FOREIGN POLITICAL INTERFERENCE IN THE GOVERNANCE OF LISTED COMPANIES: A MARKET AND BEHAVIORAL ANALYSIS

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This Article examines how regulators and a company's stakeholders can and should respond to external political interference from a foreign government. This Article argues that the interactions created by different stakeholders influence the market's response to such interference. This Article uses the "Party building" political movement in China to illustrate how Chinese businesses listed in Hong Kong reacted to interference from the Chinese Communist Party (CCP). The Party building is the CCP's attempt to strengthen its control of listed companies by: having CCP organization's in a company (organizational interference), controlling management decisions (management interference), and controlling human resources (human resources interference). The political campaign offers a rare chance to observe how corporate stakeholders respond to external political interference from another country. This Article shows that fewer than a third of the companies examined were early adopters of Party building provisions. This suggests that managers have not been willing to accept political interference, especially when their companies are registered outside of China. However, companies that have adopted "Party building" provisions in their corporate charters have generally accepted some organizational interference or managerial interference. Still, they have been less accommodating to more direct control over personnel or human resources decisions. Consequently, this Article argues that securities regulators, in an open market, should adopt a market-driven approach to counter foreign political interference that empowers shareholders by increasing transparency, instead of implementing drastic interventions, such as mandatory delisting.

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I. INTRODUCTION

This Article examines how securities regulators should respond to the political influence exercised by a foreign government on companies listed on its domestic securities exchange. Should a securities regulator rely on market power to curb foreign political interference? Alternatively, should a host regulator adopt stringent measures to combat foreign powers? The efficiency of either approach depends on the reactions of corporate stakeholders. The importance of an appropriate response to foreign political interference is accentuated by reports of foreign interference in elections[1] and China's rise as a political and economic power.[2]

There is little doubt that political pressure, from domestic or foreign actors, can affect listed companies when a stock market is international and has many foreign listed entities, such as the New York Stock Exchange.[3] Political influence by a foreign government ("foreign political interference" or external political interference) raises two key questions: (1) whether foreign political influence on the corporate governance of a locally listed company hurts the targeted firms' value or the overall market; and (2) how the host market regulator should deal with such interference. For clarification, the term "host market regulator" refers to the securities regulator of the stock exchange where a foreign company is listed. For example, for Chinese companies listed for trading in Hong Kong: the home market would be in Mainland China and consequently, the home government would be the Chinese government. Conversely, the Hong Kong stock market is the host market and Hong Kong's regulators (such as the Hong Kong Securities and Futures Commission and the Hong Kong Exchange) are the host regulators.

This Article posits that political interference into the governance of a company should be deterred. This Article generally refers to 'political interference' as an exercise of power by political actors to influence a corporate decision. Political interference can take many forms: from political connections or appointees, to ordering a company to comply with a demand.[4]

1. For example, there were allegations that Russia interfered with the U.S. presidential election in 2016. *See, e.g.*, *2016 Presidential Election Investigation Fast Facts*, CNN (Aug. 27, 2020, 1:25 PM), https://edition.cnn.com/2017/10/12/us/2016-presidential-election-investigation-fast-facts/index.html [https://perma.cc/8DV4-25KL]; *2016 Presidential Campaign Hacking Fast Facts*, CNN (Oct. 28, 2020, 3:12 PM), https://edition.cnn.com/2016/12/26/us/2016-presidential-campaign-hacking-fast-facts/index.html [https://perma.cc/5FCM-L6KQ]. There is also concern that China meddled with Taiwan's presidential election in January 2020. *See, e.g.*, Sheridan Prasso & Samson Ellis, *China's Information War on Taiwan Ramps Up as Election Nears*, BLOOMBERG (Oct. 23, 2019, 4:00 PM), https://www.bloomberg.com/news/articles/2019-10-23/china-s-information-war-on-taiwan-ramps-up-as-election-nears [https://perma.cc/8DTR-GUDS].

2. For example, the Chinese gross domestic product (GDP) on a purchasing power parity basis amounted to less than 5% of global GDP in the 1980s but it has amounted to over 15% of global GDP since 2012 and has surpassed the share of GDP of the United States in relation to global GDP. *See* Wayne M. Morrison, CONG. RSCH. SERV., RL33534, CHINA'S ECONOMIC RISE: HISTORY, TRENDS, CHALLENGES, AND IMPLICATIONS FOR THE UNITED STATES 11 fig.7 (2019).

3. Based on the information provided by the New York Stock Exchange, there are 507 non-U.S. issuers listed for trading in the New York market as of April 30, 2020. *See Current List of All Non-U.S. Issuers*, N.Y. STOCK EXCHANGE (Apr. 30, 2020), https://www.nyse.com/publicdocs/nyse/data/CurListofallStocks.pdf [https://perma.cc/62KX-NGMX].

4. *See infra* Part II.A.1.

Although political connections may benefit a company,[5] political interference generally depresses a company's value.[6]

Interference depresses a company's value by exacerbating the costs associated with the principal-agent problem. In general, a relationship between the principal (i.e., the company) and its agents (i.e., the managers) implies some information asymmetry and moral hazard. For example, managers may use company resources' for their personal benefit.[7] To counter this, the principal (i.e., the company) incurs monitoring costs to reduce the risk of misconduct.[8] Management's wrongful conduct could also create losses.[9] Those costs, or losses, are commonly referred to as "agency costs," which hurt the company's value.[10] When foreign powers interfere in a company's corporate governance, managers may be pressured to make decisions that benefit politicians, rather than the company and its shareholders. If so, it could result in losses to the company (e.g. the company providing services at a lower price to the politician) and thereby increasing the agency costs.

Political interference also increases the risk of corruption or wrongdoing, such as "tunneling" or disadvantageous related-party transactions.[11] For example, state-owned enterprises (SOEs) experience some degree of political intervention due to state ownership. The Organization for Economic Cooperation and Development (OECD) noted that SOEs might suffer from "undue hands-on and politically motivated ownership interference, leading to unclear lines of responsibility, a lack of accountability and efficiency losses in the corporate operations."[12] To illustrate, the Chinese government ordered state-owned banks to extend credit to rescue its' economy during the global financial crisis.[13] Without the

5. *See infra* Part II.A.2.

6. *See infra* Part II.A.2.

7. *See generally* Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AM. ECON. ASS'N 134 (1973) (discussing issues related to agency, such as moral hazard and information asymmetry).

8. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

9. *Id.*

10. *Id.*

11. "Tunneling" generally refers to "the transfer of resources out of a company to its controlling shareholder (who is typically also a top manager)." Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000).

12. OECD, GUIDELINES ON CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES 12 (2015 ed. 2015) [hereinafter GUIDELINES ON STATE-OWNED ENTERPRISES].

13. *Giant Reality-Check*, ECONOMIST: FIN. & ECON. (Aug. 31, 2013) [hereinafter *Giant Reality-Check*], http://www.economist.com/news/finance-and-economics/21584331-four-worlds-biggest-lenders-must-face-some-nasty-truths-giant-reality-check [https://perma.cc/7425-G463].

order, bank managers would have been less likely to extend credit to a borrower if it meant higher risk of default after the financial crisis.[14] Whether SOEs operate efficiently and whether they should be wholly or partially privatized is beyond this Article's scope. However, even when an SOE is partially state-owned, concerns that political interference might affect the overall market and other non-state shareholders remain. Because of the agency costs to the company and stakeholders, political interference should be avoided.

The strategies that securities regulators adopt to manage political interference depends on various factors. A regulator is part of its' domestic government and, consequently, subject to politics. For example, an independent financial regulator, such as the Securities and Exchange Commission in the United States, "provide[s] greater confidence and trust that regulatory decisions are made with integrity."[15] An independent regulator is more likely to maintain competitive neutrality when government and non-governmental entities are regulated under the same framework.[16] Independence and impartiality are crucial when regulatory conduct has a significant impact on the industry.[17] However, the independence, and consequently effectiveness, of a regulator depends on its domestic government's institutional integrity.

In the case of foreign interference, how securities regulators ("host regulators") respond also depends on the relationship between the government of the company's home country and the government hosting the stock exchange ("host market"). There are also difficulties with enforcing rules against breaches of directors' duties or inappropriate disclosures by a foreign company. For example, host regulators may not be able to serve notice, secure evidence, or freeze assets when a company primarily operates in another jurisdiction.[18] The lengths to which a securities regulator must go to address foreign political interference also depends on how domestic corporate stakeholders react to foreign political influence.

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14. There was a debt bubble occurring in China after the 2008 global financial crisis. *Why China's Debt Defaults Are More Alarming This Time*, BLOOMBERG (Dec. 10, 2020, 11:18 AM) [hereinafter *China's Debt Defaults*], https://www.bloombergquint.com/quicktakes/why-china-s-debt-defaults-are-more-alarming-this-time-quicktake [https://perma.cc/5RTU-PE86].

15. OECD, THE GOVERNANCE OF REGULATORS: BEING AN INDEPENDENT REGULATOR 34 (2016).

16. *Id.*

17. *Id.*

18. *See, e.g.*, Wai Yee Wan et al., *Public and Private Enforcement of Corporate and Securities Laws: An Empirical Comparison of Hong Kong and Singapore*, 20 EUR. BUS. ORG. L. REV. 319, 334–35 (2019) (suggesting the difficulty of gathering evidence against directors, particularly in foreign listings, as a possible explanation for the rarity of private enforcement actions brought against directors in Hong Kong and Singapore).

This Article explores how corporate stakeholders, namely managers and current and prospective shareholders,[19] react to foreign political interference. Their response to foreign political interference informs a securities regulator's approach. This Article also examines responses that a host regulator may adopt when facing political interference by a foreign government or political entity. Potential regulatory responses include: no action; moderate measures, such as insisting on disclosure and transparency; or stringent measures, like delisting or prohibitions from listing. As previously suggested, each approach must be evaluated within the context of a given market.

This Article examines responses to external political interference through the CCP's "Party building" (or *dangjian*) political movement, an intrusion into the governance of Chinese companies listed on a foreign stock exchange.[20] The Chinese Communist Party (CCP or the Party) already had some presence in some Chinese companies before the recent Party building movement. By the end of 2016, approximately 67.8% of the 2.73 million private enterprises in China had a Party organization representing the CCP (e.g. committee comprising of CCP members) in the companies.[21] The CCP attempted to further strengthen its role in the governance of SOEs through Party building.[22] In October 2016, President Xi Jinping made a speech re-affirming the CCP's leadership of SOEs,[23] stressing that Party organizations

19. *See generally* MASAHIKO AOKI, CORPORATIONS IN EVOLVING DIVERSITY: COGNITION, GOVERNANCE, AND INSTITUTIONS 20 (2010) (discussing the separation of control and management in a corporate structure); MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 21 (2006) (discussing how ownership, management, and employment fit together in a firm).

20. Zhonggong Zhongyang Bangong Ting (中共中央办公厅) [General Office of the Chinese Communist Party Central Committee], *Guanyu Zai Shenhua Guoyou Qiye Gaige Zhong Jianchi Dang de Lingdao Jiaqiang Dang de Jianshe de Ruogan Yijian* (*关于在深化国有企业改革中坚持党的领导加强党的建设的若干意见*) [*The Opinions on Upholding Party Leadership and Strengthening Party Building in Deepening the Reform of State-Owned Enterprises*], ZHONGHUA RENMIN GONGHEGUO ZHONGYANG RENMIN ZHENGFU (中华人民共和国中央人民政府) [THE CENTRAL PEOPLE'S GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA] (Sept. 20, 2015, 6:15 PM), http://www.gov.cn/xinwen/2015-09/20/content_2935593.htm [https://perma.cc/785G-XRZX].

21. Xianchu Zhang, *Integration of CCP Leadership with Corporate Governance: Leading Role or Dismemberment?*, 1 CHINA PERSP. 55, 60 (2019).

22. *Id.* For more details on the meaning of Party building in addition to having party organizations in the company, see *infra* Part III.A.

23. *Xi Jinping Zongshuji Dui Guoqi Dangjian Gongzuo Ti Le Naxie Xin Yaoqiu* (*習近平總書記對國企黨建工作提了哪些新要求*) [*New Requirements Raised by General Secretary Xi Jinping Regarding State-Owned Enterprises' Party Building Works*], ZHONGGUO GONGCHANDANG XINWEN WANG (中国共产党新闻网) [CPC NEWS] (Oct. 12, 2016, 10:52 AM) [hereinafter *New Requirements Raised by General Secretary Xi Jinping*], http://dangjian.people.com.cn/BIG5/n1/2016/1012/c117092-28772532.html [https://perma.cc/BW2P-P3SU].

must be incorporated into a company's governance framework.[24] He also emphasized the importance of the CCP's leadership for SOE managers, and the Party's goals as an important objective of the company.[25] It was a sign that the Chinese government was "unwilling to relinquish too much control over China's state companies."[26]

However, the CCP did not confine Party building to SOEs. The campaign extends to private enterprises, joint ventures between SOEs and foreign companies,[27] and foreign enterprises in China.[28] The latest amendment to the Code of Corporate Governance, issued by the China Securities Regulatory Commission (CSRC), required all listed companies to implement CCP organization and provide resources for the Party organization.[29] Listed companies must also include Party provisions in their corporate constitution.[30] This increases the risk that the CCP could influence privately held and even foreign companies. This also impedes foreign regulators, also known as host market regulators, from curbing the growing influence of the CCP over cross-listed Chinese businesses.[31]

This Article examines how companies listed on the Hong Kong Exchange (HKEx), with assets, earnings, or significant activities in Mainland China ("Chinese businesses"), responded to President Xi Jinping's

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24. *Id.* A Party organization is an organization or committee comprised of members of CCP in the company. SCOTT LIVINGSTON, CTR. FOR STRATEGIC & INT'L STUD., THE NEW CHALLENGE OF COMMUNIST CORPORATE GOVERNANCE 2–3, https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/210114_Livingston_New_Challenge.pdf [https://perma.cc/YZ25-MAAA] (last visited Mar. 25, 2021). A Party organization follows instructions from leaders of the CCP. *Id.*

25. *New Requirements Raised by General Secretary Xi Jinping*, *supra* note 23.

26. Emily Feng, *Xi Jinping Reminds China's State Companies of Who's the Boss*, N.Y. TIMES (Oct. 13, 2016), https://www.nytimes.com/2016/10/14/world/asia/china-soe-state-owned-enterprises.html [https://perma.cc/9UHF-ATEP].

27. Lucy Hornby, *Communist Party Asserts Control over China Inc*, FIN. TIMES (Oct. 3, 2017), https://www.ft.com/content/29ee1750-a42a-11e7-9e4f-7f5e6a7c98a2 [https://perma.cc/8J29-3S2J].

