TESTIMONY BY HOWARD CHAO
ASIA PRACTICE HEAD, O'MELVENY & MYERS LLP

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Honorable Co-Chairmen and Members of the Commission:

Introduction

I am honored to speak on today's panel and to share my observations on participation by Chinese companies in international capital markets activities. I head up the Asia Practice of O'Melveny & Myers LLP, a leading U.S. international law firm with a strong presence in China. We have substantial operations in Beijing, Shanghai and Hong Kong, and have been involved in an increasing number of initial public offerings, or IPOs, by Chinese companies in both the U.S. and Hong Kong stock markets. We represent both Chinese issuers and international underwriters in such transactions. Because of our firm's strong California roots, we have a robust venture capital practice and, partly as a result, we have been particularly involved with the IPOs by a newer group of Chinese technology companies who are backed by venture funds. In particular, last year our firm represented Shanda Interactive Entertainment Ltd., an interactive entertainment company and one of the largest operators of online games in China, in its U.S. IPO, which was the best performing U.S. IPO of last year. More recently we represented the underwriters, led by Goldman Sachs and CSFB, in connection with the IPO of Focus Media Holding Ltd., the first Chinese advertising company to list in the U.S. and the largest NASDAQ listing of a Chinese company to date.

The issues that you have asked me to touch upon today are particularly timely since Chinese companies are now emerging as truly significant global capital markets players. The head of CSFB's Asian equity syndicate in Hong Kong was recently quoted as saying, "China is the second most important IPO market after the U.S."[1] Bloomberg Financial recently reported also that in 2005, China IPOs are expected to generate more fees for investment banks than European IPOs.[2] Indeed in absolute terms, China IPOs are attracting very large volumes of capital and at an accelerating pace. In 2003, new Chinese international stock issuances attracted approximately $8 billion. Last year the figure was in the vicinity of $13 - $14 billion. This year Chinese IPOs have already reached more than $8 billion and upwards of $17 billion is expected by the end of the year according to some estimates.[3] The Boston Consulting Group reported that China accounted for 14% of the global IPO market for 2003 and 10% in 2004.[4]

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[1] *China Tops Europe on IPOs; Goldman, Morgan to Win $550 Mln Fees*, Bloomberg.com (June 7, 2005), *available at* http://quote.bloomberg.com/apps/news?pid=nifea&&sid=aR16O0PCGJLI.
[2] *Id.*
[3] *Id.*
[4] The Boston Consulting Group, *Investment Banking and Capital Markets* (November 30, 2004).

The tapping of international capital markets by Chinese companies has significant ramifications for Chinese companies and the Chinese economy, as well as the U.S. capital markets and the U.S. economy. International capital has become an important force for sustaining the growth of and imposing market discipline on the Chinese economy. At the same time, as Chinese companies grow in size and become an increasingly significant component of the world capital markets, Chinese companies become an increasingly important customer-base for U.S. capital markets to service. As Chinese companies reach out beyond China's borders and grow into sophisticated, international concerns, the United States can, through capital market mechanisms, help shape China's developmental trajectory.

Background

"Chinese companies" are hard to define because of the many ways that they can be structured. For purposes of today's discussion, my usage of the term "Chinese company" includes not only companies incorporated in the PRC, but also companies that are domiciled outside of the PRC but whose primary business operations are in China. In fact most internationally listed mainland Chinese companies are domiciled in the Cayman Islands, Bermuda, the British Virgin Islands or other similar jurisdictions, although they conduct their primary operations in the PRC.

