

IS PRIVATE SECURITIES LITIGATION ESSENTIAL FOR THE DEVELOPMENT OF CHINA'S STOCK MARKETS?

MARLON A. LAYTON*

In recent years, financial economists have authored an influential series of articles that link strong minority shareholder protection—exemplified by private enforcement of securities regulations—to greater financial market development. Their findings, which suggest that transition economies seeking larger financial markets should reform their legal institutions so as to strengthen private enforcement, have practically become conventional wisdom, and provide support for those who argue that China needs to improve investors' ability to sue listed companies in order to encourage growth in its financial markets. This Note argues, however, that in China's current legal and political environment, various obstacles preclude private enforcement from playing a significant role in market regulation. A more viable strategy would be to strengthen public enforcement. It is more likely to be effective in China's current environment, will improve investor protection, and has been shown to have positive effects on market development.

INTRODUCTION

Since opening up to foreign trade and investment in 1979,¹ China's remarkable economic growth² has improved the lot of hundreds of millions of its citizens³ and has made it an influential player

* Copyright © 2008 by Marlon A. Layton, J.D., 2008, New York University School of Law; M.I.A. 2008, Columbia University, School of International and Public Affairs; B.B.A. 1999, Bernard M. Baruch College, City University of New York. I would like to thank Professor Jerome A. Cohen for being an inspiration and an invaluable resource to those who study China, and Professors Stephen Choi and Donald C. Clarke for their guidance and feedback. I would also like to thank the staff of the *New York University Law Review*, especially Peter Devlin, Mitra Ebadolahi, Drew Johnson-Skinner, Matt Rogers, Julia Hamilton, and Corinne Nippert. Finally, I would like to thank my family and friends for their encouragement throughout the writing process, especially my mom, and Katrin Geenen.

¹ Stanley Lubman, *Looking for Law in China*, 20 COLUM. J. ASIAN L. 1, 4 (2006).

² See KENNETH LIEBERTHAL, GOVERNING CHINA 124 (2d ed. 2004) (stating that China has “maintained the highest rate of real growth of any major economy” since late 1970s). Although there is debate about the accuracy of official Chinese statistics, which show average economic growth of over nine percent per year since reforms began, there is apparent agreement that the economy has been growing quickly. See, e.g., ECONOMIST INTELLIGENCE UNIT, COUNTRY PROFILE 2007: CHINA 36 (2007), available at <http://store.eiu.com/products.html> (click “Country Profile”; then “Archives of Issues and Articles”; then “China”; then “Country Profile China 2007”).

³ According to a 2005 World Bank report,

Across China, there were over 400 million fewer people living in extreme poverty in 2001 than 20 years previously. By 2001, China had met the foremost of the Millennium Development Goals—to reduce the 1990 incidence of poverty

on the world stage. The Chinese Communist Party (CCP), China's ruling political party,⁴ has accomplished these results by gradually implementing reforms rather than using "shock therapy"⁵—an approach that some Eastern European countries applied after the breakup of the Soviet Union.⁶ Still, the majority of China's citizens remain poor and many aspects of the country's economic⁷ and legal systems⁸ are in need of more extensive reforms.

In the early 1990s, the CCP reestablished China's stock markets to help strengthen the finances, efficiency, and competitiveness of state-owned enterprises (SOEs).⁹ In the period since, China's stock markets have been the most effective in enabling companies to raise capital as compared to transition economies in Eastern Europe.¹⁰ Although the markets currently list over 1079 companies¹¹—the majority of which are SOEs¹²—they are still small compared to mar-

by half—and it had done so 14 years ahead of the 2015 target date for the developing world as a whole.

THE WORLD BANK, FIGHTING POVERTY: FINDINGS AND LESSONS FROM CHINA'S SUCCESS (2005), <http://go.worldbank.org/QXOOI9MP30>.

⁴ The CCP "has formal . . . authority over the government," which implements the CCP's policies. Susan L. Shirk, *The Chinese Political System and the Political Strategy of Economic Reform*, in BUREAUCRACY, POLITICS, AND DECISION MAKING IN POST-MAO CHINA 59, 61 (Kenneth G. Lieberthal & David M. Lampton eds., 1992).

⁵ "Shock therapy" is the quick adoption of capitalist economic reforms, particularly the privatization of industries, so as to "creat[e] a large group of people with a vested interest in capitalism." JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS 140–41 (2002).

⁶ See *id.* at 180–81 ("China employed alternative strategies to [shock therapy] advocated by the [International Monetary Fund, the World Bank, and the U.S. Treasury]."); THE WORLD BANK, HOW CHINA BECAME AN ECONOMIC TIGER (2004), <http://go.worldbank.org/NUML9UNAH0> (stating that China ignored conventional economic thinking and chose gradual approach to economic reforms).

⁷ See STANLEY B. LUBMAN, BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO 109 (1999) ("[O]ther critical economic sectors await decisive actions, including fiscal and banking reform and the creation of true capital markets.").

⁸ See Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 CHINA ECON. REV. 451, 454 (2003) (arguing that, with exception of commercial and civil laws enacted since reforms began, China's legal system has not changed significantly since dynastic period).

⁹ See Walter Hutchens, *Private Securities Litigation in China: Material Disclosure About China's Legal System?*, 24 U. PA. J. INT'L ECON. L. 599, 612–13, 618 (2003) (stating that primary purpose of Chinese stock markets is to "support the reform of SOEs, not to allow private firms to raise capital"); *infra* notes 106–10 and accompanying text.

¹⁰ Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. L. & ECON. REV. 184, 188 (2005).

¹¹ This figure is current as of October 6, 2008. See Hong Kong Exchanges Clearing Limited, China Stock Markets Web: Market Highlights, <http://www.hkex.com.hk/csm/highlight.asp?LangCode=en> (last visited Oct. 6, 2008).

