chap. 622, available [online](#).

⁴⁷ For the law, see Prevention of Bribery Ordinance, Chap. 201, 1971, available [online](#). For a recent discussion of the courts' treatment of the extra-territorial treatment of that ordinance, see also Rohlik, Philip and Sebastian Ko, Hong Kong Court Rules on Extraterritorial Limits to the Territory's Anti-Corruption Law, *FCPA Professor*, 2014, available [online](#).

listed companies abroad will attract extra-territorial liability only for the rules enshrined in hard law.⁴⁸

Politics should – and will – determine which corporate governance principles apply extra-territorially. As a political decision, Legislative Council members would need to add extra-territoriality to the Companies Ordinance and/or Securities & Futures Ordinance – depending on the outcome of political bargaining. Relevant provisions from the Sarbanes-Oxley Act include corporate responsibility for financial reports, management assessment of internal controls, real time issuer disclosures, attempts and conspiracies to commit fraud offenses, and corporate responsibility for financial reports.⁴⁹ Relevant concepts from the Dodd-Frank Act include several very controversial issues which do not apply to Hong Kong. These include forming a board-level compensation committee, disclosure of compensation and introducing claw-back clauses into contracts which allow companies to take-back money paid to corporate executives who misstate financial results.⁵⁰ More relevant for our discussion, the Act allows for law enforcement action in cases where corporate mis-governance which adversely affects the US.⁵¹ Hong Kong's government will need to find its own set of extra-territorial issues.

What should the Legislative Council do if its members want to adopt such extra-territoriality formally and clearly? The fastest route consists of adding a provision allowing for extra-territoriality to the Companies Ordinance and the Securities and Futures Ordinance. Such a provision should note that corporate governance obligations extend beyond Hong Kong and that companies may face extra-territorial sanctions if violated. For example, a new sec. 3(5) can be added to the Securities and Futures Ordinance to say that the Ordinance does not only apply to companies or persons in Hong Kong. Section 2(7) of the same law may also make reference to such extra-territoriality. Given the novelty of extra-territoriality in Hong Kong, the provisions may signal the government's intent more than actually create the basis for effective enforcement. As the lawmakers and researchers gain experience with extra-territorial dimensions of Hong Kong's companies' foreign government practices, lawmakers may make these provisions more concrete and specific.

What about China? Article 13 of the Basic Law gives the central government in Beijing jurisdiction over foreign affairs – if extra-territoriality in itself (rather than in its effects) constitutes a “foreign affair.”⁵² Extra-territoriality does not, however, comprise such foreign affairs – as we previously discussed in citing authoritative interpretations of the Hong Kong

⁴⁸ As Mok as noted, “code provisions and recommended best practices are not mandatory rules.” See Mok, Thomas, Should The Hong Kong Code On Corporate Governance Practices Be Given Statutory Backing? *Hong Kong Lawyer*, Nov. 2014, at sec. 2, para. 2, available [online](#).

⁴⁹ See Bill To Protect Investors by Improving the Accuracy and Reliability of Corporate Disclosures Made Pursuant to the Securities Laws, and for Other Purposes [hereinafter Sarbanes–Oxley Act of 2002], at sec. 302, sec. 404, sec. 409, sec. 902 and sec. 906 respectively.

⁵⁰ Michael and Goo show that compensation does not represent a key corporate governance issue in Hong Kong. Banking represents the only place where these provisions might have a legitimate use (as disparities in banking compensation tend to follow international norms). See Kim, Hwa-Jin, Financial Regulation and Supervision in Corporate Governance of Banks, *Journal of Corporation Law* 41(3), 2016, available [online](#).

⁵¹ See Wu, Jennifer, Morrison v. Dodd-Frank: Deciphering the Congressional Rebuttal to the Supreme Court's Ruling, *University of Pennsylvania Journal of Business Law* 14(1), 2011, available [online](#).

⁵² *The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China*, 1997, available [online](#).

(Legislative Power) Order. Article 17 gives the Standing Committee of the National People's Congress the power to reject any law it deems unconstitutional. Articles 8 and 18 clearly keep British law in place. Annex III does not cancel any laws with extra-territorial effect. As China has its own extra-territorial laws, the central government should not consider the extra-territorial application of Hong Kong's corporate governance law as foreign to local legal jurisprudence. As one example of such an extra-territorial rule in China, Shen and Watters have argued that Circular 698 applies tax policy extraterritoriality, as any transaction – even between foreign entities -- transferring interest in a Chinese company taking place outside of China still attracts tax.⁵³ Therefore, the Mainland would be unlikely to hinder the extra-territorial application of Hong Kong's corporate governance – particularly as it has its own extra-territorial application of very limited parts of its own corporate governance law.