Before discussing why Chinese companies are looking to list abroad, I'll mention briefly why they do not simply list domestically in China. After all, despite its central planning past, since 1990 China has had a remarkable record of domestic stock market development in Shanghai and Shenzhen, and there are now a total of about 1,400 companies listed on those two exchanges. There are several reasons why many of the best Chinese companies are not content to list domestically:

- China's domestic listing process can be very time consuming, sometimes taking as long as four years;
- Unlike the U.S. "disclosure-based" system, listings in China involve government approvals, which require, in part, meeting certain profitability and other financial thresholds that many companies are unable to meet;
- Shares held by the original investors in a domestically listed company are usually not tradable on the exchange and can only be sold in private transactions, so that a listing does not provide a viable "exit" for investors;
- Regulations in China make it difficult for management of state owned enterprises, or SOEs, to participate in equity, whereas this practice is commonplace for companies listed in international markets;[5]
- Chinese companies that have restructured themselves as offshore holding companies (which often happens before a listing) enjoy greater independence from the Chinese government;

[5] The Chinese government just recently announced that these rules may be liberalized.

- Private companies in China have experienced great difficulty obtaining government approvals to list domestically;
- Listing on a non-PRC exchange permits profits denominated in Chinese currency to be converted into other currencies offshore; and
- China's domestic exchanges have performed poorly over the past several years.

Perhaps most importantly, the international capital markets are much larger and more liquid than Chinese domestic exchanges, and an offshore listing on a major exchange is considered a badge of honor for a Chinese company, an indication that the company is one of the elite that has won acceptance by demanding international investors. Also, recently international markets have provided higher valuations than the domestic market.

The Growth of Chinese International IPOs

Chinese companies that have gone public on international markets generally can be divided into three categories: (1) SOEs, (2) Chinese domestic private companies, and (3) international private equity or venture capital backed companies.

The Chinese government has used privatizations and overseas listings as a tool to reform and restructure some of its largest SOEs, converting them from subsidized creatures of the central plan into market driven enterprises. This has had a profound reforming effect on China's economic system. The large volume of Chinese SOE IPOs over the past decade would have been unimaginable only a few years earlier.

In addition, the government now clearly encourages the formation and development of home-grown private enterprises. Private enterprise represents as much as 40% to 60% of China's GDP according to some estimates. Private companies are growing at a rapid pace but they have difficulty listing domestically, so they often list offshore. Most of these listings have gone to Hong Kong.

Finally, foreign venture capital and larger private equity investors have become quite active in China, investing in companies at all stages of development, from startups to more mature companies. Zero2ipo, an advisory, support and value-added service provider for venture capital and related industries in China, reported that venture capital investment into China was over $1.2 billion in 2004.[6] According to a PricewaterhouseCoopers report, the aggregate deal value of private equity in China in 2004 was $2 billion with 70 China-related private equity deals announced (an increase from $1.7 billion with 53 deals announced in 2003).[7] The Asia Venture Capital Journal reported that the aggregate deal value of private equity in China from January to August 2005 is already over $2 billion.[8] In a more recent development, many of these companies are undertaking international IPOs.

[6] *China Venture Capital Annual Report 2004, available at* http://www.zero2ipo.com.cn/en.
[7] PricewaterhouseCoopers, *Continuing Strong Growth in China M&A Activity will see Larger and More Complex Transactions* (February 3, 2005), *available at* http://www.pwchk.com/home/printeng/pr_030205.html.
[8] *Asian Venture Capital Journal*, Volume 18, Number 29 (August 1, 2005).

Some of the most important large-scale IPOs of the past decade have been Chinese companies. China Unicom Limited's over $5.5 billion IPO in June of 2000 was listed in both New York and Hong Kong. In November of 2002, China Telecom Corporation Limited (now renamed China Mobile) completed its dual-listed $1.5 billion IPO and has proceeded to outperform the S&P almost every year up to the present. In 2003, China Life Insurance Company Limited was the largest IPO of the year, raising $3.4 billion in its dual-listings in New York and Hong Kong. Shanda Interactive Entertainment Limited, went public on NASDAQ in May 2004 and as mentioned earlier was the best-performing U.S. IPO in 2004. The second best was another Chinese issuer, 51job, Inc., and yet another, China Netcom, was the fifth largest IPO of 2004. China Shenhua Energy raised around $3 billion in the largest IPO to date this year. China Construction Bank is expected to be the largest global IPO in 2005 with upwards of $5 billion in proceeds.