¹² Patrick M. Norton et al., *Mergers and Acquisitions in China*, TOPICS CHINESE L. (O'Melveny & Myers LLP, Shanghai, China), Jan. 2006, at 2 ("[M]ore than 85% of . . . listed companies in China are SOEs."). Normally, "only SOEs are approved for listing on

kets in developed countries.¹³ Furthermore, as a result of the stock markets' youth, the time and effort required to develop a formal legal system "virtually from scratch,"¹⁴ and the government's gradual approach to implementing reforms, the stock markets' "legal and institutional framework . . . is still relatively primitive by Western standards."¹⁵

In a series of influential papers, a group of financial economists commonly known as LLSV¹⁶ (after the surnames of its members) theorized that differences in the strength of financial markets worldwide are explained by their legal origin, or whether a country's legal system is based on common law or civil law.¹⁷ According to the "legal origins theory," common law countries provide stronger protection of minority shareholders than civil law countries through comprehensive securities laws and private enforcement, and this stronger protection is positively correlated with well developed capital markets and economic growth.¹⁸

The legal origins theory suggests that common law institutions—especially those providing for private enforcement of securities laws—are a precondition for developing large financial markets. The theory has become very influential¹⁹ and provides support for the argument that strengthening private securities litigation should be a necessary element of development strategies in transition economies.²⁰ For example, the World Bank uses the theory to support its position that "private rights of action for minority shareholders are important for developing strong equity markets,"²¹ and bases decisions to provide

the . . . stock exchanges," resulting in very few listed private companies. LIEBERTHAL, *supra* note 2, at 266.

¹³ See ECONOMIST INTELLIGENCE UNIT, *supra* note 2, at 45 ("Capitalisation as a percentage of GDP remains low at roughly 30%—developed markets . . . have ratios of well over 100%.")

¹⁴ Pistor & Xu, *supra* note 10, at 190.

¹⁵ Gongmeng Chen et al., *Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions*, 24 J. ACCT. & PUB. POL'Y 451, 457 (2005).

¹⁶ LLSV will be used throughout this Note to refer to economists Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. See, e.g., Udo C Braendle, *Shareholder Protection in the USA and Germany - On the Fallacy of LLSV*, 7 GERMAN L.J. 257, 260 (2006).

¹⁷ *Id.*

¹⁸ See *infra* notes 36–45 and accompanying text (describing LLSV's interpretation of effects of differences between common law and civil law countries on financial market development).

¹⁹ Braendle, *supra* note 16, at 263 (noting that LLSV's research has become "a standard reference in comparative corporate and financial law").

²⁰ See Nicholas Thompson, *Laws (and Wealth) of Nations*, BOSTON GLOBE, Jan. 9, 2005, at F1 ("[P]lenty of countries are seeking LLSV's advice . . .").

²¹ THE WORLD BANK, DOING BUSINESS 2008, at 35 (2007), available at http://www.doingbusiness.org/documents/FullReport/2008/DB08_Full_Report.pdf; see also THE

financial assistance to developing countries on their “success at implementing the reforms recommended by LLSV.”²² Given the influence of the legal origins theory, it is not surprising that commentators invariably suggest that the Chinese government improve private enforcement and “protection of private ownership”²³ by allowing minority shareholders to “raise a private cause of action against a listed company and its officers and directors.”²⁴ Experience indicates, however, that “attempts to ‘transplant’ law . . . have usually failed because the legal rules so adopted are incongruent with local customs and traditions.”²⁵ It is therefore important that the government choose culturally and institutionally appropriate strategies, lest it waste “scarce developmental resources” on reforms that are “less efficacious than alternative strategies.”²⁶

China’s efforts to develop its stock markets should be guided by the characteristics and capacity of its legal institutions—particularly the judiciary, which is essential for effective private securities litigation—and to account for the risk that choosing inappropriate strategies will possibly harm development and have negative repercussions.²⁷ This Note argues that, given China’s history, culture,

WORLD BANK, INSTITUTIONAL FOUNDATIONS FOR FINANCIAL MARKETS 6–7, <http://site.resources.worldbank.org/INTTOPACCFINSE/Resourses/Institutional.pdf> (citing articles espousing legal origins theory in support of its claim that “[s]tock market development is strongly correlated with private enforcement”).

²² Thompson, *supra* note 20.

²³ Jiangyu Wang, *Dancing with Wolves: Regulation and Deregulation of Foreign Investment in China’s Stock Market*, 5 *ASIAN-PAC. L. & POL’Y J.* 1, 61 (2004).

²⁴ William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China’s Communist Politics and Capitalist Securities Market*, 27 *BROOK. J. INT’L L.* 477, 512–13 (2002); *see also* Wenhai Cai, *Private Securities Litigation in China: Of Prominence and Problems*, 13 *COLUM. J. ASIAN L.* 135, 151 (1999) (stating that civil remedies have “largely been overlooked” and that “private remedies can provide much better deterrence” than public enforcement); Chenxia Shi, *Protecting Investors in China Through Multiple Regulatory Mechanisms and Effective Enforcement*, 24 *ARIZ. J. INT’L & COMP. L.* 451, 490, 495 (2007) (“[L]aw should be reformed in order to give investors a right to commence class actions”); Jiong Deng, Note, *Building an Investor-Friendly Shareholder Derivative Lawsuit System in China*, 46 *HARV. INT’L L.J.* 347, 385 (2005) (“In order to develop strong and healthy capital markets, China should remove all . . . hurdles to building an investor-friendly shareholder derivative lawsuit system.”).

²⁵ John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 *YALE L.J.* 1, 5 (2001) (citation omitted).

²⁶ Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 *HARV. L. REV.* 460, 516–17 (2006).

²⁷ *Cf.* STIGLITZ, *supra* note 5, at 184 (stating that China’s government slowly liberalized economy, putting money into inefficient SOEs to maintain employment levels and avoid social instability); CARL E. WALTER & FRASER J.T. HOWIE, *PRIVATIZING CHINA* 8, 15 (2d ed. 2006) (noting that early market regulations served to “resolve[] the state’s fears over loss of control” and that government was initially reluctant to establish securities markets for fear of “social unrest”).

and current circumstances, the government should focus its efforts on developing its stock markets by strengthening public enforcement, as opposed to private enforcement.