Options for Limited Cross-Border Enforcement Cooperation

As noted previously, Hong Kong can not adequately export stringent corporate governance rules to places like the Mainland through its Listing Rules. A number of authors wrongly argue that mergers and acquisitions represent an important vector in transmitting “better” corporate governance rules.⁵⁴ For example, Kim and Lu argue that differences in corporate governance actually drive M&A activity – as firms from developed countries “cherry pick” fast growing firms located in jurisdictions with weaker corporate governance practices.⁵⁵ Yet, their arguments – and authors writing with the same world-view -- put the proverbial cart before the horse. As we showed already, corporate governance drives listing and M&A decisions far more than such listing and M&A drive changes in corporate governance. Natural change/evolution will not lead to significant change in corporate governance on the Mainland without some external force.

At present, Hong Kong has very limited options for encouraging compliance with its stringent corporate governance rules abroad. Hong Kong and many of its trading/investment partners have signed on to an International Organization of Securities Commissions' Memorandum of Understanding (IOSCO MOU) promising to expand consultation and cooperation between national financial regulators.⁵⁶ Yet, the Memorandum of Understanding only concerns the sharing of information – rather than facilitating tangible help in conduct investigations and

⁵³ Shen, Wei and Casey Watters, Is China Creating A New Business Order? Rationalizing China's Extraterritorial Attempt to Expand the Veil-Piercing Doctrine, *Northwestern Journal of International Law & Business* 35(3), 2015, available [online](#). For the circular they cite, see also China State Administration of Taxation, Notice of the State Administration of Taxation on Strengthening the Management of Enterprise Income Tax Collection of Proceeds from Equity Transfers by Non-resident Enterprises, *Circular No. 698*, 2009.

⁵⁴ We do not have the space to describe the problems with these studies. For readers interested in making up their own minds, see Martynova, Marina and Luc Renneboog, Spillover of Corporate Governance Standards in Cross-Border Mergers and Acquisitions, *Journal of Corporate Finance* 14(3), 2008, available [online](#). See also Coffee, John, Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance, *Columbia Law Review* 102(7), 2002, available [online](#). See also Chen, Yun, and Yuan-Qiong He, The Research on Impact of Dual Listing on Corporate Governance and Corporate Performance: Evidence from Chinese Dual Listed Companies, 2008, available [online](#).

⁵⁵ See Kim, Han and Yao Lu, Corporate Governance Reforms Around the World and Cross-border Acquisitions, *Journal of Corporate Finance* 22(1), 2013, available [online](#).

⁵⁶ See International Organization of Securities Commissions, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*, 2002 (revised 2012), available [online](#).

enforcing rules across borders. The SFC can, for example, use the MOU to possibly collect evidence on corporate governance violations conducted outside of Hong Kong. Yet, if Hong Kong wanted to refer a corporate governance violation to the Mainland authority, nothing in the MOU requires that the Mainland government receive, or act on, such information.⁵⁷ Thus, even if the extra-territorial application of Hong Kong's corporate governance rules has no appreciable effect on deterrence and enforcement, at least the Securities and Futures Commission would put online information related to the agreements the regulator has made with foreign regulators.⁵⁸

Extending the US-based conduct-effect approach to international law, authors like Lanois might logically argue that Hong Kong thus may apply corporate governance law extra-territorially if violation of these laws significantly affected Hong Kong.⁵⁹ The US's SEC has exercised discretion and good judgment when seeking to apply extra-territorial law – and any attempt in Hong Kong would likely (and similarly) require respecting foreign countries' sovereignty.⁶⁰ Similarly to our point made earlier, such an application would encourage convergence in corporate governance regulations – as Mainland companies (for example) adapt to Hong Kong's corporate governance rules which might apply directly to them.⁶¹ If such a view is correct, Hong Kong authorities would not need to actually enforce these rules. The threat of extra-territorial enforcement of Hong Kong's corporate governance rules would encourage firms in the Mainland and elsewhere to adopt changes to their local law which they already comply with in any case. If Hong Kong's authorities helped the foreign jurisdiction with investigating and/or prosecuting serious corporate governance violations, such assistance would help that foreign jurisdiction improve its own abilities to enforce securities and corporate law.⁶² Extra-territorial application of Hong Kong's corporate governance rules would encourage jurisdictions like the Mainland to adopt more stringent corporate governance rules.⁶³

What legal instruments might Hong Kong rely on in policing the conduct and effects of poor/harmful corporate governance practices across borders? Mann and Berry describe the ways

⁵⁷ Like usual, the SFC does not provide information on its specific adoption of the MOU. The only public evidence available proving that the SFC has signed on to the multilateral MOU comes from a one line statement on its website. See also Securities and Futures Commission, IOSCO MMOU, 2016, available [online](#).

