

# START THINKING NOW: HOW TO MITIGATE LEGAL RISKS INVOLVED IN THE PUBLIC OFFERING PROCESS

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**Start thinking now: how to mitigate legal risks involved in the public offering process**

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Chinese enterprises have been gaining listings on U.S. exchanges at an increasing rate. According to Reuters, Chinese initial public offerings were some of the best performers in the U.S. in 2009, but also some of the worst. So it is suggested that underwriters be more cautious in 2010.

The reason behind this is because Chinese enterprises are growing at a rapid rate and eager to raise capital in the U.S. However, existing problems such as a lack of an internal control system and knowledge about disclosure requirements are the main reason that more and more Chinese enterprises are getting involved in class action lawsuits. Data have shown that about 11.5% of NYSE-listed Hong Kong and Chinese companies were involved in class actions. And in NASDAQ, the percentage is even higher, at 17.2%.

Dealing with a class action lawsuit is usually a long and complicated process requiring lots of time and money. The worst thing is that it will affect the company's reputation and stock price in the market. Therefore, start thinking now about how to mitigate this legal risk if your company plans to go public.

In order to mitigate this risk, the first thing that managers of the Chinese enterprises need to understand is the disclosure requirements. Private companies that want to become publicly-owned must comply with the registration requirements of the Securities and Exchange Commission (SEC). In addition, the SEC requires those companies to follow similar disclosure rules as public listed companies.

As required by law, companies that wish to be listed on an exchange need to file a registration statement with the SEC and the securities exchange. The statement must include the following information: (1) audited financial statements; (2) a summary of selected financial data; (3) management's description of the company's business and financial condition; (4) a summary of the company's material business contracts; (5) and a list of all forms of cash and noncash compensation given to the chief executive and the top five officers; and (6) compensation paid to

all officers and directors as a group. Moreover, a company's entire business plan must also be disclosed.

The disclosure rules are changing constantly. On Dec. 2009, the SEC amended disclosure requirements for a public company's proxy statement and Form 10-K in an effort to enhance disclosure related to compensation and corporate governance. Although it only relates to annual reporting, private companies that intend to go public need to understand those updates and changes on disclosure rules to make sure it complies with all rules and regulations once it becomes public.

In addition, all information that has been disclosed in a registration statement must be factual and accurate. Misrepresentations in the registration statement will cause the company and executive officers to be exposed to civil and criminal liabilities. The best approach is to designate an individual who then is responsible for verification at this early stage. It is suggested to have a lawyer as the team leader because they are familiar with disclosure rules and compliance requirements.

Due diligence is another important way to mitigate legal risk. Lawyers will conduct a legal due diligence on corporate matters and an accountant handles the financial aspect. Through due diligence, lawyers and accountants will discover the weakness in corporate governance and make necessary changes to the company structure.

Beyond that, an effective internal control system is also essential for legal risk management. The SEC not only requires disclosure of the results, but also the process, especially after the enactment of the Sarbanes-Oxley Act. The Act provides more strict requirements for financial reporting to protect investor's best interests. It also identifies corporate fraud and record-tampering as criminal offenses, which makes the internal control system more important. An effective internal control system is expensive. Take the China National Petroleum Corporation for example, it spent two years and over 10 million RMB on its internal control system set-up to prepare its public offering in the U.S. However, once you spent the amount of money and time in avoiding and mitigating risks – set up an internal control and anti-fraud system. The chances that your company may get into trouble in the future will be much less.