The effects of public enforcement on the development of financial markets have not been widely studied.²⁸ This Note uses findings from recent studies of the impact of public enforcement on financial market development to argue that in China, improving public enforcement is a viable and preferable strategy for financial market development in the absence of effective private securities litigation.²⁹

The Note proceeds in three parts. Part I presents the legal origins theory and critiques of it. Part II describes China's legal institutions, stock markets, securities regulations, and private securities litigation. Part III presents the results of recent research that show a positive relationship between strong public enforcement and stock market development, argues that various factors preclude private securities litigation—but not public enforcement—from playing a significant role in China's market regulation and development, and offers proposals for strengthening public enforcement.

I

LEGAL ORIGINS AND THE DEVELOPMENT OF FINANCIAL MARKETS

As noted above, LLSV's legal origins theory has helped to support the consensus that common law systems—especially those with strong private enforcement of securities laws—better provide for financial market development. This Part describes the legal origins theory, its findings, and criticisms of the theory.

A. *The Legal Origins Theory*

In *Legal Determinants of External Finance*,³⁰ LLSV sought to determine whether certain legal rules influence the size of financial markets.³¹ First, they classified a sample of forty-nine countries

²⁸ Chen et al., *supra* note 15, at 462; see also John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 244 (2007) (stating that previous studies have largely focused on differences among “law on the books”—that is, on formal and substantive legal rules”).

²⁹ This Note does not argue that there will never be a role for private securities litigation in China. While the country's political and legal institutions cannot currently support private enforcement, and therefore cannot effectively influence market development, this situation may change in a manner that enables China to do so in the future.

³⁰ Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) [hereinafter *Legal Determinants*].

³¹ Legal rules and the quality of their enforcement vary across countries. LLSV sought to show that, where a legal system effectively protects shareholders, companies are better

according to their legal origin—civil law or common law. Second, they assessed the size of each country’s financial markets by calculating the ratios of market capitalization of listed firms relative to gross national product (GNP),³² the number of listed companies relative to population size, and the number of initial public offerings (IPOs) relative to population size.³³ Third, they compiled a shareholder rights index—the most important element of which they considered to be a shareholder’s right to enforce securities laws by bringing legal claims against a company’s directors—that assessed “how well legal rules themselves protect investors.”³⁴ Finally, they measured “rule of law” by asking investors to rate the quality of law enforcement in each country.³⁵ LLSV found that the value of their shareholder rights index was highest in common law countries and positively correlated with the size of financial markets.³⁶ They concluded that “a good legal environment,” as exemplified by laws in common law countries that protect minority shareholders and allow investors to enforce such laws in court, “expands the scope of capital markets.”³⁷

able to obtain external financing, resulting in higher-valued capital markets. *Legal Determinants*, *supra* note 30, at 1131–33. Mainland China, the focus of this Note, was not included in the study.

³² *Legal Determinants*, *supra* note 30, at 1132–34. The ratio of market capitalization to GNP is used to make cross-country comparisons of the size of stock markets. It is calculated by dividing the total market value of all listed companies by the value of a country’s economic output. Developed countries typically have ratios of over one hundred percent, but China’s ratio is about thirty percent. See ECONOMIST INTELLIGENCE UNIT, *supra* note 2, at 45.

³³ *Legal Determinants*, *supra* note 30, at 1133–35. These variables “reflect the stock and the flow of new companies obtaining equity finance.” *Id.* at 1135.

³⁴ *Id.* at 1136. The index assessed the right of shareholders to mail proxy votes, vote at a general meeting without first having to deposit their shares, vote cumulatively, challenge management decisions in court, or call a shareholder’s meeting with ten percent or less of share capital. Higher values indicated that the law provided shareholders with more rights. *Id.* at 1134 tbl.1. LLSV also developed a “creditor rights index” that “aggregates the various rights that secured creditors might have in liquidation and reorganization.” *Id.* at 1135 tbl.1, 1137.

In subsequent papers, LLS—referring to the first three authors of the LLSV four-some, namely Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer—replaced LLSV’s shareholder rights index with other measures, but their conclusion that legal origins influence the development of financial markets still stands. Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285, 291–92 (2008) [hereinafter *Economic Consequences*] (stating that corrections made to variables used have “strengthened the original results”). For a description of the elements of the new shareholder rights index, see *infra* note 151.

³⁵ *Legal Determinants*, *supra* note 30, at 1136. Higher scores indicated more of a tradition of law and order. *Id.* at 1134 tbl.1.

³⁶ *Id.* at 1137–46 (presenting data and describing results of regression analysis).

³⁷ *Id.* at 1149.

In sum, the legal origins theory states that legal origin is the source of the differences in laws across countries because common law systems focus on supporting markets while civil law systems focus on implementing policies.³⁸ It further states that differences in legal rules influence economic outcomes.³⁹ The authors hypothesize that the common law better protects minority shareholders because they can more easily sue to enforce their rights, judicial lawmaking is more flexible, and the regulatory process is less centralized and more efficient.⁴⁰ In common law systems, investors are better able to recover their losses through private enforcement because the common law's emphasis on fiduciary duties and the flexibility of judicial lawmaking enable judges to quickly respond as new situations arise that negatively impact shareholders.⁴¹ This instills confidence in the markets and makes it more likely that people will invest, thereby broadening both the investor base and the stock markets.⁴²

The theory posits that common law governments allow market forces to determine an efficient level of regulation and are less involved in regulating markets.⁴³ Additionally, judicial lawmaking promotes market development by being responsive to new situations and by maintaining an efficient, non-stifling level of regulation. In contrast, according to the theory, the judiciary in civil law systems relies on a central code and is unable to create law as new situations arise. This makes it difficult for investors to recover losses and thus limits their protection.⁴⁴ Civil law countries also tend to overregulate markets, hindering their development.⁴⁵ The combination of these factors in civil law countries limits the growth of the investor base and results in smaller, less efficient financial markets.

B. *Criticisms of the Legal Origins Theory*

Because the legal origins theory is provocative and because its implications for development in transition economies are so great,⁴⁶ it

³⁸ *Economic Consequences*, *supra* note 34, at 4.