28. Alexandra Stevenson, *China's Communists Rewrite the Rules for Foreign Businesses*, N.Y. TIMES (Apr. 13, 2018), https://www.nytimes.com/2018/04/13/business/china-communist-party-foreign-businesses.html [https://perma.cc/3B6T-SBQJ].

29. Shangshi Gongsi Zhili Zhunze (上市公司治理准则) [Code of Corporate Governance for Listed Companies in China] (promulgated by China Sec. Regulatory Comm'n & State Econ. & Trade Comm'n, Jan. 7, 2002, revised Sept. 2018), art. 5, [hereinafter China Corporate Governance Code], http://www.csrc.gov.cn/zjhpublic/zjh/201809/P020180930584077967335.pdf [https://perma.cc/L4BH-LNLK].

30. *Id.*

31. Shirley Yam, Opinion, *Regulators' Silence on Communist Party Presence in Listed State Companies Is Deafening*, S. CHINA MORNING POST (July 20, 2018, 2:54 PM), https://www.scmp.com/business/article/1993277/regulators-silence-communist-party-presence-listed-state-companies [https://perma.cc/76FB-J5AA]; Jennifer Hughes, *China's Communist Party Writes Itself into Company Law*, FIN. TIMES (Aug. 14, 2017), https://www.ft.com/content/a4b28218-80db-11e7-94e2-c5b903247afd [https://perma.cc/967P-SAT3].

Party building campaign. Although Chinese businesses operate predominantly in China, they can be incorporated in Mainland China or an offshore jurisdiction, like Bermuda.[32] After examining corporate stakeholders reactions, the Article then explores how host regulators (e.g., Hong Kong) respond to political interference by foreign governments (e.g., China). Although Hong Kong is strictly-speaking not a foreign market in relation to the People's Republic of China, Hong Kong offers a useful perspective as an international financial center with many Chinese businesses' listings.[33]

Part II analyzes several types of political interference and the general impact of foreign actors' political interference on a company's governance. Part II then considers how corporate stakeholders and securities regulators can respond to political interference. Shifting to focus on China, Part III examines the Party building movement and its effect upon businesses listed on the Hong Kong Exchange, measured by the amendments to corporate constitutions. Following the findings presented in Part III, Part IV explores regulatory strategies to combat foreign political interference. Part V concludes by suggesting that regulators should rely on transparency and market forces to contain foreign political interference.

II. OVERVIEW OF POLITICAL INTERFERENCE, MARKET REACTIONS AND CONTAINMENT STRATEGIES

This Part provides an overview of foreign political actors interfering with corporate governance and its effects on stakeholders and firm value. Utilizing a behavioral perspective, it analyzes the potential responses of companies and stakeholders to political interference and how companies can manage such pressure. Finally, this Part examines regulatory responses to address political interference, including improving transparency and disclosure, controlling foreign listings through listing requirements, and changing corporate hierarchies.

A. The Ramifications on Corporate Governance and Firm Value

This Section briefly introduces ways that government actors interfere with a company, such as state ownership, political connections, regulatory interventions, and mandating a political institution's creation, like China's

32. *See infra* Part III.B.1.

33. Pursuant to the Hong Kong Exchange, there were 1,241 companies (out of a total of 2,449 listed in the exchange) that were considered to be Mainland enterprises at the end of 2019. HKEX, HKEX FACT BOOK 2019 1 (2019), https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/HKEX-Fact-Book/HKEX-Fact-Book-2019/FB_2019.pdf?la=en [https://perma.cc/G35F-PLPV].

Party building requirement. This Section then examines the effects on the governance and value of listed companies.

1. Types of Political Interference

Political interference takes many forms. A company may interact with government agencies, politicians, and companies owned by or linked to the state while conducting business. Those interactions open the door for government actors to interfere with the governance of a company. For example, a politician can pressure a company to hire his son when there are other better candidates for the same position.[34] Although external forces impose pressure, a company may also invite political interference. This Article refers to invited interference as "internal political interference," and uninvited interference as "external political interference." Although this Article focuses on uninvited interference, specifically by a foreign government, some internal political interference aspects are also explored in this Section.

a. Political Interference Through Equity Ownership

One common form of political interfence is through ownership of equity stakes in a domestic company by the state.[35] For instance, existing empirical studies show that compliance with Party building reforms[36] was positively correlated with state ownership in China.[37]

The OECD defines an SOE as "any corporate entity recognized by national law as an enterprise, and in which the state exercises ownership."[38] In short, a corporate entity qualifies as an SOE if a state government exercises effective control of the management of the company.[39] Furthermore, different levels of government—such as local, state, and federal—may control a state enterprise. In China, SOEs may be controlled by central, provincial, or local governments, creating different SOEs layers. Sometimes, an SOE is a subsidiary of another state-owned company. For example, the China Resources Group, a state-owned conglomerate, has

34. Andrei Shleifer & Robert W. Vishny, *Politicians and Firms*, 109 Q.J. ECON. 995, 1002 (1994) [hereinafter *Politicians and Firms*].

35. OECD, CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES: A SURVEY OF OECD COUNTRIES 20–21 (2005).

36. *See infra* Part III.A.

37. *See* John Zhuang Liu & Angela Huyue Zhang, *Ownership and Political Control: Evidence from Charter Amendments*, INT'L REV. L. & ECON., July 31, 2019, at 1, 2; Lauren Yu-Hsin Lin & Curtis J. Milhaupt, *Party Building or Noisy Signaling? The Contours of Political Conformity in Chinese Corporate Governance* 21 (Eur. Corp. Governance Inst., Law Working Paper No. 493/2020, 2020), https://ssrn.com/abstract=3510342 [https://perma.cc/RMW3-NG4S].

38. GUIDELINES ON STATE-OWNED ENTERPRISES, *supra* note 12, at 14.

39. *Id.* at 14–15.

multiple subsidiaries in China and Hong Kong, such as China Resources Land and China Resources Power, which are also SOE's.[40]

In addition to a state agency itself owning equity in the company, the state may also indirectly control an SOE through public or quasi-public entities. For example, the majority of shares in the Tsinghua Unigroup, a producer of semiconductors, are owned by Tsinghua Holdings. Tsinghua Holdings is a wholly-owned subsidiary of Tsinghua University, which in turn is subject to the control of China's Ministry of Education.[41]

The state can also establish a stake in a company through a sovereign wealth fund. A sovereign wealth fund could be generally defined as a state-owned investment fund or entity that is commonly established from balance of payments surpluses, foreign exchange reserves, fiscal surpluses or government transfer payments, etc.[42] For instance, the Singaporean government centralizes its control over certain companies, generally labeled "government-linked companies,"[43] through a wholly-owned sovereign wealth fund called Temasek Holdings.[44] Alternatively, some countries allow state operators to effectively control a company even if the state holds a minority interest.[45]

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40. *See, e.g.*, *Governance*, CHINA RES., http://en.crc.com.cn/investors/governance/ [https://perma.cc/DM9X-DSUT] (last visited Mar. 13, 2021).

41. Announcement from Qi Lian, Chairman, Sun East Technology (Holdings) Limited, Grant of Waiver from Strict Compliance with the Minimum Public Float Requirement (Sept. 2, 2016) (on file with SINO ICT Holdings Limited) ("Tsinghua Holdings is a wholly-owned subsidiary of Tsinghua University, which is a tertiary education institution directly under the Ministry of Education of the People's Republic of China.").

42. *See What is a Sovereign Wealth Fund?*, SWFI, https://www.swfinstitute.org/research/sovereign-wealth-fund [https://perma.cc/H556-H9WJ] (last visited Dec. 25, 2020).

43. Christopher Chen, *Solving the Puzzle of Corporate Governance of State-Owned Enterprises: The Path of the Temasek Model in Singapore and Lessons for China*, 36 NW. J. INT'L L. & BUS. 303, 312, 317–19 (2016).

44. *See id.* at 312–14 (describing the creation of Temasek Holdings, an investment company model, and noting that although Temasek owned and managed its own investments after having received initial support from the government, it now only controls twelve of the initial thirty-five companies that comprised its portofolio); Yvonne C.L. Lee, *The Governance of Contemporary Sovereign Wealth Funds*, 6 HASTINGS BUS. L.J. 197, 229–30 (2010) (comparing Government of Singapore Investment Corp and Temasek). For more historical perspectives, see generally Tan Cheng-Han et al., *State-Owned Enterprises in Singapore: Historical Insights into a Potential Model for Reform*, 28 COLUM. J. ASIAN L. 61 (2015) (analyzing the foundation of Singapore's successful government-linked companies and to what extent this model can be applied to China's reformation of its state-owned enterprises).

45. For example, the Ministry of Finance owned only 12.19% of shares in Changhua Bank, one of the oldest commercial banks in Taiwan, as of April 2020. *See Major Shareholders*, CHANG HWA BANK [hereinafter *Major Shareholders*], https://www.bankchb.com/frontend/mashup_eng.jsp?funcId=35ebfbf315 [https://perma.cc/X6GB-GPJ3] (last visited Aug. 21, 2020). However, four directors (out of nine) on the board of the bank are nominees of the government. *See Members of the Board of Directors*, CHANG HWA BANK, https://www.bankchb.com/frontend/mashup_eng.jsp?funcId=9b9b580615 [https://perma.cc/J9X4-DH7P] (last visited Aug. 21, 2020). Both the chairman and the chief executive officer are

Although SOEs are commonly subject to political interference, the degree of interference vary across countries. For example, Singapore's government has exercised substantial self-restraint by not interfering with the management of government-linked companies.[46] In contrast, the Chinese government has shown more willingness to interfere with corporate decisions, such as instructing state-owned banks to extend credit to distressed companies during the global financial crisis in 2008.[47] Reports also emerged that, in 2015, the Chinese government asked state-owned banks to lend money to traders to prop up the stock market.[48] Furthermore, fourteen of the twenty-five companies listed on China's new Science and Technology Innovation Board ("STAR" board) under the Shanghai Stock Exchange have "state-owned investors among their top three shareholders," and state-owned wealth funds dominate trading activity.[49] This indicates a high possibility that the Chinese government used state ownership to influence a company's decision to list on the new STAR board (instead of other stock markets) or bought the shares of these companies for policy reasons, including propping up the new stock market. Moreover, a state's willingness to control a company may also depend on the industry. In Taiwan, utility companies—e.g., electricity and water suppliers—remain firmly controlled by the government, whereas SOEs in other industries—e.g., banking—have been privatized since the late 1980s.[50]

b. Political Interference through Other Means

Political interference may also manifest through political connections, regulatory authority or simply political power held by a politician or political party. If a government or a politician has an appointee in a company's board or management—e.g. as a nominee director or a well-known politician's son—the government or politician can influence a company's governance

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nominees of the Ministry of Finance which also appointed the Director General of National Treasury Administration onto the board as a non-executive director. *Id.* In essence, the Ministry of Finance has effective control over the management of bank, despite holding only 12.19% of shares. *Major Shareholders*, *supra* note 45.

46. Chen, *supra* note 43, at 365.

47. *See Giant Reality-Check*, *supra* note 13.

48. Gabriel Wildau, *China's Biggest State Banks Recruited into Stock Market Rescue*, FIN. TIMES (July 17, 2015), https://www.ft.com/content/c30b6f3a-2c3d-11e5-8613-e7aedbb7bdb7 [https://perma.cc/7ECV-RZXP].

49. Tom Hancock & Wang Xueqiao, *State-Owned Investors Dominate China's New Tech Exchange*, FIN. TIMES (Aug. 10, 2019), https://www.ft.com/content/87dd12b2-ba85-11e9-8a88-aa6628ac896c [https://perma.cc/Y8A4-WUGU].

50. Huei-Wen Pao et al., *The Road to Liberalization: Policy Design and Implementation of Taiwan's Privatization*, 5 INT'L ECON. & ECON. POL'Y 323, 334–36 (2008).

and decisions. Nevertheless, the extent of influence depends on the relationship between politically connected persons and the company.

Political interference can be exercised through regulations, especially highly regulated industries.[51] A bank might need approval to appoint a chief executive officer. A politician who wants to influence the bank may instruct a relevant regulator to delay approval until the bank complies with political demands. Similar interference could occur if a business requires a license or permit—e.g., a construction permit to develop a site. This power is apparent in highly regulated industries, such as banks or telecommunication firms, where companies frequently interact with regulators.

In addition, companies are subject to overt political interference by a politician or a political party due to the politician or political party's dominant power in a country. For example, as elaborated below, China's Party building movement has attempted to formalize the CCP's presence within companies.[52] The CCP has thereby written itself into companies' governance structure,[53] even where the Party lacks an equity stake.

2. The Pros and Cons of Political Interference on Companies

Political interference can benefit companies. However, interference, whether invited or not, can harm a company and its value. This Section first considers invited political interference, through the lens of political connections, and then examines costs of other forms of external political interference.

Political connections offer both economic and noneconomic benefits to a company. For example, political connections can increase the likelihood of acquiring government contracts or favorable loans from state-owned banks.[54] Companies may also have better access to international sources of funds.[55] Well-connected companies are more likely to be bailed out when international institutions, like the World Bank, provide financial assistance to a national government.[56] In China, politically connected banks are more likely to lend to politically connected companies, which are, in turn, more

51. *See Politicians and Firms*, *supra* note 34, at 1015.

52. Before the political movement, some companies already had CCP organizations, but their presence was not officially recognized in the companies' constitutions. *See infra* Part III.A.

53. Hughes, *supra* note 31.

54. Agyenim Boateng et al., *Politically Connected Boards, Ownership Structure and Credit Risk: Evidence from Chinese Commercial Banks*, 47 RSCH. INT'L BUS. & FIN. 162, 164–65 (2019).

55. *See* Shujun Ding et al., *Political Connections and Agency Conflicts: The Roles of Owner and Manager Political Influence on Executive Compensation*, 45 REV. QUANTITATIVE FIN. & ACCT. 407, 408 (2015).