Not only has China's presence in global capital markets been significant in dollar terms, the number of Chinese international IPOs has increased appreciably since 2000 and will likely continue to increase. In the 28 years from 1972 through 1999 around 150 Chinese companies listed in the major international stock markets around the world (Hong Kong, US, London, Australia, Canada and Japan). In the four years from 2000 through 2003, there were over 120 Chinese IPOs in these markets, and around 120 more in the past year and a half alone. Not only has the number of deals increased, but the average size of China IPOs is up considerably. Less then a decade ago, China's international IPOs were relatively small in dollar value terms and there were far fewer listings in the international market outside of Hong Kong. Since the late 1990s, however, an increasing number of Chinese issuers have launched IPOs on a range of international markets and raised proceeds in excess of $1 billion in some cases, ranking among the largest in the world.

The pace of Chinese companies going public is only likely to increase going forward. It appears that the flow of SOE IPOs will likely continue in waves as new sectors are privatized. The next wave of sectors appears to be financial services, energy, industrial (especially automotive), and possibly media. The banking sector is particularly active currently. Market sources indicate that there are a significant number of Chinese domestic private companies and international private equity and venture capital backed Chinese companies preparing for international public offerings. In particular, our firm's pipeline of IPO deals includes a significant number of venture backed companies.

The pipeline of Chinese companies planning to access international capital markets may be the largest that it has ever been. Given the numbers of Chinese companies projected to come to market, it appears likely that within a few years, Chinese companies will constitute a significant and increasing portion of the market capitalization of international capital markets. Trading volumes in Chinese company securities will be significant. Revenues generated by Chinese companies for international financial services firms will become increasingly important and stock exchanges that capture this business may significantly benefit as well.

The Historical Role of Hong Kong and US Exchanges for Chinese Companies

Hong Kong has played a very important role for Chinese companies going public. The Hong Kong Stock Exchange (HKEx) classifies listed Chinese companies as either H-share or red-chip companies. The HKEx uses the term "H-share company" to refer to Chinese incorporated companies (usually SOEs) listed in Hong Kong, and uses the term "red-chip company" to refer to offshore incorporated companies which are significantly controlled by Mainland China shareholders (at least 20% to 30%, depending on certain factors). At this point the HKEx is increasingly dominated by these China-related companies.

The market capitalization of Chinese companies on the HKEx (both H-share and red-chip) is, according to a research paper published on the Hong Kong Securities and Futures Commission website, around $200 billion and growing.[9] The HKEx offers some unique advantages to Chinese companies:

- Hong Kong has a large class of investors knowledgeable about and interested in investing in China;
- in general, China companies are likely to get more analyst coverage in Hong Kong than elsewhere;
- Hong Kong has grown over the years into a major financial center;
- investment banks, stock analysts and other professional financial sector services have traditionally based their Asia operations in Hong Kong; and
- underwriting and other transaction fees tend to be lower in Hong Kong than in the U.S.

Although a greater number of Chinese companies has historically listed in Hong Kong than in the United States, the United States has until recently attracted the larger Chinese IPOs, raising tens of billions of dollars for Chinese companies since the early 1990s. Several key factors have historically contributed to the relative attractiveness of the U.S. exchanges, including:

- greater market depth and liquidity;
- access to follow-on capital;
- greater prestige;
- high quality advisory services; and
- greater availability of stock options.

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[9] Joseph Lee and Joanna Poon, *The Listing of Mainland Companies on HKEx and the Implications for Hong*, Research Paper No. 17 (September 2004), *available at* http://www.sfc.hk/sfc/html/EN.