⁵⁸ See Arner et al. outline the lack of SFC's transparency and the unavailability of agreements which other official sources cite. See Douglas Arner, Douglas, David Donald, Say Goo, Wei-Xing Hu, Chen Lin, Bryane Michael, Frank Song, Wilson Tong, Cheng-Gang Xu, Dariusz Wojcik, Simon Zhao, Assessing Hong Kong as an International Financial Centre, *University of Hong Kong Faculty of Law Research Paper 2014/012*, 2014, available [online](#).

⁵⁹ Lanois' arguments apply to the US. Yet, nothing in his discussion suggests that his principles apply uniquely or exclusively to the US. Indeed, he notes later in the article that failing to enforce Sarbanes-Oxley abroad results in discriminatory (advantageous) treatment of foreign companies. See Lanois, Paul, Between a Rock and a Hard Place: The Sarbanes-Oxley Act and its Global Impact, *Journal of International Law and Policy* 5(4), 2007, p. 4:14, available [online](#).

⁶⁰ Id at p. 4:13.

⁶¹ Id.

⁶² For evidence, see Carvajal, Ana and Jennifer Elliott, The Challenge of Enforcement in Securities Markets: Mission Impossible? *IMF Working Paper 09/168*, 2009, available [online](#).

⁶³ We have observed such convergence as "ripple effects" (in Vakkur and Herrera-Vakkur's language) when the US adopted both the Sarbanes-Oxley and Dodd-Frank extra-territorial measures. For the econometrics behind foreign adoption, see Vakkur, Nicholas and Zulma Herrera-Vakkur, Ripple effects: Sarbanes Oxley's Impact Upon Investor Risk in a Global Economy, *Review of Accounting and Finance* 11(2), 2012, available [online](#).

regulators cooperate to enforce securities and corporate laws abroad.⁶⁴ They claim that requests under the Hague Convention, mutual legal assistance treaties, and bilateral/ multilateral memoranda of understanding among regulators serve as the basis for enforcing rules (including corporate governance rules) across borders.⁶⁵ Under the Hague Convention, the relevant authority in Hong Kong may send the relevant regulatory or court decision to the foreign equivalent of our Chief Secretary for Administration. The Foreign Judgments (Reciprocal Enforcement) Ordinance – and in the Mainland’s case, the Mainland Judgments (Reciprocal Enforcement) Ordinance and especially section 21 – provide for sending Hong Kong’s requests to foreign authorities for enforcement.⁶⁶ Hong Kong already has such agreements with most of the governments in the region.⁶⁷ The lack of cross-border enforcement shows that these agreements do not provide an adequate basis for international cooperation.

What would Hong Kong’s limited extra-territorial application of its corporate governance rules look like? Hong Kong’s proposed extra-territorial enforcement would, in practice if not in letter, not go as far as US enforcement in so-called “F-squared” and F-cubed” cases.⁶⁸ Indeed, the US itself has started to back peddle on the use of conduct/effects tests – in favour of less capricious and arbitrary transactional tests. To mirror the US’s recent thinking, Hong Kong courts would need to litigate cases involving corporate governance when the “purchase or sale of the security is made in the [Hong Kong] or whether the security in the transaction is listed on a [Hong Kong] stock exchange.”⁶⁹ Yet, Hong Kong’s lawmakers would do well not to impose limits on such extra-territoriality. Authors like Beyea argue that the US Supreme Court’s curtailment of such extra-territoriality undermined investor confidence – and thus investment.⁷⁰ Extraterritorial

⁶⁴ See Mann, Michael and William Barry, Developments in the Internationalization of Securities Enforcement, *International Law* 39, 2005, available [online](#).

⁶⁵ We vehemently disagree that “on a worldwide basis, securities regulators have developed a successful, multi-faceted approach to the challenges posed by the internationalization of the world’s securities markets” (Id at p. 668). Our discussion provides suggestions for achieving such internationalisation.