³⁹ *Id.* at 64.

⁴⁰ See Roe, *supra* note 26, at 470–75 (describing effects of common law institutions on financial outcomes as posited by legal origins theory).

⁴¹ *Id.* at 469–70.

⁴² *Cf. id.* at 470–72 (“Shareholders buy stock more comfortably when they know that a judge will protect them later from insider overreaching.”).

⁴³ *Cf. id.* at 471 (“Common law systems are more decentralized and less regulatory. They facilitate the private, marketplace transactions that allow securities markets to thrive.”).

⁴⁴ *Id.* at 470, 473–74.

⁴⁵ *Id.* at 471.

⁴⁶ See Coffee, *supra* note 25, at 5 (“[T]he implications . . . seem profoundly pessimistic for parts of the world seeking to develop deeper, more liquid securities markets.”).

has been criticized on numerous fronts—none of which can be detailed completely in this Note. In recent papers, LLS⁴⁷ have dismissed some criticisms and acknowledged others, while maintaining that the legal origin theory's findings are still valid.⁴⁸ Critics, for example, have argued that the causal relationship between legal origins and financial market development described by the theory is reversed, and that it is actually strong markets that beget strong laws.⁴⁹ In response, LLS have argued that because legal origins “shape legal rules protecting investors, these rules cannot be just responding to market development.”⁵⁰

Critics have also argued that, in practice, securities regulation in common law countries is primarily statutory and more intense than in civil law countries;⁵¹ this dynamic is in direct contrast to the legal origins theory's position that common law governments are less involved in regulating markets. LLS have responded by stating that this phenomenon is actually consistent with the theory because statutory disclosure requirements in common law countries originate from judicially defined fiduciary duties, which “seek to sustain markets rather than replace them.”⁵²

Finally, critics have argued that LLS's studies do not support the conclusion that public enforcement is relatively unimportant compared to private enforcement.⁵³ LLS have maintained their position that public enforcement is inferior to private enforcement: In a 2006 paper, they stated that public enforcement “plays a modest role at best” in stock market development, while extensive disclosure

⁴⁷ The fourth economist of LLSV, Robert Vishny, did not work on subsequent papers cited in this Note. Thus LLS refers to the first three authors of the LLSV foursome. See *supra* note 34.

⁴⁸ See generally *Economic Consequences*, *supra* note 34, at 45–59.

⁴⁹ See Coffee, *supra* note 25, at 80–81 (positing that as securities markets developed in United States and United Kingdom, investors demanded legal rules to fill enforcement gaps); Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1680 (2002) (arguing that greater level of financial development and corresponding larger population of investors may result in “the enactment of laws providing for stronger investor protections”).

⁵⁰ *Economic Consequences*, *supra* note 34, at 20–21. The authors also stated that findings from other papers “relieve[] the reverse causality concerns,” and went on to summarize those findings. *Id.* at 21–22.

⁵¹ See Roe, *supra* note 26, at 474–75.

⁵² *Economic Consequences*, *supra* note 34, at 44–45.

⁵³ Howell E. Jackson & Mark J. Roe, Public Enforcement of Securities Laws: Resource-Based Evidence 32, 37 (June 3, 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=1000086> (stating that LLS's findings do not support their conclusion that public enforcement is unimportant relative to private enforcement).

requirements and the ease with which investors can recover damages play significant roles.⁵⁴

These back-and-forth arguments have by no means settled the issue, and the importance of private enforcement remains disputed. With this in mind, this Note seeks to demonstrate that the debate has neglected a critical factor in the effectiveness of private enforcement—the particular financial and legal institutions of the country in question. The next Part provides relevant background and context for evaluating this Note's proposals by describing characteristics of China's legal and political environment, stock markets, securities regulations, and private securities litigation.

II

LEGAL INSTITUTIONS, STOCK MARKETS, SECURITIES REGULATIONS, AND PRIVATE SECURITIES LITIGATION IN CHINA

This Part identifies characteristics of China's legal institutions, focusing on the nation's judiciary, stock markets, securities regulations, and private securities litigation. Many of these characteristics support the argument that China's current environment is more conducive to a significant role for public, as opposed to private, enforcement—despite the LLSV-driven promotion of the latter.

A. *China's Legal Institutions*

A country's legal system is “a unique and finely tuned product of the overall cultural context in which it is embedded.”⁵⁵ Understanding China's legal system is a challenge for Westerners because it is imbued with Chinese traditions that do not fit neatly into the “categories, constructs, and relationships of Western jurisprudence.”⁵⁶ It is important to analyze China's legal institutions and approach to legal and economic reforms, as well as the likelihood of success of future reforms, from a Chinese perspective.⁵⁷

⁵⁴ Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 20 (2006) [hereinafter *What Works in Securities Laws?*].

⁵⁵ Jianhua Zhong & Guanghua Yu, *Establishing the Truth on Facts: Has the Chinese Civil Process Achieved this Goal?*, 13 J. TRANSNAT'L L. & POL'Y 393, 443 (2004) (quoting Janet E. Ainsworth, *Categories and Culture: On the “Rectification of Names” in Comparative Law*, 82 CORNELL L. REV. 19, 28 (1996)).

⁵⁶ THOMAS B. STEPHENS, *ORDER AND DISCIPLINE IN CHINA: THE SHANGHAI MIXED COURT 1911–1927*, at 3 (1992); see also JONATHAN D. SPENCE, *THE SEARCH FOR MODERN CHINA* 123 (2d ed. 1999) (stating that when Qing dynasty's legal code was translated, it was clear that Chinese and Europeans had different views of what constituted law).