Market Trends: Movement away from U.S. Listings for Non-Technology IPOs

On April 16, 2004, this Commission heard testimonies on a range of issues relating to China's presence in the global capital markets. Since that time there have been two significant market trends that have become more pronounced, which I would like to bring to your attention. First, a trend has emerged where many non-technology Chinese companies are avoiding listing in the United States and are instead listing elsewhere. Although the U.S. market (especially NASDAQ) continues to draw Chinese technology companies because of the favorable valuations and analyst research coverage it offers for that sector in particular, this year there have been no SOE or other Chinese non-technology registered offerings in the United States. Several recent larger IPOs have ended up in Hong Kong and elsewhere: Air China's more than $1 billion IPO listed in London and HK. Shanghai Electric Group Company Limited (about $700 million), Shenhua Energy (about $2.95 billion) China Cosco Holdings Company Limited (about $1.2 billion) and Bank of Communications (about $1.9 billion) each listed only in Hong Kong and not the United States.

What is behind this redirection of these mega-sized China deals away from U.S. exchanges? One concern that Chinese issuers have voiced when contemplating a U.S. listing is regarding the Sarbanes-Oxley Act of 2002, or SOX. In particular, SOX Section 302, which requires that CEOs and CFOs certify their company's annual and quarterly reports, and SOX Section 404, which relates to internal controls, are often mentioned as reasons to avoid the U.S. market. Direct costs associated with Sections 302, 404 and other Sections of SOX (including, for example, increased external auditing fees and increased costs relating to implementation of corporate governance mechanisms) as well as costs associated with the attendant increase in contingent liability risk have, according to many, shifted the cost-benefit balance in favor of listing outside the United States.[10] In addition to costs and risks to the company, under SOX officers and directors face increased personal liability risk and greater potential criminal penalties for securities laws violations and other fraudulent acts. SOX tends to be an even greater concern for foreign issuers such as Chinese issuers because (1) SOX compliance costs are high and Chinese issuers tend to be cost conscious; (2) Chinese company executives tend to be less familiar with U.S. corporate governance standards; and (3) Chinese company CFO's are often are more familiar with PRC generally accepted accounting principles, or GAAP, and International Accounting Standards, or IAS, and have less experience with U.S. GAAP. Moreover, we believe that parent companies of Chinese SOEs (which by definition are Chinese SOEs also) contemplating international listings may be reluctant to expose themselves to U.S. corporate governance and disclosure related liabilities resulting from their control person relationship with a U.S. listed company.

Independent of SOX, however, there is also a concern that the risk of class action law suits is much greater in the United States than in virtually any other country. For example, in Hong Kong there are no specific procedures for bringing shareholders class actions. Underscoring this concern, a significant number of Chinese companies listed in the United States

[10] A review of SOX undertaken by Financial Executives International, a non-profit professional organization, suggests that the cost of compliance with Section 404 alone could be about $3 million dollars for companies with revenues around $2.5 billion. *See* Financial Executives International, *Sarbanes-Oxley Compliance Cost Estimates, available at* http://www.fei.org/news/404_july.cfm.

have been the subject of class action lawsuits in the past few years. For example, the following companies have been sued during the past several years: Netease, Asiainfo, UTStarcom, Chinadotcom (now CDC Corporation), China Life, Kongzhong, 51job, and Sina.

Where else have the Chinese companies gone to list, in addition to Hong Kong? Singapore has also attracted a significant number of Chinese company IPOs. Chinese listings there have spiked recently with less than 20 before 2000 and as many as 60 since 2000. In addition, a small number of Chinese companies have listed in London, Canada, Australia, and in Japan. Although it has only attracted a handful of companies to date, the London Stock Exchange is actively competing for Chinese company listings. It opened an office in Hong Kong in October 2004. Japan has had an initial success in attracting Xinhua Finance Ltd to complete a listing in Tokyo in October 2004.

Market Trend: New Wave of VC-Backed Technology Company Listings in U.S.

The second major market trend has been a wave of international venture capital backed Chinese technology companies coming to list in the U.S. stock markets, particularly on NASDAQ. The most active segments have been the internet, wireless or value-added telecom.