⁶⁶ We do not provide a detailed background on these ordinances in order to focus more on future cooperative arrangements. See Foreign Judgments (Reciprocal Enforcement) Ordinance, Chapter 319, available online. See also Mainland Judgments (Reciprocal Enforcement) Ordinance, Chapter 597, available [online](#).

⁶⁷ Indeed for the OECD, these memoranda of understanding represent the way of promoting enforcement across borders. For a list of these cooperative agreements, and the strategies for pursuing cross-border collaboration on the enforcement of corporate governance-related law, see Fianna Jurdant, *Public Enforcement and Corporate Governance in Asia: Guidance and Good Practices*, 2014, available [online](#).

⁶⁸ For a relatively recent overview, see Coupland, Jennifer, A Bright Idea: A Bright-Line Test for Extraterritoriality in F-Cubed Securities Fraud Private Causes of Action, *Northwestern Journal of International Law & Business* 32, 2012, available [online](#). For a readable overview, see Hanusik, Thomas and Traci Rodriguez, I Don’t Live in the United States, So How Can the SEC Sue Me? SEC Actions against a Foreign National Living Outside the United States, *Bloomberg*, 2008, available [online](#).

⁶⁹ We have substituted the phrase Hong Kong for the United States, to draw the obvious parallel with our paper’s subject. Such a formula thus preserves a presumption against extra-territoriality – particularly important in Hong Kong’s context, whereas Hong Kong’s Basic Law restricts the governments exercise of powers in international/foreign affairs.

⁷⁰ We do not wish to go into the details of US law. Suffice it to say that the US Congress, reacting to limits imposed by the Supreme Court, expressly sought the extra-territorial application of parts of the Dodd-Frank Act. Sections 929P(b) and 929Y represent the most important parts of that law. See Beyea, Genevieve, Morrison v. National Australia Bank and the Future of Extraterritorial Application of the U.S. Securities Laws, *Ohio State Law Journal* 72, 2011, available [online](#). See also Painter, Richard, The Dodd-Frank Extraterritorial Jurisdiction Provision: Was It Effective, Needed or Sufficient?, *Harvard Business Law Review* 1, 2011, available [online](#). See also U.S. Securities and Exchange Commission, Study on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of

application of US corporate governance rules has not led to disagreements, conflict or the abandonment of comity between countries.⁷¹ Indeed, at least in the financial sector, many companies working across borders may already expect to feel the impacts of extra-territorial administrative decisions.⁷² Thus, once the Legislative Council adopts extra-territorial corporate governance measures, political and economic pressures may encourage further expansion of such extra-territoriality.

Indeed, various scholars argue that a company's agreement to list on a foreign exchange makes the company – and those who direct it – bound by the foreign law of the listing exchange's jurisdiction. Lanois makes the case poignantly – noting that the listing decision entails “implied consent” to submit to the courts of the jurisdiction where the company lists.⁷³ In his analysis, he notes that, “securities laws are entitled to be applied extraterritorially when foreign issuers have agreed to submit to the jurisdiction of the country where they wish to be listed.... The extraterritorial application of a national law would hence result from a voluntary decision made by the foreign corporation.”⁷⁴ Legal scholars like Besmer see the basis for effective enforcement in these implicit – or explicit – companies' agreements to comply with listing regulations' rules and enforcement actions.⁷⁵ What happens if the management of a company listing in Hong Kong explicitly sign contracts to be bound to Hong Kong law and enforcement actions (which might be the same or differ from those applied to domestic parties)? At the very least, listing companies' could signal their acceptance to comply with, and face punishment for violating, Hong Kong's corporate governance rules.

A gradual approach toward implementing such extra-territoriality in practice should begin with the Listing Rules themselves. Regardless of the SFC's of Hong Kong Stock Exchange's currently self-perceived capacity to implement corporate governance rules extra-territorially, the Listing Rules should note that the rules apply extra-territorially – possibly in Chapter 2 (under general principles) and again in the first section (The Code) of Appendix 14 (which presents the rules).⁷⁶ Given the likely harms to small companies, enforcement would apply on the Main Board, but not the GEM.⁷⁷ If the SFC acts like the SEC, such a declaration might even open the door for the

the Securities Exchange Act of 1934 As Required by Section 929Y of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2012, available [online](#).

⁷¹ We have already reviewed the evidence. But Coffee provides fodder for readers interested in assessing the opposite view. See Shirley, Jonathan, International Law and the Ramifications of the Sarbanes-Oxley Act of 2002, *Boston College International and Comparative Law Review* 27(2), 2004, available [online](#). See also Coffee, John, Extraterritorial Financial Regulation: Why E.T. Can't Come Home, *Cornell Law Review* 99(1259), 2014, available [online](#).