⁵⁷ See William C. Jones, *Trying To Understand the Current Chinese Legal System*, in UNDERSTANDING CHINA'S LEGAL SYSTEM 7, 14–15 (C. Stephen Hsu ed., 2003) (“Rather

China's governments traditionally have been large centralized bureaucracies that are vested with executive, legislative, and judicial authority.⁵⁸ The concept of judicial independence was never a characteristic of the legal system.⁵⁹ For example, during the Qing dynasty—China's last dynasty, which ruled from 1644 to 1911⁶⁰—magistrates who received no formal legal training⁶¹ adjudicated cases but lacked independence: They were essentially the “means through which the Emperor governed at the lowest level,” and their primary duty was “protecting and advancing the interests of the state.”⁶² They “were subject to strict rules in the exercise of their powers” and their “actions were subject to review” by their superiors.⁶³ They therefore had no meaningful adjudicative power. Adjudication primarily consisted of magistrates proposing decisions to their superiors, subject to revision before being approved.⁶⁴

Similarly, modern China is a unitary state with little judicial independence. The CCP and central government promulgate legislation, delegate power to local governments as they see fit, and oversee local governments through a “parallel structure of party organizations at each level of government.”⁶⁵ The judiciary is a part of the bureaucratic hierarchy, with courts⁶⁶ being “parallel to, rather than superior

than try to fit Chinese law into western patterns, it would seem wise to try to approach Chinese law in the way the Chinese did Otherwise there is the temptation to concentrate on matters that we recognize as similar to our own ideas.”).

⁵⁸ See *id.* at 8–9 (stating that defining feature of China's post-unification system of government was strong central government with no separation of powers).

⁵⁹ Cf. *id.* at 9 (stating that magistrates were not “judge[s] as we understand the term. . . . [but rather were] official[s] who carried out all governmental functions at the local level”).

⁶⁰ See generally SPENCE, *supra* note 56 (providing comprehensive historical account of China's dynastic period).

⁶¹ Jones, *supra* note 57, at 16. Magistrates were “civil servants . . . selected by competitive examinations based on . . . philosophy and literature.” *Id.*

⁶² *Id.* In addition to adjudicating cases, magistrates were responsible for tax collection and defending their city in the event of “an uprising or foreign invasion.” *Id.* (quoting T.T. CHU, LOCAL GOVERNMENT UNDER THE CH'ING 16 (1962)).

⁶³ *Id.* at 9.

⁶⁴ See *id.* at 16 (“In any significant case, [the magistrate] could only propose decisions which could be (and often were) revised or reversed by superiors.”).

⁶⁵ RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW 214 (2002); see also Peter H. Corne, *Creation and Application of Law in the PRC*, 50 AM. J. COMP. L. 369, 369–73 (2002) (describing delegation of power and hierarchy of Chinese governmental authority).

⁶⁶ There are four levels of courts in China: the Supreme People's Court, High People's Courts, Intermediate People's Courts, and Basic Level People's Courts. PEERENBOOM, *supra* note 65, at 283. The Supreme People's Court is the highest court and “is responsible for [the] interpretation of laws, administration of the judiciary, and adjudication.” *Id.*; see also NANPING LIU, OPINIONS OF THE SUPREME PEOPLE'S COURT: JUDICIAL INTERPRETATION IN CHINA 21–24 (1997) (describing relationship between Supreme People's Court and lower courts).

to, other units of the Chinese bureaucracy.”⁶⁷ Courts are “administratively and institutionally accountable”⁶⁸ to, and financed by, the corresponding level of government that created them.⁶⁹ They are subject to supervision from CCP organizations and procuratorates,⁷⁰ have limited adjudicative authority,⁷¹ are charged with other responsibilities such as tax collection,⁷² and primarily employ judges who are not legally trained.⁷³ This organizational structure leads to court proceedings being improperly influenced and is an abridgment of the judiciary’s authority. For example, because local governments select and pay judges in their own courts, they often leverage their influence by pressuring judges to favor local defendants in court proceedings.⁷⁴ Moreover, the courts’ power to effectuate judgments is weak, as up to

⁶⁷ Lubman, *supra* note 1, at 29; Ignazio Castellucci, *Rule of Law with Chinese Characteristics*, 13 GOLDEN GATE U. ANN. SURV. INT’L & COMP. L. 35, 51 (2007) (“Chinese courts operate as specific organs of the State, implementing the State policy at a local level, through the legal system, through judicial directives, hierarchies and internal procedures.”).

⁶⁸ Randall Peerenboom, *Judicial Independence and Judicial Accountability: An Empirical Study of Individual Case Supervision*, 55 CHINA J. 67, 71 (2006).

⁶⁹ PEERENBOOM, *supra* note 65, at 280.

⁷⁰ *Id.* Procuratorates are responsible for investigating and prosecuting crimes. The Supreme People’s Procuratorate, the highest level of procuratorate, is also responsible for “offer[ing] judicial interpretations in the actual application of law in the work of prosecution.” Castellucci, *supra* note 67, at 52 (quoting Chinese Government’s Official Web Portal, Major Functions of the SPP, http://english.gov.cn/2005-09/02/content_28500.htm (last visited Aug. 27, 2008)).

⁷¹ See Donald C. Clarke, *Empirical Research into the Chinese Judicial System*, in BEYOND COMMON KNOWLEDGE: EMPIRICAL APPROACHES TO THE RULE OF LAW 164, 178 (Erik G. Jensen & Thomas C. Heller eds., 2003) (stating that because judges can be punished for having their decisions reversed, they often seek the advice of superior courts prior to rendering a decision); Jonas Grimheden, *Strategies for Reform of the Judiciary in China: One Concept, Two Descriptions*, 9 NEWSLETTER DER DEUTSCH-CHINESISCHEN JURISTENVEREINIGUNG E.V. 114, 117 (2002), available at <http://www.zchinr.de/upload/25/News02-3u4.pdf> (“According to the Judge’s Law the individual judge doesn’t have independent adjudicative authority.”).

⁷² See Clarke, *supra* note 71, at 174–75 (“[L]ocal governments often enlist judges in the work of birth control, tax collecting, urban beautification, and the physical expulsion of beggars.”).

⁷³ Hualing Fu, *Putting China’s Judiciary into Perspective: Is it Independent, Competent, and Fair?*, in BEYOND COMMON KNOWLEDGE: EMPIRICAL APPROACHES TO THE RULE OF LAW, *supra* note 71, at 193 (“[T]he majority of judges have little or no legal education”); Lubman, *supra* note 1, at 29 (stating that percentage of judges with “proper LL.B degrees” is estimated at less than ten percent and applicants for judgeships were not required to take national bar examination until 2002); Grimheden, *supra* note 71, at 117 (stating that in 1998 only 5.6% of court officials had basic university degree and only 0.25% held graduate degrees).