56. Mara Faccio et al., *Political Connections and Corporate Bailouts*, 61 J. FIN. 2597, 2597, 2617 (2006).

likely to be bailed out in an economic crisis.[57] Notably, politically connected executives receive more compensation from non-state-owned companies than from state-owned companies.[58] The difference suggests that non-state-owned companies offer more rewards for political connections.[59]

In addition to benefits to the company, the state may benefit from political connections. The Chinese government has a strong interest in Alibaba, an e-commerce giant, because government agencies use its platforms to conduct billions of dollars of transactions.[60] A politically-connected appointee may restrain management's conduct by acting as unofficial government oversight. External oversight may force managers "to cut wages and bonuses when enterprise performance is poor."[61] The benefits of political connections are not limited to less developed or more corrupt countries. Political connections provide corporate rent-seeking even in a low-corruption environment.[62] Although political connections can be useful,[63] quantifying the value of such connections may be challenging.[64]

Despite the benefits brought by political connections, even invited interference can harm a company. A politically connected chief executive officer is found to be more likely to implement strategic initiatives and credit policies that favor the government than a less connected officer. Implementing those initiatives or policies would in turn increase the risk of default for Chinese banks.[65] Comparing forty-seven countries, companies with political connections were found to possess higher leverage, more substantial market power, but performed worse than non-connected

57. Chi-Hsiou D. Hung et al., *Bank Political Connections and Performance in China*, 32 J. FIN. STABILITY 57, 57, 67 (2017).

58. Ding et al., *supra* note 55, at 407, 429–30.

59. *See id.*

60. Jay Somaney, *Chinese Government Has a Huge "Stake" in Alibaba*, FORBES (Oct. 18, 2015, 6:30 AM), https://www.forbes.com/sites/jaysomaney/2015/10/18/chinese-government-has-a-huge-stake-in-alibaba/?sh=23bf93a125b8 [https://perma.cc/8SJT-88PN]. Alibaba's platforms include the likes of Taobao and Tmall. *Id.*

61. Eric C. Chang & Sonia M.L. Wong, *Political Control and Performance in China's Listed Firms*, 32 J. COMP. ECON. 617, 620 (2004).

62. Mario Daniele Amore & Morten Bennedsen, *The Value of Local Political Connections in a Low-Corruption Environment*, 110 J. FIN. ECON. 387, 387, 401 (2013).

63. Raymond Fisman, *Estimating the Value of Political Connections*, 91 AM. ECON. REV. 1095, 1095–96 (2001).

64. *See id.* at 1095 ("The claim was that in Southeast Asia, political connectedness, rather than fundamentals such as productivity, was the primary determinant of profitability and that this had led to distorted investment decisions. . . . However investigations in this area have not progressed beyond the level of case study and anecdote. That is, there has been no attempt to estimate the degree to which firms rely on connections for their profitability.").

65. Boateng et al., *supra* note 54, at 171.

companies.[66] The difference in financial performance between politically connected and non-connected companies depend on a country's economic development and corruption.[67] For instance, "[c]ountries that are richer, more democratic, and have free press have more disclosure [by politicians]."[68] It was also found that "[p]ublic disclosure . . . is positively related to government quality, including lower corruption."[69]

Other than the benefits that political connection offers companies, it is widely argued that political interference generally harms companies' value. First, political interference in a company's governance increases agency costs.[70] It is taken for granted that those who exercise political interference reap some personal benefits, such as patronage hiring or procuring goods.[71] Government officials may pursue their political objectives at the expense of company shareholders.[72] To illustrate, if managers' incentives come from their political interests, rather than their business acumen, they may promote their careers at the expense of the company. This reflects the common perception that SOEs are improperly managed and less efficient than their private counterparts.[73] In many countries, state-owned banks increase their lending in election years.[74] In some cases, political interference could be a form of corruption. In China, political interference by local Party committees was associated with negative firm performance, and such a negative impact on firm value outweighs any reduction in managerial agency costs, e.g., by restraining largest shareholders from expropriation.[75]

Second, issues of accountability arise when government actors interfere with a company's governance while lacking any legal obligations to its

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66. Mara Faccio, *Differences Between Politically Connected and Nonconnected Firms: A Cross-Country Analysis*, 39 FIN. MGMT. 905, 906 (2010).

67. *Id.* at 905.

68. Simeon Djankov et al., *Disclosure by Politicians*, 2 AM. ECON. J.: APPLIED ECON. 179, 179 (2010).

69. *Id.*

70. *See generally* Ross, *supra* note 7 (presenting a short summary of the economic theory of agency and a discussion of the factors that influence agent behavior, such as fee schedules and the distribution of information between the principal and the agent); Jensen & Meckling, *supra* note 8 (offering a fuller discussion of the economic theory of agent behavior by listing the types of agency costs and how the principal's use of monitoring and incentives can affect such costs).

71. *Politicians and Firms*, *supra* note 34, at 995–96.

72. Joseph P. H. Fan et al., *Institutions and Organizational Structure: The Case of State-Owned Corporate Pyramids*, 29 J.L. ECON. & ORG. 1217, 1221–22 (2012).

73. OECD, PRIVATISING STATE-OWNED ENTERPRISES: AN OVERVIEW OF POLICIES AND PRACTICES IN OECD COUNTRIES 20 (2003).

74. I. Serdar Dinç, *Politicians and Banks: Political Influences on Government-Owned Banks in Emerging Markets*, 77 J. FIN. ECON. 453, 453, 475–76 (2005).

75. Chang & Wong, *supra* note 61, at 617.

shareholders. In many common law countries[76] and China[77], directors and some senior management, owe a fiduciary duty to the company. When a political actor is not a director or lacks an official role within the company, they also lack any legal responsibility for their conduct—e.g., a poor management decision—even if it results in loss.

Third, divergent views between stakeholders and external actors may lead to a conflict of interest.[78] As mentioned earlier, the Chinese government requested that state-owned banks extend credit to SOEs during the global financial crisis. The interference over the bank's decisions was for the state's interests—i.e., to prop up the economy—but not necessarily aligned with the banks' or their shareholders' interests because higher non-performing loans might hurt the bank's value.[79] In this situation, there is a conflict of interests between the state's interests and the interests of the company. Minority investors are likely to suffer when the government actor enjoys power disproportionate to its interests in the company.[80] In addition, there could be an inherent conflict of interest from the state's dual role as a shareholder and regulator.[81] On the one hand, state's exercise of regulatory power—e.g. applying fines for pollution—increases costs and reduces profits of an SOE; on the other, if the state decides not to exercise regulatory power because it might hurt the value of the state's equity stakes in a company,it could be detrimental to the society, e.g., for environmental protection.

Even the state owner can tunnel at the expense of shareholders. Through political pressure, the state can induce a company to serve their objectives.[82] These actions may be done in the name of some public interest, like reducing unemployment or managing labor relations. However, such gains are usually at the expense of the company—e.g., hiring unsuitable or unnecessary

76. *See* Percival v. Wright [1902] 2 Ch. 421, 425 (UK) (explaining that directors are trustees of the company and must act in the company's best interests when disposing of its shares).

77. *See* Zhonghua Renmin Gongheguo Gongsi Fa (中华人民共和国公司法) [Company Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), arts. 147, 148, http://www.lawinfochina.com/display.aspx?id=4685&lib=law [https://perma.cc/5UWE-TGYX].

78. Zhang, *supra* note 21, at 59–60.

79. *See Giant Reality-Check*, *supra* note 13.

80. Zhang, *supra* note 21, at 59; Lauren Yu-Hsin Lin, *Institutionalizing Political Influence in Business: Managerial Resistance and Insider Control*, 45 VT. L. REV. (forthcoming 2021) (manuscript at 1) (on file with author).

81. Mariana Pargendler, *State Ownership and Corporate Governance*, 80 FORDHAM L. REV. 2917, 2919 (2012).

82. This has been described as a "grabbing hand," a term coined by Andrei Shleifer and Robert W. Vishny. *See generally* ANDREI SHLEIFER & ROBERT W. VISHNY, THE GRABBING HAND: GOVERNMENT PATHOLOGIES AND THEIR CURES (1998) (using "grabbing hand" as a term to describe the imposition of predatory policies, such as arbitrary taxes, by public sector institutions).

employees—and could, therefore, damage the company's value.[83] The problem may be heightened if an SOE is wholly or partially privatized but remains heavily regulated.[84] In this situation, the company has private investors but continues to be exposed to the same degree of political interference. Arguably, SOEs' related-party transactions (i.e. transactions with connected persons of the company) may decrease social welfare when the state attempts to prop up SOEs with benefits that are otherwise unavailable to private enterprises.[85]

In addition, political interference could result in poor management and financial performance. A study found that having more political connections hampered an SOE's globalization efforts.[86] In Taiwan, companies with robust corporate governance focused less on building political connections, and politically connected companies were likely to demonstrate poor corporate governance.[87] Similarly, politically connected financial institutions in the United States have higher leverage levels and greater volatility that exposes financial institutions to higher financial risk than their non-politically connected counterparts.[88]

In sum, companies can benefit from their political connections. However, external political interference can harm corporate governance and reduce a company's value. Understanding the costs and benefits of political interference, the following sections analyze stakeholders' reactions to external political interference. It then explores possible responses for securities regulators or stock market operators.

B. A Behavioral Analysis of Reactions to External Political Interference

Managers' and stakeholders' responses determine the effectiveness of external interference and inform how host market regulators curb such interference. This Section explores the possible reactions of corporate

83. *See generally* Yingyi Qian, *Enterprise Reform in China: Agency Problems and Political Control*, 4 ECON. TRANSITION 427 (1996) (discussing how the allocation of control rights between managers and the government leads to political and agency costs for SOEs).

84. *Politicians and Firms*, *supra* note 34, at 1015.

85. Curtis J. Milhaupt & Mariana Pargendler, *RPTs in SOEs: Tunneling, Propping, and Policy Channeling* 2 (Eur. Corp. Governance Inst., Law Working Paper No. 386/2018, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3119164 [https://perma.cc/9DAV-WX9D].

86. Hao Liang et al., *An Anatomy of State Control in the Globalization of State-Owned Enterprises*, 46 J. INT'L BUS. STUD. 223, 223 (2015).

87. Chung-Hua Shen et al., *Do Strong Corporate Governance Firms Still Require Political Connection, and Vice Versa?*, 39 INT'L REV. ECON. & FIN. 107, 118 (2015).

88. *See generally* Leonard Kostovetsky, *Political Capital and Moral Hazard*, 116 J. FIN. ECON. 144, 144 (2015) ("[P]rior to the 2008 financial crisis, politically-connected financial firms had higher leverage and were more likely to increase their leverage . . . . which was associated with worse performance . . .").

stakeholders including managers, current shareholders, and prospective investors. This Article posits that corporate stakeholders should object to external political interference unless they can gain personally from such interference. If they provide sufficient opposition, the effect of political interference could be avoided or compromised to some extent. Corporate stakeholders' responses and their effectiveness in curbing political interference then determine how regulators should respond to foreign political interference.

First, companies' managers generally resist political interference by external actors unless a manager has political connections. Irrespective of whether a company is a private enterprise or SOE, interference affects managerial discretion. Restrictions on managerial discretion could affect the company's performance and value. For example, Chinese companies "tend to perform better when managers have flexibility in labor deployment."[89] Hence, managers should prefer more flexibility in managerial discretion and reduce the influence of politicians.

Moreover, even managers of SOEs are expected to resist external political interference. In addition to reduced managerial discretion, external political interference provides additional oversight[90] that managers may not like. Without additional oversight, managers of an SOE would enjoy significant discretion over state assets and benefit from on-the-job consumption and perks.[91] Consequently, even the managers of an SOE have incentives to resist political interference.

However, the effectiveness of SOE managers' resistance to political interference depends on the control exerted by a government. The stronger the control, the more likely an SOE is subject to direct political interference. In contrast, if a company is more remote from the source of political influence, this might lessen the power of political interference, and managers are more likely to object to it. For example, an SOE's management is subject to more direct political pressure if the government is a controlling shareholder. In contrast, a company's lower position in the corporate pyramid indicates a higher chance of resisting or being immune from political interference from external political interference through the state

89. Lixin Colin Xu et al., *Politician Control, Agency Problems and Ownership Reform: Evidence from China*, *in* THE REVIVAL OF PRIVATE ENTERPRISE IN CHINA 199, 216 (Shuanglin Lin & Shunfeng Song eds., 2007).

90. For example, one example of extra oversight by a political entity is the CCP's imposition of a disciplinary committee on the company. *See infra* Part III.A.

91. Yingyi Qian, *Reforming Corporate Governance and Finance in China*, *in* CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES: INSIDER CONTROL AND THE ROLE OF BANKS 215, 222 (Masahiko Aoki & Hyung-Ki Kim eds., 1995).

owner.[92] The reason is that the instructions of an ultimate state owner (i.e., the controlling shareholder of the parent SOE) are not necessarily enforced down a corporate pyramid structure. Therefore, an SOE experiences less pressure when the company is a subsidiary, or even a subsidiary of a subsidiary, of another state-owned company, resulting in higher managerial discretion. In other words, SOEs in which the managers enjoy greater autonomy are more likely to resist harmful political interference if managers think it hurts the company.[93]

Managers' responses to external political interference also differ depending on the source of influence. For example, suppose the controlling owner of an SOE is the Ministry of Finance. In that case, the company is more likely to respond more forcibly to political interference by the finance minister or the prime minister than to interference exercised by a local city councilor in the rural area. Similarly, SOE managers closer to Beijing are more likely to follow instructions from the CCP's leaders or by the central government, given their vicinity in terms of connection to the center of political power and geographical distance. Thus, it is reasonable to expect that SOEs in which the managers enjoy greater autonomy are more likely to resist political interference.[94]

Second, the divergence of interests among shareholders also complicates a company's response to political interference. Non-state shareholders generally object to political interference because it reduces the company's value and, hence, their investment's value.[95] However, non-state shareholders may not object when interference benefits them individually or the company. For shareholders who are the state or government agency, their responses depend on the owner's nature and the political environment.

Third, prospective investors, similar to minority shareholders, are more likely to object to external political interference. For investors in the equity market, a collective adverse reaction could result in either a downward price movement in the stock market or undervaluation of a companies' share prices. A company's financing costs might increase when issuing new shares or bonds. If the share price becomes too low, it increases the likelihood of a prospective investor's takeover. The possibility of competition for corporate control may constrain management's willingness to accept external political interference.[96] Therefore, if the possibility of a hostile takeover is real,

92. Fan et al., *supra* note 72, at 1221.

93. Lin, *supra* note 80, at 35. Lin, *supra* note 80, at 35.

94. *Id.*

95. *See supra* Part II.A.

96. *See generally* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (demonstrating an active market for control of corporations by examining various

managers are less likely to accept external political interference that may hurt the company's value.

The diversity of views held by corporate stakeholders create dynamic interactions. Their interests shape how a company, as a whole, responds to political interference. This Article argues that shareholders, prospective investors, and corporate management are more likely to resist external political interference unless they have something to gain. Their responses impact the effectiveness of political interference. If together, corporate stakeholders provide strong enough resistance, external political interference should not be effective, and its negative impact on firm value could be avoided or reduced. If this is the case, the market can provide the power to deter or curtail the effect of external political interference.

