**Disclosing China’s Corruption Risks: A Securities Regulation Perspective**

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*Abstract*

Risk disclosure is an important tool for securities regulation. Disclosures in securities offering documents and regulatory filings are expected to provide investors with publicly accessible, meaningful and reliable information to assist them with risk assessment and investment decisions. The disclosure requirement can also motivate securities issuers to attend to improve their risk management.

Since the late 1990’s, outside investors have looked to invest in China through securities offered by China-based issuers in the international capital markets. One significant challenge for outside investors is to understand and evaluate various risks of investing in China, including those related to China’s high corruption risk environment. The current approach to disclosing corruption risks under the U.S. securities law allows issuers, often assisted by professional intermediaries such as underwriters and lawyers, the discretion on whether or not to include related risk factor language in disclosure documents. Issuers are supposed to make a good faith judgment about whether corruption risks as applied to them are material enough to warrant disclosure. Unlike other commonly seen risk factors on China, corruption risks are not included in offering documents and/or Exchange Act filings of all China-based issuers. In theory, an issuer’s self-selection in risk disclosure signals to the investors; an investor who compares disclosures of different companies may tell low corruption risk companies from high risk ones based on which companies did not include corruption risk languages, and which did. For example, issuers from China’s pharmaceutical industry are much more likely to include corruption risk factors than those from the IT sector, indicating higher corruption risks for businesses in the former than in the latter.

Closer observations of risk disclosure practices in reality suggest, however, that due to a series of practical limits, such signaling mechanism does not work as effectively in informing investors about corruption risks of China-based issuers. For example, many state-owned and private China-based companies operating in highly regulated sectors such as energy, resources, telecommunication and real estate has never mentioned their corruption risks in disclosure documents. Their grounds for taking the view that corruption risks are not material to them are questionable. Marketing interest and practical concerns render Chinese issuers strongly inclined not to discuss corruption in public documents. Professional intermediaries involved in the disclosure drafting process have limited avenues and incentives to diligence corruption risks. The nature of corruption risks and certain cognitive biases on the issuers and intermediaries also likely contribute to the decision of non-disclosure. Although non-disclosure are not all driven by those underlying practicalities, as long as some are, the materiality-based disclosure approach cannot effectively inform the investors.

The SEC may consider taking away from issuers their discretion in corruption-related risk disclosure and impose affirmative disclosure requirements, including for a description of an issuer’s corruption risk management in more prominent parts of the offering documents and filings (in addition to the currently required disclosure of code of ethics), and even a separate statement evaluating such risk management’s effectiveness (provided passing cost-benefit analysis). The change in approach from materiality analysis to mandated disclosure may alter the incentives for issuers and professional parties in the disclosure production process, contributing to more meaningful disclosures and better corporate governance.