⁷⁴ Lubman, *supra* note 1, at 30. Another way to influence outcomes is through Individual Case Supervision, where the local government or procuratorate challenges a decision in order to have a case retried, although, on balance, Independent Case Supervision is thought to prevent more local favoritism than it facilitates. Peerenboom, *supra* note 68, at 71–72, 78–80.

fifty percent of civil judgments go unenforced.⁷⁵ This is a result of various factors, including insufficient personnel, unwillingness to enforce against a powerful local party,⁷⁶ and the refusal of other agencies to provide assistance.⁷⁷

Another longstanding characteristic of the Chinese legal system is the State's emphasis on policy over law. During the Maoist period,⁷⁸ for example, the government believed laws to be too rigid and therefore incompatible with the needs of "the revolution."⁷⁹ Legislation, deemed subservient to policy, served only as a rubber stamp on policy pronouncements,⁸⁰ and judges were directed to decide cases according to policy goals rather than legal principles.⁸¹ Today, while the CCP has stated its intention to elevate the prominence of rule of law⁸² vis-à-vis policy,⁸³ the majority of laws and regulations passed by the national legislature are simply embodiments of CCP policies⁸⁴ rather

⁷⁵ PEERENBOOM, *supra* note 65, at 287. Chinese courts bear the responsibility of enforcing judgments, unlike in other countries where the police are responsible. *Id.*

⁷⁶ See Donald C. Clarke & Angela H. Davis, Paul, Weiss, Rifkind, Wharton & Garrison, *Dispute Resolution in China: The Arbitration Option*, in CHINA 2000: EMERGING INVESTMENT, FUNDING AND ADVISORY OPPORTUNITIES FOR A NEW CHINA 151, 155 (Benedict Rogers & Lotte Pang eds., 1999) ("[T]he court, under the influence of local authorities, may attempt to protect the interests of influential local enterprises.").

⁷⁷ Lubman, *supra* note 1, at 29 (noting that state-owned banks sometimes refuse requests to freeze accounts or delay in doing so). According to a survey of intermediate- and basic-level court judges in Chongqing, government agencies account for thirty-two percent of all interference with enforcement actions. PEERENBOOM, *supra* note 65, at 307.

⁷⁸ The Maoist period lasted from 1949–1976. Jones, *supra* note 57, at 22.

⁷⁹ See LUBMAN, *supra* note 7, at 130 (noting Mao Zedong's attitude regarding rigidity of law).

⁸⁰ See *id.* at 74 ("Courts . . . were used chiefly to formalize the most serious punishments in order to propagandize Party policies and educate the masses on desired behavior.").

⁸¹ See *id.* at 75 (stating that government functionaries were instructed to "decide cases so the outcomes promoted specific short-term goals, such as reducing industrial accidents or fulfilling quotas for the purchase of grain from peasants").

⁸² While there are competing definitions of "rule of law," there is "broad consensus as to its core meaning and basic elements. At its most basic, rule of law refers to a system in which law is able to impose meaningful restraints on the state and individual members of the ruling elite . . ." PEERENBOOM, *supra* note 65, at 2. Peerenboom characterizes the Chinese version of rule of law as "Statist Socialist[]," defined as a market-based economy with significant state ownership, a nondemocratic system primarily led by the CCP, and an "interpretation of rights that emphasizes stability, collective rights over individual rights, and subsistence as the basic right rather than civil and political rights." *Id.* at 3. This is different from "Liberal Democratic" rule of law, which espouses free-market capitalism, multiparty democracy, and a "liberal interpretation of human rights that gives priority to civil and political rights over economic, social, cultural, and collective or group rights." *Id.*

⁸³ In 1996, Jiang Zemin, then President of China, adopted an "official policy formulation of ruling [China] in accordance with the law and establishing a socialist rule-of-law state." *Id.* at 6. This policy was later incorporated into China's Constitution. *Id.*

⁸⁴ See *id.* at 10, 213 ("[T]he official interpretation of the role of the Party . . . is to set the general policy direction for society. . . . CCP policy is now to be transformed into laws

than expressions of the will of the people.⁸⁵ Policies still trump laws, as exemplified by the CCP's extralegal interference with "day-to-day governance,"⁸⁶ the use of internal CCP rules instead of judicial sanctions to punish party members for legal violations,⁸⁷ and judges' use of "ideological discretion" when deciding cases.⁸⁸

The Chinese legal system also traditionally placed greater emphasis on penal laws and "control and discipline,"⁸⁹ hindering the development of civil laws⁹⁰ and thus civil dispute resolution. For example, the Qing Code primarily regulated the "official activities of government officials" and focused very little on the activities of private citizens.⁹¹ Instead, village mediation committees dealt with disputes between individuals and used "customary law" to resolve them.⁹² In modern China extrajudicial means, such as mediation, continue to play an important role⁹³ due to government encouragement⁹⁴ as well as the "expensive and time-consuming" nature of litigation.⁹⁵ Mediation committees may use legal principles as a guide, but are also permitted to rely on "social morality" in cases where there are no clear laws or regulations.⁹⁶

and regulations . . ."). The legislative process is frequently described as "rubber stamping" CCP proposals. See, e.g., James Reynolds, *China MPs Exercise Rubber Stamp*, BBC NEWS, Mar. 13, 2007, <http://news.bbc.co.uk/2/hi/asia-pacific/6446483.stm> (noting that national legislature has never rejected CCP proposal).

⁸⁵ PEERENBOOM, *supra* note 65, at 213 (stating that, under Statist Socialist rule of law, CCP "reserves the right to make fundamental policy decisions whereas in a democracy such decisions are left to the people").

⁸⁶ *Id.* at 214.

⁸⁷ *Id.*

⁸⁸ James Hugo Friend, Foreword, *The Rocky Road Toward the Rule of Law in China: 1979-2000*, 20 NW. J. INT'L L. & BUS. 369, 375 (2000).