C. Response Strategies by Securities Regulators

This Section examines response strategies that securities regulators might adopt when listed companies in the stock market face foreign political interference. This Section first illustrates challenges to securities regulators if political interference comes from domestic sources and examines the difficulties of dealing with foreign political interference after a company's listing. This Section then presents three possible options: strengthening market power through transparency, greater control through listing requirements, and forcing companies to change corporate structures. In the end, this Article argues that strengthening market power through a higher degree of transparency to help corporate stakeholders to resist foreign political interference is the better approach.

When interference comes from domestic sources, securities regulators' responses will depend on the domestic government's politics, institutional structure, and power balance. A regulator's ability to issue regulations, for example, might do little to inhibit interference. For instance, when the CCP issued instructions to incorporate Party building into corporate constitutions, the China Securities Regulatory Commission (CSRC) followed up by adding them into the code of corporate governance.[97] Given the CCP's dominance,[98] the CSRC could not address the Chinese government's political interference.

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antitrust and economic implications of competition and mergers on shareholders and management); David Scharfstein, *The Disciplinary Role of Takeovers*, 55 REV. ECON. STUD. 185 (1988) (analyzing how takeover threats, when used as a means of creating capital market competition, play a role in disciplining management).

97. China Corporate Governance Code, *supra* note 29.

98. *China Anniversary: How the Communist Party Runs the Country*, BBC (Sept. 30, 2019), https://www.bbc.com/news/world-asia-china-49631120 [https://perma.cc/82QX-8DTJ]; Christina Zhou, *China's Communist Party is at a Fatal Age for One-Party Regimes. How Much Longer Can It Survive?*, ABC NEWS (Jan. 5, 2020, 7:18 PM), https://www.abc.net.au/news/2020-01-05/chinas-communist-party-

Securities regulators face a different kind of challenge with foreign political interference. First, the response of a securities regulator depends to some extent on the relationship between the countries where the regulator is and where political interference originates. For example, regulators in a larger market, like the Securities and Exchange Commission in the United States, have more power to deal with foreign political interference than regulators in smaller markets like Singapore or regulators in a subordinated jurisdiction like Hong Kong. Second, market conditions affect responses to foreign political interference. Larger stock exchanges with a deeper pool of listed companies like the New York Stock Exchange (NYSE) or the NASDAQ may be more likely than their smaller peers to impose listing or conduct requirements based on undesirable political interference. As the largest stock exchanges in the world, according to market capitalization,[99] the NYSE and NASDAQ have more ability to either filter companies who want to list or force compliance with their requests. Companies may not want to endanger their successful initial public offerings (IPOs) or secondary listings in the U.S. capital market for financial, reputational, or other concerns. Consequently, the market restrains political interference, at least seemingly.

Market conditions can also adversely affect how regulators perceive foreign political interference, especially in a smaller country. For example, neither Singapore nor Hong Kong possesses the political leverage to bargain with the Chinese government. Hong Kong is administered as a special administrative region under the PRC.[100] Although politically distinct and farther away, Singapore is a smaller country that relies on trade and financial

is-at-a-fatal-age-for-one-party-regimes/11807138 [https://perma.cc/GX5V-AYMD]; Ming Xia, *The Communist Party of China and the "Party-State,"* N.Y. TIMES, https://archive.nytimes.com/www.nytimes.com/ref/college/coll-china-politics-002.html [https://perma.cc/CVQ2-8EE9] (last visited Mar. 7, 2021).

99. *See, e.g.*, Becca Cattlin, *What are the Largest Stock Exchanges in the World?*, IG (Mar. 12, 2019, 11:01 AM) https://www.ig.com/au/trading-strategies/what-are-the-largest-stock-exchanges-in-the-world—180905 [https://perma.cc/WE8Z-VLTD]; Rolando Y. Wee, *Biggest Stock Exchanges in the World*, WORLD ATLAS (Apr. 25, 2017), https://www.worldatlas.com/articles/biggest-stock-exchanges-in-the-world.html [https://perma.cc/D6PP-2FMY].

100. *See The Hong Kong Special Administrative Region*, MINISTRY FOREIGN AFF. CHINA, https://www.fmprc.gov.cn/mfa_eng/ljzg_665465/zgjk_665467/3572_665469/t17814.shtml [https://perma.cc/Z98H-6UL9] (last visited Feb. 26, 2021). Since Great Britain handed over Hong Kong to the People's Republic of China in 1997, Hong Kong has been treated as a "special administrative region" in China, enjoying some degree of autonomy based on Hong Kong's Basic Law, including using its own laws and courts. *Id.* However, Hong Kong is not an independent country. *See id.* Some international organizations list Hong Kong as "Hong Kong, China." *See id.* (explaining that Hong Kong may join the World Trade Organization, other international organizations and international trade agreements under the name "Hong Kong, China").

services with Chinese businesses to support its economy.[101] Due to heavy competition for listings, Hong Kong and Singapore governments are likely to welcome Chinese companies, despite the political interference associated with Chinese companies. With the rise of Chinese technology giants like Alibaba and Tencent, both Singapore and Hong Kong have allowed the listing of companies with dual-class shares[102] to attract more high-rise Chinese companies.[103]

Before a company is listed on a stock exchange, regulators can prevent political interference *ex ante* by rejecting the company's listing if there are concerns over foreign political interference. For example, the Holding Foreign Companies Accountable Act (HFCAA) requires that foreign issuers, who retain a non-inspected, registered public accounting firm in a foreign jurisdiction, establish that they are not owned or controlled by a foreign government.[104] If the Public Company Accounting Oversight Board (PCAOB)[105] cannot inspect a foreign public accounting firm for three consecutive years, the foreign issuer will be banned from listing their shares on U.S. securities exchanges.[106]

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101. Per the Singapore government's statistics for 2017, finance and insurance services accounted for 13.3% of Singapore's gross domestic product, while wholesale and retail trade accounted for 17.6% of the gross domestic product. SING. DEP'T OF STATISTICS, SINGAPORE IN FIGURES 2018, at 9 (2018), https://www.singstat.gov.sg/-/media/files/publications/reference/sif2018.pdf [https://perma.cc/5EQU-WDPF].

102. In a typical dual-class shares structure, a company's equity is divided into multiple classes of shares with one class entitling holders to multiple voting rights and another class sold to public investors with one vote per share. Holders of the former class are usually the company's founders and executives. Aurelio Gurrea-Martínez, *Theory, Evidence, and Policy on Dual-Class Shares: A Country-Specific Response to a Global Debate* 5 (Ibero-Am. Inst. for Law & Fin., Working Paper 3/2019, 2019), https://papers.ssrn.com/abstract=3397880 [https://perma.cc/9N5N-H93Z]. There are academic debates as to whether the dual-class shares structure hurts firm value and corporate governance. *See generally* Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 384–93 (2002) (explaining how dual-class shares can be a control enhancing mechanism that creates significant disparities between the control and ownership of a firm); Ting Li & Nataliya Zaiats, *Corporate Governance and Firm Value at Dual Class Firms*, 36 REV. FIN. ECON. 47, 67–68 (2018) (finding that dual-class firms are more likely to employ increased shareholder rights provisions and those rights are often not significantly associated with firm value).

103. *Hong Kong and Singapore Succumb to the Lure of Dual-Class Shares*, ECONOMIST (Mar. 1, 2018), https://www.economist.com/finance-and-economics/2018/03/01/hong-kong-and-singapore-succumb-to-the-lure-of-dual-class-shares [https://perma.cc/39EN-HJCX].

104. Holding Foreign Companies Accountable Act § 2, 15 U.S.C.A. § 7214(i)(2) (Westlaw through Pub. L. No. 116-222).

105. Created by the Sarbanes-Oxley Act of 2002, the PCAOB was a non-profit corporation established by the Congress of the United States to oversee the audit of public companies in order to protect investors and public interests. *About*, PUB. COMPANY ACCT. OVERSIGHT BD., https://pcaobus.org/About/Pages/default.aspx [https://perma.cc/Q2UJ-PXGP] (last visited Feb. 26, 2021).

106. 15 U.S.C. § 7214(i)(3). The Trump administration issued a set of recommendations in July 2020 to implement the bill and give existing issuers a transition period until January 1, 2022. Soyoung

However, a regulator's options are limited when a company has already been listed. This Article specifically considers three options to deal with interference: bolstering transparency requirements to assist corporate stakeholders to respond to foreign political interference, imposing more stringent listing standards to force companies out of the market, or prescribing a company to change its corporate structure to immunize it from external political interference. This Article discusses each in turn.

1. Strengthening Corporate Stakeholders through Transparency

Securities regulators could bolster available information by strengthening disclosure requirements regarding foreign political interference. By requiring disclosure of material information or notices to shareholders, informed stakeholders can better respond to the nature and scope of political interference. In other words, this is a relatively non-intrusive approach. By providing relevant information public, the market price can reflect the information and the extent of political interference. It then can generate market forces to restrain a company's responses to foreign political interference.

Disclosure empowers the market to correct for political interference. If a company's share price falls, the market sends a signal to other market participants to self-correct. A lower valuation of the company's shares could incentivize managers to resist interference to reduce further devaluation. If the market's response sufficiently damages the company, the management and shareholders might resist the interference. If this is the case, the costs of interference could be contained. Alternatively, a lower valuation might invite market participants to acquire a larger stake in the company or compete for control. Corporate managers would thus be incentivized to avoid political interference to reduce the chance of a potential takeover by another person or entity unless they are political appointees. Regulators can create an environment, through disclosure requirements, where the market effectively corrects for potential interference.

However, there are also limitations to the effectiveness of disclosure and the market's power. First, there has been considerable debate on the market's ability to absorb information.[107] Information regarding alleged interference may be unclear. For example, disclosure requirements may not reach informal conversations, such as state officials requesting that managers

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Ho, *Trump Administration Seeks to Delist U.S.-Listed Chinese Companies for Blocking Audit Inspections*, THOMSON REUTERS (Aug. 10, 2020), https://tax.thomsonreuters.com/news/trump-administration-seeks-to-delist-u-s-listed-chinese-companies-for-blocking-audit-inspections [https://perma.cc/TH2H-JJ5L].

107. *See generally* EMILIOS AVGOULEAS, THE MECHANICS AND REGULATION OF MARKET ABUSE: A LEGAL AND ECONOMIC ANALYSIS 45–56 (2005) (discussing the history and criticism of the assumptions underlying the Efficient Capital Market Hypothesis and the Capital Asset Pricing Model).

of a state-owned bank maintain credit lines. Likewise, notice may be given regarding the appointment of a new chairman, but the reason for the appointment may be excluded. This limits the effectiveness of disclosure requirements and, consequently, the market's ability to respond to political interference adequately.

Second, the market for corporate control might not exist, so that the chance of being taken over by a third party is low. Some countries may deter takeovers for policy reasons, like bolstering "national champions" or protecting local industries.[108] The degree of concentrated ownership and the nature of the controlling owner would also impact the takeover market's effectiveness.[109] Also, assuming that such a market exists, it is still questionable whether it effectively reduces agency problems.[110] In many countries, hostile takeovers are virtually non-existent. Moreover, the market for corporate control of an SOE is less likely if the state is unwilling to sell their positions. These entrenched positions could prevent any takeover of an SOE by an outsider, although that SOE might bid to take over other companies.[111] In this situation, market pressures may be inadequate to control external political interference.

2. Greater Control Through Listing Requirements

Securities regulators can directly address foreign political interference through listing requirements. Once a company is already listed, addressing foreign political interference through warnings, suspensions, or delisting may not be effective or could detrimentally affect shareholders' interests.[112] Host market regulators have little power to enforce rules against a foreign government. For example, the Securities Exchange Commission is unlikely to acquire a court order to stop the CCP from setting up Party organizations when that company's headquarters and assets are in China.

Furthermore, although suspending trading or delisting could remove foreign interference from the market, they are draconian measures that could adversely affect the overall market. Minority shareholders will suffer if they

108. Paul Davies et al., *Control Transactions*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 205, 240 (3d ed. 2017).

109. *See id.*

110. *See* Charlie Weir, *The Market for Corporate Control*, *in* THE OXFORD HANDBOOK OF CORPORATE GOVERNANCE 328, 338–39 (Mike Wright et al. eds., 2013) (arguing that the predominance of non-hostile takeovers raises questions about whether the market for corporate control is an effective mechanism for disciplining corporations).

111. *See, e.g.*, Chiara D. Del Bo et al., *Governments in the Market for Corporate Control: Evidence from M&A Deals Involving State-Owned Enterprises*, 45 J. COMP. ECON. 89, 90 (2017).

112. For example, under U.S. law, the Securities and Exchange Commission has the power to suspend the trading of a security if, in the Commission's opinion, the suspension is in the public interest and necessary to protect investors. Securities Exchange Act of 1934, 15 U.S.C. § 78l(k).

cannot cash out their shareholdings after a trading suspension or mandatory delisting due to an event (i.e., political interference) beyond their control. Securities regulators would also have to weigh draconian measures against the costs of losing listings in stock exchanges if companies that are exposed to foreign political interference decide to avoid the U.S. market and list elsewhere.

3. Changing Corporate Structure to Immunize the Company

Securities regulators could require changes in corporate structures to place a company in the lower level of a corporate pyramid to shield companies from political pressure. A study found that intervening layers of corporate hierarchies empowered managers by distancing them from direct political pressure, and the Chinese government built corporate pyramids (i.e., a corporate group with layers of holding companies and subsidiaries in its vertical structure) to insulate managers from political interference, despite the risk of increased agency costs.[113] Hence, to ensure that managers are more empowered to resist political interference, it is arguable that a company should be allowed to be listed if it is in the lower part of a corporate pyramid. However, this approach is also counter-intuitive. On the one hand, securities regulators generally prefer transparency and accountability in the corporate structure. Being in the lower level of a corporate pyramid hardly improves transparency. On the other hand, a complicated corporate structure may also interfere with effective monitoring over the management's conduct. Therefore, this Article does not prefer this approach.

4. Summary

Securities regulators must decide which approach most efficiently counters foreign political interference. In an open market with powerful institutional investors, promoting transparency and disclosure could efficiently curb foreign political interference. Greater transparency can empower managers, shareholders, and prospective investors to decide what is best for the company in light of foreign political interference. In other words, this Article proposes a market-driven approach to deal with foreign political interference. The approach is preferred to suspension or mandatory delisting, as the latter hurts shareholders' interests. However, the market-driven approach's effectiveness depends on whether corporate stakeholders could respond to foreign political interference, as the Article predicts. The next Part explores how Chinese businesses listed in Hong Kong responded to the CCP's Party building movement.