⁷² Nothing exemplifies the use of administrative remedies across borders like the SEC's administrative subpoena. See Betman, Ronald and Jonathan Law, The (Too) Long Arm of the S.E.C.: When a Foreign Employee of a U.S.-Based Multinational Financial Services Client is Threatened with a Subpoena, *Berkeley Business Law Journal* 10, 2013, available [online](#).

⁷³ See Lanois, Paul, Between a Rock and a Hard Place: The Sarbanes-Oxley Act and its Global Impact, *Journal of International Law and Policy* 5(4), 2007, at II.a, available [online](#).

⁷⁴ Id at II.a para. 3.

⁷⁵ See Besmer, Veronica, The Legal Character of Private Codes of Conduct: More than Just a Pseudo-Formal Gloss on Corporate Social Responsibility, *Hastings Business Law Journal* 2, 2006, available [online](#).

⁷⁶ See HKEx, Rules and Guidance on Listing Matters, 2016, available [online](#).

⁷⁷ As noted previously, econometric studies show that Sarbanes-Oxley negatively impacted on smaller firms, making such regulation and enforcement distortionary. See Iliev, Peter, The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices, *Journal of Finance* 65(3), 2010, available [online](#).

SFC to provide beneficial *ad hoc* advice to foreign companies – rather than simply acting only as bad cop.⁷⁸ Thus changes to the Listing Rules can implement Lanois’ view of listing as an implicit contract to fall under the jurisdiction of the stock exchange where the company lists. The corporate governance rules should require companies to sign contracts (statements) to fall under Hong Kong’s extra-territorial jurisdiction. Such a move – even if such contracts have no legal force in the foreign country’s home jurisdiction – at least gives the SFC and other authorities a more solid basis for challenging corporate malfeasance. Recommendations aimed at changing the Companies Ordinance and the Securities and Futures Ordinance at least set the basis for these changes to Hong Kong’s Code of Corporate Governance.

Why don’t we provide more details? Would Hong Kong’s extra-territoriality work like in the US? What powers would its law enforcement have abroad? We leave these questions unanswered. Politics will determine the existence and nature of any extra-territorial corporate governance policies. Simply writing extra-territoriality into Hong Kong’s laws will require significant time and energy. To take one example, any change in the Listing Rules would require a change in the Securities and Futures Ordinance giving the specific, particular Listing Rule provision extra-territorial effect (as the Listing Rules don’t carry the force of law in themselves). Yet, by living them “ungrounded” in the Securities and Futures Ordinance (namely without any article in the Ordinance giving the Rule force of law), the Listing Rule provision would act like the signal of intent we have argued for at this stage. Such a seemingly silly move would clearly result from the political need to move reform slowly – rather than from any rigorous legal reasoning.⁷⁹ Any more discussion of specifics would be pre-mature.

Conclusion

What role could the extra-territorial application of corporate governance play in helping the Mainland’s companies adopt corporate governance reform? With the growing adoption of extra-territorial corporate governance rules (mostly coming from the US), such a theoretical question will have a practical significance for numerous international financial centres’ jurisdictions besides Hong Kong. As a thought experiment, Hong Kong’s lawmakers can in principle adopt such extra-territorial application. Such extra-territorial application can help improve corporate governance on the Mainland – if the Mainland government and the Communist Party so desire. Any actual legal drafting though, in the short term, would likely best consist of small symbolic steps – via small changes to the Companies Ordinance and the Hong Kong Stock Exchange’s Listing Rules. Like all other reform in China, such an experiment should dictate whether a good idea in theory represents one in practice.

⁷⁸ For a description of this overseas work by the SEC, see SEC, International Enforcement Assistance, 2016, available [online](#).

⁷⁹ Writing rules explicitly without legal force would seem to the western jurist as a waste of time. Yet, from the politics-of-reform perspective, such a move might help market participants adjust to the new idea – on a voluntary basis – rather than through enforced law. Eventually, the changes we described to the Securities and Futures Ordinance and Companies Ordinance might give such a Listing Rule the force of law. For a discussion of the need to establish ‘normative principles’ when dealing with the politics and timing of extra-territorial application (at least in the US context), see Gibney, Mark, The Extraterritorial Application of U.S. Law: The Perversion of Democratic Governance, the Reversal of Institutional Roles, and the Imperative of Establishing Normative Principles, *Boston College International and Comparative Law Review* 19(2), 1996, available [online](#).