⁸⁹ LUBMAN, *supra* note 7, at 300 ("Both long before and since the PRC was established, law has been regarded in China exclusively as an instrument of control and discipline.").

⁹⁰ See Jones, *supra* note 57, at 14 (stating that civil law as it relates to concerns of citizens did not exist historically in China).

⁹¹ *Id.* at 11-13.

⁹² *Id.* at 18; see also STEPHENS, *supra* note 56, at 5 (stating that disputes were resolved according to values of higher-ranked authorities, "generally from among the leaders of the immediate group" in which the dispute arose).

⁹³ See Fu, *supra* note 73, at 198-99 (stating that use of mediation prevents "great number" of disputes from reaching courts and that in 1999 there were approximately 170,000 judges and more than nine million mediators in China); Pistor & Xu, *supra* note 10, at 193 (concluding that courts have, so far, not imposed liability in cases brought by investors, "although some cases have been settled after court mediation").

⁹⁴ Fu, *supra* note 73, at 198 (stating that mediation is "actively promoted and organized by the government").

⁹⁵ LUBMAN, *supra* note 7, at 220.

⁹⁶ *Id.* at 221.

The general consensus, both inside and outside China, is that legal reforms will continue long into the future.⁹⁷ While U.S. laws have partially influenced the direction of China's legal reforms, especially in the commercial sphere,⁹⁸ China's legal system is not moving inexorably towards a Western model. Rather, its "ultimate form . . . cannot be predicted It will almost certainly be significantly different from the legal system[] of . . . the United States of America."⁹⁹ Longstanding characteristics of China's legal institutions—a central government, subservient judiciary, use of policy in the absence of laws, and reliance on extrajudicial dispute settlement—will undoubtedly influence its future form and functions.

More specifically, the CCP, as the leader of a "single party socialist state,"¹⁰⁰ will be instrumental in shaping future legal reforms. Viable strategies for future development of China's stock markets through improved enforcement of securities regulations must be consistent with the CCP's central role in guiding development and its desire to maintain power.¹⁰¹ For private securities litigation to protect investors effectively and influence financial market development, for example, the judiciary would have to be given more authority and independence from the central government. While this would strengthen the legal system, it is unlikely to happen in the near future because a more independent and authoritative judiciary could act as a check on the CCP's actions, thereby encroaching upon its absolute rule of China.¹⁰²

B. China's Stock Markets

Despite the relatively recent emergence of China's stock market and subsequent reforms, the markets continue to be largely government-owned and -controlled, limiting the options for strengthening private enforcement. In 1990, China reestablished stock markets¹⁰³ in

⁹⁷ See *id.* at 299–300 (“[T]he best that can be hoped for is incremental reform, and it would be wise for Western observers to take, as China must, a long view.”).

⁹⁸ See *infra* notes 170–71 and accompanying text.

⁹⁹ Jones, *supra* note 57, at 40–41.

¹⁰⁰ PEERENBOOM, *supra* note 65, at 10.

¹⁰¹ Dan Blumenthal, *Maintaining Communist Rule in China*, FORBES.COM, Oct. 22, 2007, http://www.forbes.com/2007/10/20/china-congress-power-oped-cx_dbl_1022china-power.html (describing CCP's goal of adapting so that it maintains its “monopoly on power”).

¹⁰² See John K.M. Ohnesorge, *China's Economic Transition and the New Legal Origins Literature*, 14 CHINA ECON. REV. 485, 491 (2003) (stating that CCP has no “material incentive to share political power by creating an independent power center in the courts”).

¹⁰³ China's previous stock markets were shut down shortly after the CCP's ascent to power in 1949 because share ownership was thought to be inconsistent with Marxist principles. Sandra P. Kister, Note, *China's Share-Structure Reform: An Opportunity To Move*

Shanghai¹⁰⁴ and the southern city of Shenzhen.¹⁰⁵ The stock markets were not reestablished to aid privatization of SOEs, to help entrepreneurs and private companies raise capital from the public, or to expand the public's investment options. Rather, the goal was to finance weak SOEs¹⁰⁶ with private savings, to end their reliance on borrowing from state-owned banks, and to improve their efficiency and long-term prospects.¹⁰⁷ Although the stock markets did give the public an additional investment option, this was not the government's primary goal. By allowing individuals to shift money from ailing banks¹⁰⁸ and the real estate market to the stock markets, the government could reduce the extent of social instability in the event of bank

Beyond Practical Solutions to Practical Problems, 45 COLUM. J. TRANSNAT'L L. 312, 316 (2007).

¹⁰⁴ See Shanghai Stock Exchange, About SSE, http://www.sse.com.cn/sseportal/en_us/ps/about/bi.shtml (last visited Oct. 27, 2008).

¹⁰⁵ See Shenzhen Stock Exchange, About SSE, <http://www.szse.cn/main/en/aboutsse/sse-overview/> (last visited Oct. 27, 2008). After the handover of Hong Kong in 1997, Hong Kong's stock market came under Chinese control. Hutchens, *supra* note 9, at 599 n.1. As of 2007, the capitalization of Hong Kong's stock market was about the size of China's two Mainland markets combined. See *Data: China's Stock Market Capitalization Passes HK*, CHINA POST, Apr. 12, 2007, available at <http://www.chinapost.com.tw/news/archives/business/2007412/106970.htm> (noting Hong Kong's capitalization at US\$1.795 trillion and aggregate of Mainland's two exchanges' capitalization at US\$1.8 trillion). Under the "one country, two systems" principle, Hong Kong is not governed by Mainland laws. See XIANGGANG JI BEN FA pmbl. (stating that Mainland's "socialist system and policies will not be practised in Hong Kong"); Hutchens, *supra* note 9, at 599 n.1 (noting that Hong Kong independently regulates its stock market). This Note focuses on regulation of the Mainland stock markets, and excludes Hong Kong.