113. Fan et al., *supra* note 72, at 1219.

III. PARTY BUILDING IN HONG KONG

This Part explores political interference by a foreign actor through the CCP's Party Building requirement in China. Section A examines three kinds of Party building provisions: organizational, management, and human resources. Section B uses the rate of adoption as a measure of compliance with external political interference. Overall, their response demonstrates compliance with political interference, illustrated by the requirements imposed from the CCP of relevant Party building provisions. Section C then examines Hong Kong's reaction to that political interference by observing share prices. Section D summarizes the findings present.

A. Understanding Party Building

The CCP is writing itself into the country's largest companies' corporate constitutions, which this Article refers to as the "Party building" movement. In January 2017, the State-owned Assets Supervision and Administration Commission (SASAC) of the State Council and the CCP Central Organization Department jointly issued an official notice asking SOEs to incorporate Party building provisions into their corporate constitutions, including their sample provisions.[114] The Party building movement then extends from SOEs to private enterprises.[115] In short, Chinese companies must formalize the CCP's role in the company by recognizing the CCP's party organization and power in their corporate constitutions. "While the new language makes explicit investors' long-held assumption of party influence, the changes are the first time the party rather than the government has been named, investors said."[116]

This Article classifies Party building provisions into three categories: (1) general provisions establishing the CCP's role in the company ("organizational interference"); (2) provisions that give the CCP a role in management decisions ("management interference"); and (3) provisions that grant the CCP control over management or human resources personnel

114. Guanyu Zhashi Tuidong Guoyou Qiye Dangjian Gongzuo Yaoqiu Xieru Gongsi Zhangcheng de Tongzhi (关于扎实推动国有企业党建工作要求写入公司章程的通知) [Notice Regarding the Promotion of the Requirements of Incorporation of Party Building Work into the Articles of Associations of State-Owned Enterprises] (promulgated by the Org. Dep't of the Cent. Comm. of the Chinese Communist Party & the State-Owned Assets Supervision & Admin. Comm'n of the State Council, Mar. 15, 2017, effective Mar. 16, 2017), Zu Tong Zi (组通字) [2017] No. 11, [hereinafter Requirements of Incorporation of Party Building Work], https://jzb.zju.edu.cn/_upload/article/files/38/38/dbe8ec03469692297d7dcc27ec95/7158a359-54f9-4543-a7f4-fdcab818d633.pdf [https://perma.cc/2829-6U9Z] (China).

115. *See* Hornby, *supra* note 27.

116. Hughes, *supra* note 31.

(“human resources interference”).[117] This Section elaborates on each category in more detail below.

First, organizational interference requires a company’s constitution to formally introduce the CCP’s Party organization as an organ of the company. Before Party building, a company might informally have a Party organization inside the company.[118] However, the CCP’s Party building campaign requires a company to formalize its existence in its constitution. There could be several forms of organizational interference. A company’s constitution can state that it will follow the “Constitution of the Communist Party of China.”[119] More importantly, a company’s constitution must expressly create a Party organization, or Party committee, as a company organ alongside the board of directors and shareholders.[120] The Party committee is expected to exercise “the core leadership role, providing direction, managing the overall situation and ensuring implementation [of CCP’s policies].”[121] Through those provisions, the CCP establishes itself inside a company to lead the company and ensure that it will follow the CCP’s instructions. In addition to creating the Party committee, a company

117. We use the phrase “management interference” in the same way Liu and Zhang use the phrase “decision-making control;” and use “human resources interference” in the same way Liu and Zhang use “personnel control.” Liu & Zhang, *supra* note 37, at 8.

118. Zhang, *supra* note 21, at 56.

119. *E.g.*, *Zhongguo Guoji Hangkong Gufen Youxian Gongsi Zhangcheng* (中国国际航空股份有限公司章程) [*Articles of Incorporation of Air China Limited*], Air China, art. 11 (Oct. 19, 2018), http://www.airchina.com.cn/cn/images/investor_relations/%E5%9B%BD%E8%88%AA%E8%82%A1%E4%BB%BD%E5%85%AC%E5%8F%B8%E7%AB%A0%E7%A8%8B(2018.10.19%E4%BF%AE%E8%AE%A2%E7%89%88).pdf [https://perma.cc/R9Y6-N3ED], *translated in Articles of Association of Air China Limited*, FIN. TIMES (Oct. 22, 2018) [hereinafter *Air China (2018)*], https://markets.ft.com/data/announce/full?dockey=1323-13836412-0UEHL36DSUMC7N01048PBFPN16 [https://perma.cc/XYK4-BRXJ]; *Zhongguo Tiejian Gufen Youxian Gongsi Zhangcheng* (中国铁建股份有限公司章程) [*Articles of Incorporation of China Railway Construction Corporation Limited*], China Ry. Constr. Corp., art. 1 (June 11, 2018), http://www.crcc.cn/module/download/downfile.jsp?classid=0&filename=2b5279493c084a87b6a744b716b61ac0.pdf [https://perma.cc/8QVE-JBM5], *translated in Articles of Association of China Railway Construction Corporation Limited*, HKEX [hereinafter *China Railway Construction Corp. (2018)*], https://www1.hkexnews.hk/listedco/listconews/sehk/2019/1218/2019121801017.pdf [https://perma.cc/8K7U-GG8T] (last visited Mar. 15, 2021); *Zhongguo Gongshang Yinhang Gufen Youxian Gongsi Zhangcheng* (中国工商银行股份有限公司章程) [*Articles of Incorporation of Industrial and Commercial Bank of China*], Indus. & Commercial Bank of China, art. 13 (Sept. 25, 2017), http://v.icbc.com.cn/userfiles/Resources/ICBCLTD/download/2017/gszc_cn.pdf [https://perma.cc/AN5H-33A9], *translated in Articles of Association of Industrial and Commercial Bank of China Limited*, ICBC [hereinafter *ICBC (2017)*], http://v.icbc.com.cn/userfiles/Resources/ICBCLTD/download/2017/gszc_en.pdf [https://perma.cc/D7FK-TTBF] (last visited Mar. 15, 2021).

120. *E.g.*, *Air China (2018)*, *supra* note 119, art. 11; *China Railway Construction Corp. (2018)*, *supra* note 119, art. 247; *ICBC (2017)*, *supra* note 119, art. 13.

121. *ICBC (2017)*, *supra* note 119, art. 13. *See also Air China (2018)*, *supra* note 119, art. 11 (“The Party committee shall perform the core leading and political functions, control the directions, manage the situation and ensure the implementation.”).

is also obligated to provide "sufficient personnel to handle Party affairs and . . . sufficient funds to operate."[122] In short, the CCP can use the company's resources to sponsor its Party organization.

The CCP can also strengthen its grip on a company's organizational structure through a disciplinary inspection committee.[123] The CCP disciplinary inspection committee serves as the CCP's anti-corruption enforcement agency and Party rules.[124] A company manager could be subject to the Party's investigation or penalties for violation of Party disciplines. Therefore, the presence of a disciplinary inspection committee greatly enhances the CCP's power to interfere with a company's governance through the Party's disciplinary actions. Additionally, the appointment of a full-time deputy secretary allows the CCP to maintain a constant presence within the company to, for example, monitor management. Deputy-secretaries are also responsible for the implementation of CCP policies and instructions within the company.[125] Thus, the presence of a full-time deputy secretary should enhance the CCP's grip on a company.

Second, provisions regarding management interference require that managerial decisions comply with CCP policies. By interfering with management decisions, it reduces the management's discretion in governing the company. For example, one common provision requires that the "board of directors shall make inquiries with the Party committee before making decisions on major issues of the Company."[126] In another example, a company's constitution that "the President shall hear the opinion of the Party Committee of the Company before he hosts the office meeting to discuss and decide on material issues in relation to the production, operation and management of the Company."[127] By requiring the board of directors or managers to solicit the Party organization's opinions before making a material decision, the CCP interferes with the company's management decisions. Such interference could reduce a company's value if the CCP's interests are not aligned with its overall interest. If management and Party

122. *Air China (2018)*, *supra* note 119, art. 11. *See also ICBC (2017)*, *supra* note 119, art. 13 ("The working organs of the Party shall be established, equipped with sufficient staff to deal with Party affairs and provided with sufficient funds to operate the Party organization.").

123. *E.g.*, *ICBC (2017)*, *supra* note 119, arts. 52–53.

124. Guo Yong, *The Evolvement of the Chinese Communist Party Discipline Inspection Commission in the Reform Era*, 12 CHINA REV. 1, 2 (2012).

125. *E.g.*, *Air China (2018)*, *supra* note 119, art. 106; *ICBC (2017)*, *supra* note 119, art. 52.

126. *Air China (2018)*, *supra* note 119, art. 113. *See also China Railway Construction Corp. (2018)*, *supra* note 119, art. 166 ("The Board shall hear the opinions of the Party Committee of the Company before making decisions on material issues of the Company."); *ICBC (2017)*, *supra* note 119, art. 144 ("The opinions of the Party Committee shall be heard before the board of directors decides on material issues of the Bank.").

127. *China Railway Construction Corp. (2018)*, *supra* note 119, art. 202.

officials disagree on a matter, presumably, the management should follow the CCP's instruction, even if it is not for the company's best interests (e.g., lending money to an SOE to prop up the latter's finance). Otherwise, a manager is exposed to the risk that he might be subject to the CCP's disciplinary actions or other penalties by the CCP (e.g., no promotion in the future). Thus, it may affect how managers make decisions for the company's best interests if they know the CCP monitors them.

Finally, the CCP can also interfere with human resources decisions. In addition to having Party organization and requiring the management to consult the CCP before a management decision, another way to insert the CCP's role in a company is by requiring most senior managers to be Party members or serving in the Party organizations. The CCP could also interfere with the promotion of a company's managers or employees and ensure that they follow the CCP's policies and instructions. For example, the constitution of the International and Commercial Bank of China (ICBC), one of the largest banks in the world,[128] specifies as follows:

> Eligible members of the Party Committee can join the board of directors, the board of supervisors and the senior management through legal procedures, while eligible members of the board of directors, the board of supervisors and the senior management can also join the Party Committee in accordance with relevant rules and procedures.[129]

Based on this provision, a person can only be appointed as a director if the person is considered eligible by the CCP, and people likely must be loyal to the Party to be considered eligible. In addition, the chairman of the board and Party secretary of the Party committee can be the same person.[130] Although such a measure would undoubtedly help enforce the CCP rules inside a company, it is disputed whether such a person could uphold their fiduciary duty of loyalty.[131]

128. The ICBC is one of the global systemically important banks (G-SIBs) designated by the Financial Stability Board, alongside the likes of Bank of America and Goldman Sachs, etc. *See* FIN. STABILITY BD., 2019 LIST OF GLOBAL SYSTEMICALLY IMPORTANT BANKS (G-SIBS), Annex (2019).

129. *ICBC (2017)*, *supra* note 119, art. 52. *See also Air China (2018)*, *supra* note 119, art. 106 ("Eligible members of the Party committee are entitled to be admitted to the board of directors, the supervisory committee, and the management through legal procedures, and eligible Party members from the board of directors, the supervisory committee, and the management are entitled to be admitted to the Party committee in accordance with relevant rules and procedures."); *China Railway Construction Corp. (2018)*, *supra* note 119, art. 247 ("Eligible members in the Board, Supervisory Committee and management may join the Party Committee in accordance with relevant requirements and procedures.").

130. *E.g.*, *Air China (2018)*, *supra* note 119, art. 106; *China Railway Construction Corp. (2018)*, *supra* note 119, art. 247; *ICBC (2017)*, *supra* note 119, art. 52.

131. Zhang, *supra* note 21, at 60.

Additionally, the Party committee may be responsible for developing the CCP's cadres[132] and supervising the process of appointing management personnel. Below is an example of how the Party committee is instructed to act:

> [t]o adhere to the principle of the Party exercising leadership over cadres, the selection of management by the board of directors, and the exercise of power as regards the right of cadres' appointment by the management in accordance with laws. The Party committee shall deliberate and give opinions on the candidates nominated by the board of directors or the general manager, or recommend nominees to the board of directors or the general manager. The Party committee of the Company, together with the board of directors, shall observe the proposed candidates and give opinions collectively.[133]

This provision allows the CCP to control human resources decisions on the appointment of personnel. By controlling the appointment and promotion of personnel, the CCP can strengthen its control of a company directly by, for example, having a person that the CCP favors to be in a company's higher position.

In summary, the Party building movement aims to strengthen the CCP's control over listed companies and entrench its role as a core element of corporate governance. The political campaign is a product of the "legal and ideological struggle in an uncertain course charted by CCP policies" since the 1970s between the market economy and political authoritarianism.[134] It also underlines the conflict between China's stated policy of following the corporate governance principles and the desire to strengthen CCP's role in a listed company.[135] Eventually, the "integration of the Party leadership with corporate governance may further complicate the already overloaded legal framework and its rational function,"[136] increasing the "challenges and difficulties to the accountability and enforcement of corporate governance."[137]

132. In general, a cadre "refers to a public official holding a responsible or managerial position, usually full time, in party and government." Marcia R. Ristaino, *Party and Government*, *in* CHINA: A COUNTRY STUDY 407, 434 (Robert L. Worden et al. eds., 4th ed. 1988). The CCP's cadre system serves as an important regime function for the CCP to control human resources and managerial positions within the Party and the Chinese government, on all levels.

133. *Air China (2018)*, *supra* note 119, art. 107(2); *see also China Railway Construction Corp. (2018)*, *supra* note 119, art. 248(ii) ("The Party Committee of the Company shall . . . adhere to the principle of the Party exercising leadership over the cadres, the principle of the legitimate selection of operators by the Board, and the exercise of power as regards the right of cadres' appointment by the operators in accordance with law.").

134. Zhang, *supra* note 21, at 57.

135. *Id.* at 55–56, 59.

136. *Id.* at 60.

137. *Id.*

In sum, Party building provisions open the doors to CCP interference to varying degrees. Of the three kinds of provisions, one introduces the CCP into a company through a Party organization (i.e., the organizational interference). The second grants the Party organization the *ex ante* power to review major company decisions (i.e., "management interference"). The third allows the CCP to control the appointment of the company's board of directors or managers (i.e., human resources interference). Party building is meant to have a substantial impact on Chinese businesses, whether they are SOEs or not.