During the "tech bubble" period in the late 1990's there were a few Chinese companies of this type that were listed in the United States, including Sina, Netease, Sohu, Chinadotcom, Asiainfo and UTStarcom. However, with the bursting of the bubble, there were virtually no Chinese technology IPOs in the U.S. for the years 2001 and 2002. In 2003, with the reawakening of the technology sector, although only one Chinese technology IPO was concluded, a number of companies commenced the IPO process and in 2004 eleven Chinese technology IPOs were completed. This year the deals started more slowly, perhaps as a result of a general market softening, and to date there have been four deals completed. However, the pace has been picking up significantly in the past few weeks, and anecdotal information as well as our firm's internal pipeline suggests that this will be another very good year for this sector. Exhibit I lists recent Chinese venture backed technology IPOs by year.

There is one noteworthy difference between this new generation of Chinese technology companies and many of the earlier technology companies that went public during the 1990's tech bubble – this new generation are generally profitable, and, in many cases, have remarkable earnings growth rates. These new companies tend to be operationally stronger and have a greater potential for international success. In addition, the size of public offerings by this new generation, on average, tends to be increasingly larger.

These companies also have a very different profile than the traditional non-technology Chinese companies that listed in the U.S. They are international venture backed, which means that a significant portion of their funding originates from sophisticated, international institutional investors. Major venture firms often have a significant say in the choice of management of these companies and (especially while the companies are still private) appoint representatives to their boards of directors. Thus, the management and board of directors tend to be much more international in outlook, and they often have strong technical and management backgrounds.

Many of them are U.S. citizens or permanent residents. These companies are operationally very different from SOEs.

Therefore, it is not surprising that these companies opt to list in the United States. Their management is used to the U.S. capital markets environment, and their venture capital investors tend to expect their companies to do their IPOs in the United States. U.S. markets understand technology companies best and tend to value them at higher price multiples than other markets, such as the HKEx. U.S. markets give better liquidity to investors who are exiting. For technology companies, listing in the U.S. offers credibility and cachet. In addition, unlike SOEs and even most Chinese domestic private companies, venture backed companies usually use a holding company outside of China to hold their operations in China and therefore are not required to get government approvals prior to listing in the United States.

Our experience is that companies of this type tend to be more familiar with U.S. disclosure rules, standards of corporate governance, and other market expectations. On average they tend to have higher management standards than many other Chinese companies. They tend to be more market-driven.

Our law firm, because of our very substantial California and China practices, has a significant pipeline of these types of deals. We are witnessing growth of this sector first hand. In prior years, most of the venture funds backing Chinese technology companies tended to be China specialty venture funds or Asia regional venture funds. Many of the early IPO successes in this sector were funded by this type of venture fund. In the past year, in a further development, many mainstream Silicon Valley based venture funds have started to invest in China based technology startup companies. Our firm has been involved in a large number of these transactions, and we expect that many of these companies will seek a U.S. IPOs in the not too distant future.

Conclusion

As you can see, a great deal can happen in China in one year. Not only are Chinese international IPOs gaining further momentum, but the nature of their participation in the U.S. capital markets has changed significantly. We are seeing a clear bifurcation between the listing destinations of Chinese non-technology and Chinese technology companies. In the past year almost all of the former are choosing to avoid the U.S., whereas almost all of the latter have chosen to list here.

While the loss of many Chinese non-technology listings for the U.S. should be cause for some concern, I do not mean to recommend a lowering of the high corporate governance and disclosure standards of the United States. We are aware of the ongoing debates about whether the benefits of certain provisions of SOX outweigh the associated compliance costs for those provisions. Notwithstanding, we believe that the strong corporate governance standards demanded in the U.S. have a positive effect on all U.S. listed companies and the markets in which they trade. I do have some personal reservations about how prevalent class actions are in the U.S. in general (not just with respect to Chinese companies), and indeed our firm has been at

the forefront of class action litigation reform recently.

The good news is that U.S. stock markets are getting virtually all of the new wave of Chinese technology companies. These are dynamic, fast-growing, internationally-minded companies that look very similar to many of our U.S. technology companies. It could well be that these will be the real growth story for China, not the SOE IPOs. And the pipeline of these companies is very significant, which is good news for the U.S. capital markets.

I hope that my perspectives on these recent developments have been of use to the Commission, and I thank you for inviting me to testify.