B. Adopting Party Building Provisions

1. Chinese Businesses Listed in Hong Kong

This Part examines how Chinese businesses on the Hong Kong Exchange (HKEx) responded to the CCP mandate to incorporate Party building provisions. HKEx classifies Chinese businesses into two categories: H-share companies and red-chip companies.[138] Hong Kong defines H-share companies as those "incorporated in Mainland China and whose listings in Hong Kong are approved by the China Securities Regulatory Commission (CSRC)."[139] In contrast, "red chip companies are enterprises that are incorporated outside of the Mainland and are controlled by Mainland government entities."[140] Although registered outside China, a red-chip company usually derives more than 55% of its revenue or assets from China.[141] This means that a red-chip company's major business operations and revenue come from the Mainland. As of 2018, 104 H-share companies (those incorporated in mainland China) were cross-listed on the Shanghai or Shenzhen Stock Exchanges, making their shares available for trading in domestic and foreign markets. In contrast, no red-chip company (those incorporated outside mainland China) is cross-listed on a Chinese stock exchange.

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138. *China Dimension*, HKEX [hereinafter *China Dimension*], https://www.hkex.com.hk/Market-Data/Statistics/Consolidated-Reports/China-Dimension?sc_lang=en [https://perma.cc/2C2T-68X7#select1=0&select2=0] (last visited Jan. 16, 2021) (use the second drop down menu under the words "CHINA DIMENSION" to navigate between "List of H Share Companies" and "List of Red Chip Companies" lists).

139. *Overview of the Listed Market*, HKEX [hereinafter *Overview of the Listed Market*], https://www.hkex.com.hk/Global/Exchange/FAQ/Getting-Started/Overview-of-the-listed-market?sc_lang=en [https://perma.cc/2E2W-Z5UT] (last visited Jan. 16, 2021) (click on the words "In what ways are H-share companies different from red chips? How can investors obtain the lists of the companies?"); *see also* FTSE RUSSELL, GUIDE TO CHINESE SHARE CLASSES: V.1.5, at 3 (2019).

140. *Overview of the Listed Market*, *supra* note 139.

141. FTSE RUSSELL, *supra* note 139.

In order to list on a foreign stock exchange, Chinese companies often adopt the "variable interest entity" (VIE) corporate structure. Sina's initial public offering, which runs a popular web portal in China, popularized the VIE structure among Chinese businesses who wanted to carry out their initial public offerings and list on a foreign stock exchange.[142] As a VIE, business operations are still conducted by the domestic Chinese company (Company X) in China, but the entity listed in a foreign stock exchange is a company incorporated in a foreign country (Company Y). The foreign incorporated entity (Company Y) does not directly own the domestic business (Company X) and *vice versa*. Instead, Company Y's control over Company X is established through a complex web of contracts.[143] Company X's profits or losses are eventually reflected in Company Y's account. Despite the inherent risks associated with the opaque structure,[144] it helps evade Chinese laws that restrain foreign capital in Chinese companies and circumvents controls over foreign direct investment.[145] This might explain the popularity of the VIE structure among Chinese companies who use foreign-incorporated entities for their initial public offerings. Over 92 percent of Chinese companies listed on the NASDAQ use the VIE structure.[146] The VIE structure also means that Company Y is only listed in a foreign stock exchange and not cross-listed in a Chinese stock exchange.

Chinese companies often list on the HKEx, given Hong Kong's proximity to China's southern shore. Hong Kong's status as an international financial center helps Chinese companies "raise capital in a freely convertible currency . . . for their business development", enjoy greater liquidity, and a better regulatory environment.[147] Listing on HKEx also boost investors' confidence because of Hong Kong Securities and Futures Commission corporate governance requirements that are on par with

142. Mengwei Ma, *The Perils and Prospects of China's Variable Interest Entities: Unraveling the Murky Rules and the Institutional Challenges Posed*, 43 H.K.L.J. 1061, 1061–62 (2013); Yu-Hsin Lin & Thomas Mehaffy, *Open Sesame: The Myth of Alibaba's Extreme Corporate Governance and Control*, 10 BROOKLYN J. CORP. FIN. & COM. L. 437, 444–46 (2016).

143. Ma, *supra* note 142, at 1063.

144. *Id.* at 1067–71.

145. Samuel Farrell Ziegler, Note, *China's Variable Interest Entity Problem: How Americans Have Illegally Invested Billions in China and How to Fix It*, 84 GEO. WASH. L. REV. 539, 541, 547–48 (2016); Ma, *supra* note 142, at 1064–65.

146. Coco Liu, *Chinese Offshore IPOs Grow More Reliant on Shaky Legal Structure*, NIKKEI ASIA (Oct. 8, 2018, 9:55 AM), https://asia.nikkei.com/Business/Markets/Chinese-offshore-IPOs-grow-more-reliant-on-shaky-legal-structure/ [https://perma.cc/9EWU-GP5M].

147. HKEX, FACT SHEET ON THE LISTING OF H-SHARES 3 (2013), https://www.hkex.com.hk/-/media/hkex-market/news/news-release/2013/130806news/fact-sheet_20th-h-shares [https://perma.cc/4CNW-MUU7].

international standards.[148] Among twelve markets, the Asian Corporate Governance Association ranked Hong Kong second, and China tenth on corporate governance.[149] To deal with the listing of Chinese businesses, the HKEx has a dedicated chapter in its listing rules that govern companies incorporated in China.[150]

By the end of 2018, 423 Chinese businesses listed in Hong Kong[151] on both the main board and the growth enterprise market (GEM) board.[152] Regardless of whether they are H-share or red-chips, most Chinese businesses listed in Hong Kong are SOE. Based on the Wind database[153], 299 (70.69%) of the 423 companies were SOEs. The central government controlled 172 of the SOEs ("central SOEs") whereas provincial or local governments controlled 127 ("local SOEs"). Less than 30 percent (29.31%) of companies were private enterprises.[154]

Of the 423, 260 were H-share and 163 were red-chips[155] (presented in Table 1 below.)

148. *Id.* at 3–4.

149. ASIAN CORP. GOVERNANCE ASS'N & CLSA LTD., CG WATCH 2018: HARD DECISIONS: ASIA FACES TOUGH CHOICES IN CG REFORM 16 (2018), https://www.acga-asia.org/files.php?aid=362&id=1196 [https://perma.cc/8NKS-2DS6].

150. *See* HKEX, LISTING RULES, ch. 19A, https://en-rules.hkex.com.hk/sites/default/files/net_file_store/HKEX4476_3208_VER40.pdf [https://perma.cc/3GPM-DDPB] (last visited Jan. 16, 2021).

151. The data is calculated based on the date of listing provided by the HKEx. *China Dimension*, *supra* note 138. The figure does not include one company, Sinotrans Shipping Ltd. (stock code: 368), which was delisted in October 2018. *Id.*

152. The Mainboard is the major market place for established listed companies in Hong Kong. In contrast, the Growth Enterprise Market (GEM) board is a "market with lower listing eligibility criteria . . . compared to the Main Board, serving the needs of small and mid-sized issuers." *See Listing Process for Listing on GEM*, HKEX, https://www.hkex.com.hk/Join-Our-Market/IPO/Getting-Started/Listing-on-GEM?sc_lang=en [https://perma.cc/H7J7-Z4AF] (last visited Dec. 29, 2020).

153. Wind database is a financial information services provider in China, specializing in financial information of Chinese companies and the Chinese market. *About Us*, WIND, https://www.wind.com.cn/en/about.html [https://perma.cc/N8UV-C3LS] (last visited September 19, 2020).

154. It should be noted that a private enterprise might still have state owners, except the state would not be a controlling shareholder.

155. The list of companies is extracted from the website of Hong Kong Exchange. *China Dimension*, *supra* note 138. Based on the list of companies, the study calculates the number of H-share and red-chip companies on both the Main Board and GEM.

Table 1. Number of Chinese Businesses Listed in Hong Kong by Listing Boards and Types

	H-share	Red-chip	Total
Main Board	236	158	394
Growth Enterprise market	24	5	29
Total	260	163	423

Among the 260 H-share companies, 59.26% (154 of 260) were identified as SOEs, and nearly 90% (142 of 159) of the red-chip companies were SOEs based on the designation by the Wind database. Thus, Chinese SOEs have not only chosen to list in Hong Kong via the H-share channel but also used foreign-incorporated entities as their listing entity in Hong Kong.

In summary, 423 Chinese businesses are listed on the Hong Kong Stock Exchange (HKEx). Most (70.69%) of the companies are SOEs. Some are incorporated in China, classified as H-share companies, and others are incorporated outside China, classified as red-chip companies. The next section explores the extent to which those 423 companies adopted Party building provisions.

2. Incorporating Party Building Provisions

This section evaluates compliance with the CCP's mandate, as measured by the rate of Party-building provisions incorporated into corporate constitutions. Given that Chinese law requires government approval to list a domestic entity in Hong Kong,[156] SOEs are more likely to be allowed to list overseas than non-SOEs.[157] This Article expected that SOEs (whether listed as H-share or red-chips) would adopt Party building given the state ownership and the CCP's control over the government under China's one-party political system. Despite the omnipresence of the CCP in China, private enterprises are less likely to comply because they are not directly controlled by the state or the CCP.

156. *See* Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Guanyu Guifan Jingnei Shangshi Gongsi Suoshu Qiye Dao Jingwai Shangshi Youguan Wenti de Tongzhi (中国证券监督管理委员会关于规范境内上市公司所属企业到境外上市有关问题的通知) [Circular of the China Securities Regulatory Commission on Several Issues Concerning the Standardization on Overseas Listing of Subordinated Enterprises of Domestically-Listed Companies] (promulgated by the China Sec. Reg. Comm'n, July 21, 2004, effective July 21, 2004), http://www.lawinfochina.com/display.aspx?lib=law&id=10081&CGid=# [https://perma.cc/UN3Q-ZDM6].

157. Mingyi Hung et al., *Political Considerations in the Decision of Chinese SOEs to List in Hong Kong*, 53 J. ACCT. & ECON. 435, 435 (2012).

Surprisingly, the data revealed a different picture. The study tracked corporate constitutions[158] to measure compliance with the CCP mandate. The study also examined the kind of compliance adopted by looking at three kinds of provisions—organizational, management, and human resources interference—into their constitutions.[159] Compliance was measured by the rate of adoption of any party-building provision among all companies. Despite encouragement from the CCP since 2016, only 33.1% of companies (140 of 423) adopted any kind of Party building provision by the end of 2018. Furthermore, 53.46% (139 of the 260) H-share companies (those incorporated in Mainland China) complied with the mandate, whereas only a single (0.61%) red-chip company (incorporated outside China) complied. In short, companies incorporated in China were more likely to adopt Party building provisions than foreign-incorporated Chinese businesses.[160]

This study also examined the compliance rate between SOEs and private enterprises. As most Chinese businesses in Hong Kong were Chinese SOEs, regardless of where the listed entity was incorporated, it was no surprise that SOEs were more likely to adopt Party building provisions than private enterprises. Of the 299 SOEs, 121 (40.47%) adopted Party building provisions. In contrast, only 19 of 124 private enterprises (15.32%) adopted such provisions.[161] However, SOEs incorporated in China were much more likely to incorporate Party building into their constitutions than SOEs incorporated offshore (i.e., the red-chips). If SOEs are supposed to be more likely to follow the CCP's mandate, the interesting question is why SOEs incorporated outside the mainland were much less likely to do so. Part IV further explores the result by examining the kinds of provisions that were adopted.

3. The Types of Party Building Provisions Adopted

Equipped with the overall compliance rate among different Chinese businesses, this Section shifts to analyzing the kinds of provisions adopted. Although SASAC issued template provisions, the provisions that were adopted varied, as demonstrated in Table 2. The Table demonstrates the

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158. HKEX NEWS, http://www3.hkexnews.hk/listedco/listconews/advancedsearch/search_active_main.aspx [https://perma.cc/3LED-FF4Y] (last visited Jan. 16, 2021). This website is the disclosure platform by the Hong Kong Exchange. To determine whether a company adopted party building provisions we searched for the company by its stock code and located different versions of a company's constitutional documents since 2015 to examine whether there has been any change made for Party Building using some keywords (e.g. "Communist").

159. *See supra* Part III.A.

160. The difference is statistically significant (*chi2* = 22.3, $p < 0.001$; *Fisher's exact* < 0.001).

161. The difference between SOEs and private enterprises is statistically significant (c*hi2* = 25.03, $p < 0.001$).

adoption rate of party-building provisions: organizational interference, management interference, and human resources interference. The following paragraphs pertains only to companies that incorporated any kind of provision. When measured against the total number of companies, the overall adoption rate for each kind of provision is less than one-third.

Table 2. The Adoption of Different Provisions

Provisions	**Number of companies**	**% of companies adopting Party building (n = 140)**	**% of total Chinese businesses listed in Hong Kong, including non-adopting companies (n = 423)**
Organizational interference			
Having Party organization	137	97.86%	32.39%
Integrating CCP constitution	139	99.29%	32.86%
Supporting Party organization's resources	119	85.00%	28.13%
With disciplinary committee	94	67.14%	22.22%
Full-time deputy Party secretary	65	46.43%	15.37%
Management interference			
Consulting Party organization before major decisions	120	85.71%	28.37%
Human resources interference			
Chairman and Party secretary are the same person	54	38.57%	12.77%
Supervising CCP's cadre	109	77.86%	25.77%

Of the companies that complied with the mandate, companies most commonly accepted provisions related to organizational interference, regardless of whether they were SOEs or private enterprises. More specifically, nearly all companies adopted the presence of the Party organization within the company (97.86%) and integrated the CCP's constitution (99.29%).[162] However, other organizational interference provisions were not uniformly adopted. Although over a majority of companies agreed to provide the Party organization with resources (85%), only two-thirds agreed to form a disciplinary committee (67.14%). Employing a full-time deputy Party secretary was even less popular (46.43%). Thus, it appears that most of the companies incorporated the presence of a Party organization, which might have already been in place, or

162. *See supra* Part III.A.

integrating the CCP's constitution. However, they did not favor the monitoring that would result from a disciplinary committee or full-time deputy secretary.

In addition to adopting organizational interference, most companies also complied with management interference. Over 85% of companies agreed to consult with the Party before making major decisions. The adoption rate is similar with supporting party organization's resources. Thus, most adopting companies seemed to be acceptable to organizational and management interference.

Despite compliance with the other two provisions, companies were less likely to accept human resources interference. Although over three-quarters of companies adopted the CCP's supervision over cadres, fewer than 40% of the companies incorporated that the chairman of the board of directors and the Party secretary would be the same person. In addition, only about 2/3 of adopting firms accept the disciplinary committee. Obviously firms adopting Party building are less keen on those two provisions.

Table 3. The Adoption of Different Provisions by SOEs and Private Enterprises

Provisions	SOEs			Private enterprises		
	Number of companies adopting	% of total SOE (n = 299)	% of SOEs adopting (n = 121)	Number of companies adopting	% of total private enterprises (n = 124)	% of private enterprises adopting (n = 19)
Organizational interference						
Having Party organization	119	39.8%	98.35%	18	14.52%	94.74%
Integrating CCP constitution	120	40.13%	99.17%	19	15.32%	100%
Supporting Party organization's resources	102	34.11%	84.3%	17	13.71%	89.47%
With disciplinary committee	81	27.09%	66.94%	13	10.48%	68.42%
Full-time deputy Party secretary	56	18.73%	46.28%	9	7.26%	47.37%
Management interference						
Consulting Party organization before major decisions	104	34.78%	85.95%	16	12.3%	84.21%
Human resources interference						
Chairman and Party secretary are the same person	44	14.72%	36.36%	10	8.06%	52.63%
Supervising CCP's cadre	96	32.11%	79.34%	13	10.48%	68.42%

Table 3 examines the kinds of "Party building" provisions adopted by SOEs and private enterprises. Two interesting questions arise from Table 3. Why did some SOEs fail to formalize Party building in their companies two years after President Xi Jinping's policy statement in October 2016?[163] Second, why did private enterprises comply despite lacking any substantial state ownership?

Politically connected private enterprises listed in Mainland China are more likely to adopt party-building provisions than other non-connected companies.[164] However, adoption tends to be symbolic.[165] Our data supports that finding. Among the companies incorporating Party building, there was little difference between SOEs and private enterprises when it came to having a Party organization, integrating the CCP's constitution, and supporting the Party organization. Adopting organizational interference provisions demonstrates minimum degrees of loyalty to the Party by accepting the CCP's presence in the company.

The difference between SOEs and private enterprises pertained to provisions regarding human resources interference. Among the private enterprises, there were more instances in which a single individual was both the chairman and the Party secretary, although there was less acceptance of CCP supervision over the Party cadre. However, there was no clear proof indicating that SOEs were more likely to accept the dual role of chairman and Party secretary[166] or the provision allowing CCP supervision of personnel and CCP cadres.[167]

In addition, among SOEs, those controlled by the central government (central SOEs) were more likely than other SOEs (local SOEs) to accept management and human resources interference. Central SOEs were more likely to adopt the provision for management interference, with 58 out of 63 (92.06%) incorporating it as opposed to 46 out of 58 (79.31%) local SOEs.[168] Central SOEs were more likely to adopt the dual position of chairman and Party secretary[169] and allow the Party organization to supervise their personnel and the CCP cadre.[170]

To some extent, the data presented in this Article is compatible with other studies focusing on SOEs listed on Chinese stock exchanges. A study

163. *See New Requirements Raised by General Secretary Xi Jinping*, *supra* note 23.

164. Lin & Milhaupt, *supra* note 37, at 19–22.

165. *Id.*

166. The difference is not statistically significant (*chi2* = 1.834, $p = 0.176$).

167. The difference is not statistically significant (*chi2* = 1.135, $p = 0.287$).

168. The difference is statistically significant (*chi2* = 4.067, $p = 0.044$).

169. The difference is statistically significant (*chi2* = 5.309, $p = 0.021$).

170. The difference is statistically significant (*chi2* = 5.083, $p = 0.024$).

found that SOEs were more likely to adopt Party-building provisions than those on foreign exchanges. The study also found that 676 out of 808 (83.67%) SOEs listed in China adopted "management interference" provisions.[171] Seven hundred thirty-two companies (90.59%) had agreed to the dual-role of chairman and Party secretary, and 713 companies (88.24%) had allowed the CCP to become involved in personnel decisions.[172] In addition, a more recent study showed that 57.88% of the adopting SOEs listed in China accepted management interference, 34.30% accepted the dual-role of chairman and Party secretary, and 65.93% agreed to the Party's control over the cadre.[173] Based on 299 SOEs listed in Hong Kong (regardless of whether they were cross-listed in China), our data showed that 34.78% of these SOEs adopted management interference, 14.72% accepted the dual-role and 32.11% agreed to the Party's control over the cadre. Comparing with other studies focusing on listed SOEs in China, this Article shows that Chinese SOEs were less inclined to adopt Party building provisions if they were listed outside of China. This aligns with prior observations that foreign-incorporated companies, or red chips, were less likely to adopt Party building.

A further question was whether the amount of state ownership stakes affects the decision to adopt Party building provisions. Previous research suggested that an SOE is more likely to adopt Party building if the state owns a higher proportion of the company.[174] This study relied on the largest shareholder's direct shareholding as a benchmark to measure state ownership because existing databases do not present full beneficial ownership data.[175] Using logistic regression, the study examined whether the number of shares held by the largest shareholder impacted Party building provisions' adoption. At first, the regression did not yield any significant result because the percentage of shares held by the largest shareholder did not correlate with the decision as to whether to adopt Party building ($p = 0.187$). However, adding a dummy variable to the equation regarding the company's H-share status showed that both the percentage of shares held by the largest shareholder ($p < 0.001$) and the company's status as an H-share company ($p < 0.001$) had a positive effect on the likelihood of adopting "Party building."

171. Liu & Zhang, *supra* note 37, at 8 tbl.3.

172. *Id.*

173. Lin & Milhaupt, *supra* note 37, at 19–20 tbl.4.

174. Liu & Zhang, *supra* note 37; Lin & Milhaupt, *supra* note 37, at 20–21 tbl.5.

175. For example, the CSMAR database provides the names of the largest shareholders or the beneficial interest holders. However, it is not clear from the database or the names whether the holders are related to the state.

The H-share dummy had a much more pronounced effect (*odds ratio* = 230.44) than the largest shareholder (*coefficient* = 1.03).

There were similar effects when adopting the same model to analyze the odds of adopting provisions related to organizational interference or human resources interference. Nevertheless, no statistically significant result emerged when the study analyzed the management interference provision. This indicated that the largest shareholder's degree of direct control would matter if a company was incorporated in China (i.e., an H-share company). It was also consistent with previous studies of Party building reforms for SOEs listed in China.[176] However, this was less of a problem for red-chip companies. The result might reflect the general disinclination of red-chip companies to adopt any Party building provisions.

Furthermore, highly regulated industries were more likely to adopt Party building provisions than less regulated industries.[177] Utilizing WIND's industry classification,[178] this study identified five highly-regulated industries: finance, public utilities, mining, energy, and real estate, based on earlier research on political influence and the post-IPO performance of Chinese companies.[179] Out of the 423 companies studied, 192 (45.39%) were in one of the highly regulated industries. These included 78 financial institutions, 29 public utility companies, 32 real estate companies, 17 energy companies, and 36 mining companies. Of those 192 highly-regulated companies, 76 companies (39.58%) included Party building in their constitutions, whereas only 27.71% of less-regulated companies complied. Thus, there was a correlation between the degree of regulation and acceptance of Party building provisions.

Companies in highly regulated industries, like finance, are expected to be more likely to adopt Party building because increased interactions with regulators invite political interference.[180] For example, public utilities such as water, electricity, and petroleum often attract strong public interest and, consequently, government intervention, exposing them to political influence. Thus, those companies are expected to experience more political pressure to

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176. Liu & Zhang, *supra* note 37; Lin & Milhaupt, *supra* note 37, at 22–23.

177. The difference is statistically significant (*chi2* = 6.680, *p* = 0.010).

178. *See* WIND, WIND HANGYE FENLEI BIAOZHUN (WIND行业分类标准) [THE INDUSTRY CLASSIFICATION STANDARDS OF WIND DATABASE] (2005), http://net.wind.com.cn/WindNET/Bulletin/express/WICS_Full_200501.pdf [https://perma.cc/REZ6-X6HQ].

179. Joseph P.H. Fan et al., *Politically Connected CEOs, Corporate Governance, and Post-IPO Performance of China's Newly Partially Privatized Firms*, 84 J. FIN. ECON. 330, 340 (2007).

180. *See Politicians and Firms*, *supra* note 34, at 1015 (noting that it is easier for politicians to use their control over regulated firms to pursue political objectives when there is heavy regulation of firms, due to lowered costs); *supra* Part II.A.1 (discussing different types of political interference in corporate governance).

adopt Party building. Given the extensive regulations, it is reasonable to assume that such entities could be more susceptible to political pressure exercised by regulatory bodies.

In particular, financial firms were more likely to adopt Party building provisions than companies in any other industry.[181] It could be because firms in financial services are subject to intensive regulations by financial regulators, whether they are banks, insurance companies, or securities brokers. However, the data cannot explain whether companies in other highly regulated industries (e.g., mining or public utilities) are more or less likely to adopt Party building. Therefore, one should be careful not to overstate the role of industry in adopting Party building.

C. Hong Kong's Reaction to Party Building

This study next considers the market's reaction to the Party building reform. Utilizing the cumulative abnormal return (CAR), [182] the study observed two events: (1) President Xi Jinping's public announcement on October 12, 2016;[183] and (2) the official publication of the "Party building" template provisions on January 3, 2017.[184] The former event was when President Xi made an important policy declaration, and the latter was when it became clear what Party building might mean in practice. We expect the market to respond to these two significant events which signal the CCP's political interference with listed companies' governance. If the market reacted negatively as measured by the CAR, it would indicate that the market disfavored the Party building reform, and the event could hurt shareholder value. The opposite would be true if the CAR were positive.

The study used shares trading data of the 423 companies listed in Hong Kong on the days surrounding the two events. The event windows were 11 days, 5 days, and 3 days before and after the event day (i.e. [-5, 5], [-2, 2], [-1, 1]) and a window of 1 day after the event day ([0, 1]). The analysis measured these companies' stock returns against the stock returns of the

181. The difference is statistically significant (*chi2* = 12.340, $p < 0.001$).

182. In general, a cumulative abnormal return is the sum of each daily abnormal return within an event window. An abnormal return is the actual stock market return minus the expected return based on a market model. *See Abnormal Return*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/abnormal-return/ [https://perma.cc/K4RH-WMH4] (last visited Mar. 25, 2021).

183. *See New Requirements Raised by General Secretary Xi Jinping*, *supra* note 23.

184. *See, e.g.*, Requirements of Incorporation of Party Building Work, *supra* note 114.

Hang Seng Index, the leading stock market index in Hong Kong,[185] for the previous 20 to 170 days before the event day.[186] Table 4 shows the results:

Table 4. Summary of Cumulative Abnormal Returns (%)

Variable	Mean	t Value	Pr > |t|	Variable	Mean	t Value	Pr > |t|
Event date: October 12, 2016 N = 373				Event Date: January 3, 2017 N = 377			
[0, 1]	0.1861	1.13	0.2593	[0, 1]	-0.752	-4.09***	<.0001
[-1, 1]	0.5625	2.69***	0.0074	[-1, 1]	-0.11	-0.62	0.536
[-2, 2]	0.8763	3.34***	0.0009	[-2, 2]	-0.391	-1.71*	0.089
[-5, 5]	2.0708	5.46***	<.0001	[-5, 5]	-1.519	-4.4***	<.0001
"*", "**" and "***" represent "p < 0.1," "p < 0.05," and "p < 0.01," respectively							

The data presented in Table 4 show a contrasting pattern. On October 12, 2016, when President Xi Jinping made the policy declaration, investors in Hong Kong reacted positively during the 3-day, 5-day, and 10-day event windows. However, when model provisions were published on January 3, 2017, the market responded negatively. On both occasions, the CAR value for the data was statistically significant.

The consistently positive response to the October 2016 announcement could be a result of optimistic market sentiment after a long holiday break in China. According to the literature, it is unclear whether long holidays could cause the stock market to rise or fall before or after the break.[187] President Xi made the announcement during a Party conference, immediately after China's long National Day holiday starting on October 1.[188] However, this

185. The current and historical constituents of the Hang Seng Index are available on the website of Hang Seng Indexes Company Ltd. *See Hang Seng Index and Sub-Indexes*, HANG SENG INDEXES, https://www.hsi.com.hk/eng/indexes/all-indexes/hsi [https://perma.cc/7X6D-R5VE] (last visited Sept. 21, 2020).

186. The data source utilized for this analysis was Datastream, an online database on the global stock markets located on the Refinitiv website. *See Datastream*, REFINITIV, https://www.refinitiv.com/en/products/datastream-macroeconomic-analysis [https://perma.cc/76W5-KQU8] (last visited September 21, 2020).

187. *See, e.g.*, Tian Yuan et al., *The Pre-Holiday Effect in China: Abnormal Returns or Compensation for Risk?*, 18 REV. PAC. BASIN FIN. MKT. & POLICIES 1550014-1 (2015); Tian Yuan & Rakesh Gupta, *Chinese Lunar New Year Effect in Asian Stock Markets, 1999-2012*, 54 Q. REV. ECON. & FIN. 529 (2014). In contrast, an Australian study found a potential pre-holiday effect on the stock market, but no post-holiday effect. *See* George J. Marrett & Andrew C. Worthington, *An Empirical Note on the Holiday Effect in the Australian Stock Market, 1996-2006*, 16 APPLIED ECON. LETTERS 1769 (2009).

188. In 2016, the National Day holiday started from October 1 and ran until October 7, 2016, followed by the weekend on October 8 and 9, 2016. Alexandra Suarez, *China's Golden Week 2016: Country Spends $180 Billion During National Holiday*, INT'L BUS. TIMES (Oct. 11, 2016, 1:49 PM),

Article does not measure the possible effect of the stock market movement following the long holiday, though the possibility that CARs were affected by holidays cannot be excluded.

Furthermore, the market may have responded positively in 2016 because the market did not fully appreciate the vague wordings in President Xi's speech, such as incorporating the Party's leadership into all corners of corporate governance or embedding Party organization into corporate governance structure.[189] In contrast, by January 2017, investors knew more precisely how the CCP would implement Party building in the corporate governance of listed companies based on the template provisions. Thus, once the substance of Party building was better understood, the market reacted negatively, indicating that the market saw the CCP's political interference through Party building to be hurting the companies (and henceforth the negative CAR in January 2017).

Observing the January 2017 event, the CARs of red-chip companies was lower than that of H-share companies. The difference in the means was statistically significant when a two-sample t-test was used.[190] This indicated that investors responded more negatively to the news when it affected red-chip companies, Chinese businesses incorporated outside China. For the three-day event window, the mean of CAR for H-share companies was 0.12%, as opposed to 0.55% for red-chips. For the five-day event window, the mean of CAR for H-share companies was 0.02%, in contrast to 0.98% for red-chips. Although most red-chips are Chinese SOEs, this suggests that the Party building movement enhanced the risk that foreign-incorporated businesses would be subject to a higher degree of political interference than outside investors were willing to accept. If so, the data reflects the negative effects of external political interference.[191] Other variables, such as whether a firm was an SOE or cross-listed in China's A-share market, lacked statistical significance.

D. Summary of Findings

This Part presents several findings regarding how Chinese businesses listed in Hong Kong responded to the Party building movement. First, only about a third of these companies accepted Party building within two years of

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https://www.ibtimes.com/chinas-golden-week-2016-country-spends-180-billion-during-national-holiday-2429709 [https://perma.cc/Z5DX-6CNF].

189. *See New Requirements Raised by General Secretary Xi Jinping*, *supra* note 23.

190. For example, $p = 0.037$ for a 3-day event window and $p = 0.031$ for a 5-day event window.

191. *See supra* Part II.A.

President Xi's policy declaration.[192] Second, companies incorporated in China, or H-share companies, incorporated were more likely to adopt "Party building" than companies incorporated outside China or red-chip companies. This suggests that foreign-incorporated companies were more resistant to the influence of the CCP. Third, among the companies that incorporated "Party building" provisions, most accepted organizational interference, such as having a Party organization. Additionally, over 75% accepted management interference through Party supervision of cadres. However, companies were less likely to incorporate a full-time deputy Party secretary or a disciplinary committee. Companies were also reluctant to have the same person serve as both the chairman and Party secretary. Fourth, for companies incorporated in China, the more shares held by the majority shareholder, the more likely the company adopted Party building. However, this effect was not as pronounced for companies incorporated outside China. From these observations, Part IV reflects on how regulators respond to foreign political interference.

IV. REFLECTIONS ON DETERRING POLITICAL INTERFERENCE BY FOREIGN ACTORS

A. Explaining the Reactions by Corporate Stakeholders

Any regulatory action to counter foreign political interference should be based on reactions by corporate stakeholders. Part II of predicted that stakeholders generally object to external political interference.[193] Managers do not welcome interference that undermines their discretion. Similarly, non-state investors disfavor political interference because the state's agenda may divert resources away from value-maximizing allocations. Therefore, companies are generally expected to resist foreign political interference.

The evidence presented in Part III supported this hypothesis. Approximately one-third of companies adopted some forms of Party building provisions. Perhaps more will succumb to continuing political pressure unless there is a radical change in the CCP's policy. However, many companies did not swiftly comply with the CCP's mandate, even among SOEs. The lukewarm responses of the SOEs were surprising. SOEs were expected to quickly adopt Party building, given their state ownership and the pre-existing relationship between the management and the CCP.

This Article argues that companies did not adopt "Party building" provisions because of management's rejection or delay, despite the external

192. As mentioned previously, President Xi Jinping made the policy declaration on October 12, 2016. *See New Requirements Raised by General Secretary Xi Jinping*, *supra* note 23.

193. *See supra* Part II.B.

governmental mandate.[194] On the one hand, it is probably not due to a strong and negative market reaction to Party building to prevent SOEs from adopting Party building. As Part III revealed, the Hong Kong market did not have a particularly strong negative reaction (reflected in the CARs) to the policy declaration in October 2016. Furthermore, the market exhibited a marginally negative reaction to the publication of template Party building provisions a few months later. Thus, although the market responded negatively to the sample provisions' publication, it did not elicit a forcible reaction. The stock market, thus, likely did not act as a restraint to compliance with the CCP.

On the other hand, reluctance to adopt Party building was also probably not due to a potential takeover by another company. Especially for Chinese SOEs, the market for corporate control was, arguably, non-existent due to tight state-ownership. Our data cannot fully measure the true level of state ownership in Chinses SOEs, as the true extent of state ownership is not fully disclosed to the public. According to the OECD, the Chinese state owned more than 70% of SOEs' voting power on average.[195] Given these high state ownership stakes, the chance that a non-state player could acquire control over a Chinese SOE outside of China was extremely low. Hence, it is highly unlikely that concern over potential takeovers restrained the decision to adopt Party building.

Thus, the decision to not comply with Party building, notably for SOEs incorporated outside of China, likely came from management. In another study focusing on companies listed in China, some companies only underwent amendments of their constitutions at the behest of SASAC, demonstrating resistance by SOE managers.[196] In fact, there have been at least two reported cases where shareholders have rejected Party building.[197] Undoubtedly, non-state shareholders played a role in the final decision if we assume that state owners should vote in favor of Party building. In one case, 39% of the holders of H-shares in the ICBC voted against Party building.[198] In another case, the Tianjin Real Estate Group shareholders voted down the Party building amendment in 2017, despite state control over 26% of its

194. Studies on Mainland-listed companies show that managerial resistance mainly comes from central SOEs that underperformed and are less competitive internationally. *See* Lin, *supra* note 80, at 29–32.

195. OECD, *Chapter 4: The Theory of the Market for Corporate Control and the Current State of the Market for Corporate Control in China*, at 34, https://www.oecd.org/daf/ca/corporategovernanceofstate-ownedenterprises/31601011.pdf [https://perma.cc/59EL-3E3L] (last visited Jan. 16, 2020).

196. *See* Lin, *supra* note 80, at 26–29.

197. *See* Zhang, *supra* note 21, at 59.

198. *Id.*

shares.[199] It has also been reported that 20.52% of minority shareholders and 52.34% of the H-share companies' foreign shareholders voted against Party building amendment proposals.[200] Therefore, it is less likely due to shareholders' revolt that companies resist Party building.

One explanation of managers' resistance is that companies listed outside China are more exposed to the stakeholders outside China, which the CCP cannot control. These companies may face more pressure from non-Chinese shareholders, especially institutional shareholders. Any significant impact on share prices may also increase the cost of financing. If so, the managers of such companies would naturally prefer to delay Party building.

The complex VIE structure[201] may also assist the management's resistance to Party building. The VIE structure could empower managers to resist political interference to some extent. Formal restraint in a VIE structured company is relatively weaker, employed through a series of contracts and corporate chains, instead of through direct shareholders' rights, typical of companies incorporated in China, through which the CCP can directly control state owners. Thus, the VIE structure implies that the parent company in China has less control over a listed entity incorporated offshore. It explains the low adoption rate by red-chip companies, which are incorporated outside China.

In addition, data presented in this Article is also consistent with the bonding theory, which suggests that cross-listing in multiple stock markets creates a "bonding mechanism."[202] In such cases, companies must comply with "higher regulatory or disclosure standards and thus to implement a form of 'bonding' under which firms commit to governance standards more exacting than those of their home countries."[203] The bonding theory could partially explain why the H-share companies were more likely to adopt "Party building" than the red-chip companies. Many H-share companies are cross-listed in either Shanghai or Shenzhen. For cross-listed companies, the actual number of shares available for trading in Hong Kong (i.e., H-shares) represents a relatively small percentage of the total number of shares.[204]

199. *Id.*

200. Lin, *supra* note 80, at 21.

201. *See supra* Part III.B.1 (describing the VIE structure).

202. John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U.L. REV. 641, 674 (1999).

203. *Id.* at 652.

204. According to one report, the average total market capitalization of the A-share market of those dual-listed companies in both China and Hong Kong was two or three times larger than that of the H-share market, despite H-shares having a higher level of free float than A-shares. FTSE RUSSELL, CAPTURING THE CHINESE A-SHARES AND H-SHARES ANOMALY 4 (2017).

Investors in China may be less sensitive to external political interference than investors in Hong Kong. Being incorporated in China also means that H-share companies face more direct political pressure than red-chip companies, as they still have their head offices in the Mainland.

That being said, companies are nonetheless amenable to some forms of organizational interference and management interference by the CCP. After all, many companies probably already had Party organization inside the company before the Party building campaign.[205] For those companies, formalizing a Party organization's presence and its role in the company may not be more than recognizing the company's existing state. In addition, although consulting Party committees for major decisions reduces managerial discretion, it might not be wise to show hostility to Party members because it could be, for one, detrimental to a manager's career. For example, a manager defying the CCP's instruction may not receive promotions in the company or other places, especially when the manager has some political ambition. Being cordial to the Party committee and formalizing some of its *de facto* functions could be an acceptable compromise. This amenability might explain why the rate of agreeing to consult the Party before a management decision has been similar to adopting Party organizations.

In contrast, the companies demonstrated hostility, measured by low adoption rate, to human resources interference and extra Party monitoring such as a disciplinary inspection committee or full-time Party secretary. For one, management should prefer to retain control over the company's human resources decisions, which are necessary for effective management. The extra oversight exercised by the Party secretary or disciplinary inspection committee may mean that a manager has to make a decision in accordance with the interests of the CCP rather than the interests of the company if the CCP's interests are not aligned with the company's.[206] This explains why these companies were less in favor of provisions that, for example, allowed the CCP to manage Party cadre and the promotion of some managers. Hence, the companies were less likely to incorporate intrusive "Party building" provisions. In other words, management preferred to conduct operations without outsiders dictating how things should be done. In turn, this indicates that company managers were deliberately selective when complying with Party building provisions. Perhaps there is a kind of trade-off. Instead of facing sustained political pressure to adopt Party building provisions, it

205. *See* Zhang, *supra* note 21, at 60 (noting that by the end of 2016, 67.8% of domest private enterprises and 70% of foreign investment enterprises had established party organizations).

206. *See* discussion *supra* Part III.A (explaining how the extra oversight and threat of diciplinary actions can cause a manager to prioritize the interests of the CCP, instead of the company's interests).

might be better to comply with less intrusive measures without relenting to more direct control.

B. Regulatory Concerns and Responses

One might surmise that the low adoption rate means that regulators need not be concerned. This Article cannot predict how the domestic political climate in China and geopolitical events in the region, like the U.S.-China trade war, will develop. If political pressure is sustained, there is a fair chance that most SOEs, or even private enterprises, will succumb to Party building. If we look beyond this case study, foreign political interference remains an issue as long as foreign governments want to influence a listed company. Investors in the stock market can still suffer losses if a foreign government decides to sacrifice the company's long-term interests and its shareholders in favor of the government's interest. The Party building movement offers a rare chance to observe how company managers and shareholders respond to external political interference from another country. Hence, the outcome of this Article will provide valuable lessons for the future.

Based on the foregoing, this Article suggests that improving transparency is a more efficient approach to empower corporate stakeholders to deal with foreign political interference in corporate governance. As demonstrated, management is generally not enthusiastic about adopting Party building. Thus, managers provide the first layer of a company's defense. They might choose to ignore the political interference before presenting it to shareholders. In addition, existing and prospective shareholders can apply pressure to the management by selling shares of the company in the market (thereby lowering share prices) if they consider political interference harmful to the company. Together, the responses by managers, shareholders, and investors could generate market power to curb the acceptance of external political interference. The low adoption rate of Party building by Chinese businesses in Hong Kong supports this argument. It is important to improve transparency and to provide information regarding external political interference to the stock market to ensure that corporate stakeholders can make sound decisions. The approach thereby allows managers and shareholders to decide what is best for their companies. The Article refers to this as the market-driven approach.

However, the ability of a market-driven approach depends on market conditions. The market requires shareholders to generate sufficient pressure on management to resist Party building or external political interference. Hong Kong's stock market is international, with a variety of individual, institutional, and international investors.[207] Hence, the market can provide the power to restrain management's conduct concerning foreign political interference. Shareholders' reactions might differ in the Chinese stock markets. This Article did not cover Chinese businesses listed in other markets (e.g., New York, London, or Singapore) and cautions against drawing too many conclusions from the data.

In addition, our data also suggests an alternative approach, that securities regulators could require companies to list with a foreign-incorporated entity outside their home market to combat external political interference. As indicated above, red-chip companies are far less likely to adopt Party building than their H-share counterparts, even though many red-chip companies are also SOEs.[208] Thus, a foreign-incorporated entity may be more immune to political interference from the CCP. If this is the case, one normative suggestion is that regulators could request a company coming from a market known to have strong political interference in corporate governance to have the listing entity incorporated outside its home market (e.g., a red-chip company). In short, a regulator could use foreign incorporated companies to insulate the market from political pressure.

Nevertheless, there are some problems with this approach. It is unclear whether there is a causal effect between the place of registration and the decision to adopt Party building. It is also unclear how and to what extent the VIE structure might remove a parent company from China's control and how the structure might result in more insulation from political interference.

However, forcing a listed entity to register outside its home market, if possible, could be a politically unpopular move—especially when the home market is a powerhouse like China. This listing requirement also does not resolve the underlying challenges of governing, monitoring, and enforcing rules against a foreign-incorporated entity when most of its assets and major businesses are in another market. Thus, any potential gain from being insulated from political interference could be outweighed by additional monitoring costs. This, however, is a subject for another study.

V. CONCLUSION

This Article proposes a market-driven approach, rooted in transparency, to resist foreign political interference in listed companies' governance. Although external political interference generally harms companies,

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207. Per the Hong Kong Exchange's survey published in 2017, institutional investors remain the largest participant group in the market, and overseas investors are the largest investor group by origin (as opposed to local investors). *See* News Release, HKEx, Survey Finds Hong Kong Securities Market Attracts Wide Range of Investors (July 13, 2017) (on file with HKEx).

208. *See supra* Part III.B.3.

stakeholders react differently depending on their interests. Securities regulators' response should, in turn, depend on the reactions of management, minority shareholders, and prospective investors. This Article utilized the Party building movement in China to examine how companies react to political interference. Based on the template provisions that the Chinese government expected companies to adopt into corporate constitutions, this Article categorizes Party building provisions into three major forms: organizational interference (relating to the formalization of CCP organization in a company), management interference (relating the CCP's role in management's decisions), and human resources interference (relating to personnel promotion and the dual role of chairman and Party secretary).

This Article focused on Chinese businesses listed in Hong Kong, an international financial center and popular listing venue of Chinese firms. Overall, less than a third of those companies adopted Party building provisions by the end of 2018.[209] Low adoption rates suggest that managers resisted political interference, especially when a company was incorporated outside Mainland China. The result shows that corporate stakeholders, including managers, shareholders, and prospective investors, were largely against Party building by the CCP, even in an international and open market like Hong Kong. This is surprising given the close relationship between Mainland China and Hong Kong and because many Chinese businesses in Hong Kong are SOEs.

Moreover, among the companies that adopted Party building provisions, they were willing to accept some degree of organizational or managerial interference. However, they did not adopt provisions that gave the Party direct control over personnel or human resources decisions. Thus, even if companies adopted Party building, managers and shareholders were resigned to the fact that Party organizations might have already existed inside the company, and that it was good to maintain some cordial relationship with the CCP. Nevertheless, corporate stakeholders were not keen to accept more direct intrusion into management, such as promoting personnel or even controlling the board of directors through the Party secretary. In conclusion, the market and corporate stakeholders have some effective responses to the CCP's Party building campaign by either not adopting or adopting less harmful forms of interference. Securities regulators should adopt a market-driven approach, through transparency requirements that empower managers and shareholders to correct for external political interference, instead of direct interventions like mandatory delisting.

209. *See supra* Part III.B.2.