¹⁰⁶ See Cheng Guo et al., *Understanding the Chinese Stock Market*, 18 J. CORP. ACCT. & FIN. 13, 14 (2007) ("In 2004, official statistics suggest that about one-third of all SOEs are loss makers, another third either break even or are plagued with implicit losses, and the remaining one-third are marginally profitable.").

¹⁰⁷ See Chen, *supra* note 8, at 456 ("[T]he very justification for starting a stock market in China was to help the SOEs raise capital from the general public and solve the money-losing SOEs' financial problems . . . not to offer the general public a way to diversify investment portfolios and hedge future consumption/income risks."); Hutchens, *supra* note 9 at 612-13 ("China's securities markets have been consciously designed from the 'top down' to support the reform of SOEs, not to allow private firms to raise capital.").

¹⁰⁸ Until recently, Chinese banks held a large amount of nonperforming loans on their books. This was due to a history of lending to financially unstable or insolvent SOEs. Xinhua News Agency, *Major Chinese Banks Post Bad Loan Ratio Decline to 8.9 pct by April*, CHINA VIEW, May 29, 2006, http://news.xinhuanet.com/english/2006-05/29/content_4618114.htm.

failures¹⁰⁹ and relieve inflationary pressures in the real estate market.¹¹⁰

To prevent investors from gaining control of SOEs through share ownership, the government created various classes of shares—state, legal-person, individual, and foreign—and predicated ownership on the shareholder's identity.¹¹¹ The state ensured that it maintained control by establishing that state and legal-person shares—constituting the majority of SOEs' outstanding equity¹¹²—were not publicly tradable.¹¹³

The illiquid share structure contributed to difficulties in calculating the market capitalization of listed firms and the stock markets.¹¹⁴ Official figures indicate that China's markets combined are the second largest in Asia behind Japan,¹¹⁵ but these figures are derived by applying the market price of tradable shares to nontradable shares.¹¹⁶ In practice, because nontradable shares trade at a steep discount to the market price of tradable shares,¹¹⁷ the stock mar-

¹⁰⁹ Wen-hong Li, *Bank Restructuring in China: Effectiveness, Limitations and Implications*, 9 *WORLD ECON. & CHINA* 20, 26 (2001), available at <http://old.iwep.org.cn/wec/English/e44.htm> (stating that government absorbed bank losses due to fear of passing them on to public).

¹¹⁰ Bill Powell, *China's Stock Market Mania*, *TIME.COM*, July 6, 2007, <http://www.time.com/time/business/article/0,8599,1640617,00.html>.

¹¹¹ See Kister, *supra* note 103, at 317–18 (describing classes of shares). State agencies and organizations at central or local levels owned state shares, legal persons (enterprises, institutions, or authorized social groups) owned legal-person shares, and individual and foreign investors owned individual and foreign shares, respectively. WALTER & HOWIE, *supra* note 27, at 74 tbl.4.3.

¹¹² Guo et al., *supra* note 106, at 14 (“In more than 80 percent of all companies, nontradable shares account for more than 50 percent of the outstanding shares.”).

¹¹³ Chen, *supra* note 8, at 455–56. Although not publicly tradable, legal-person and state shares are transferrable “on paper.” WALTER & HOWIE, *supra* note 27, at 75. Legal-person shares can be transferred to other legal persons, subject to restrictions. *Id.* at 75, 77 tbl.4.6. State shares “for all intents and purposes, are not transferable.” *Id.* at 75. The government has recently floated what were formerly nontradable shares. See *infra* notes 119–21 and accompanying text.

¹¹⁴ See Andrew Batson & Shai Oster, *Moving the Market: How Big Is PetroChina?; Market Cap May Exceed \$1 Trillion—or Not*, *WALL ST. J.*, Nov. 6, 2007, at C3 (noting difficulty of calculating value of partially illiquid, government-controlled companies such as PetroChina).

¹¹⁵ *Data: China's Stock Market Capitalization Passes HK*, *supra* note 105.

¹¹⁶ *A Mythical Market*, *BUS. CHINA*, Sept. 10, 2001, at 4 (stating that manner in which government calculates market capitalization, by valuing nontradable “shares at market prices,” is “disingenuous”).

¹¹⁷ Guo et al., *supra* note 106, at 15 (providing example of company's nontradable shares that were sold for RMB 3.55 yuan per share, while market price was over RMB 8 yuan per share); cf. WALTER & HOWIE, *supra* note 27, at 4–5 (noting that “possibility [in 2001] of huge volumes of [previously nontradable] shares coming on to the market destroyed values” of previously tradable shares).

kets' true market capitalization is significantly lower than official figures indicate.¹¹⁸

In 2005, the government began reforming the split-share structure by converting nontradable shares into tradable shares.¹¹⁹ By the end of 2006, listed companies representing 97.9% of the stock markets' capitalization had completed the reforms.¹²⁰ Still, although most shares are now tradable and can theoretically be privately owned, the government has signaled that it does not intend to significantly reduce its ownership and control of SOEs, and that it may even increase its ownership in companies operating in certain key industries.¹²¹ Thus, while the reforms will eliminate the inefficiencies associated with the split-share structure, the government will continue to have a significant ownership presence in the market.

C. Securities Regulations

China's first securities law, passed in December 1998 (effective in 1999),¹²² made the China Securities Regulatory Commission (CSRC) the principal market regulator.¹²³ The law was an important development in regulation of the market because it promised, through consolidation of regulatory authority under a single government agency, to remove "inconsistencies and inefficiencies"¹²⁴ caused by a "confused

¹¹⁸ See WALTER & HOWIE, *supra* note 27, at 4 (describing market capitalization figure obtained by applying market price to nontradable shares as "at best only notional"). China's stock market capitalization may be lower than official figures indicate also because the markets have fallen since their 2007 peak. For example, although the Shanghai Composite Index rose ninety-seven percent in 2007, China's "benchmark indexes" had fallen thirty-two percent by the end of the first quarter of 2008. Joanna Slater, *U.S. Stocks Are Doing Better than Most*, WALL ST. J., Mar. 31, 2008, at C1.

¹¹⁹ Guidance Notes on the Split Share Structure Reform of Listed Companies (promulgated by the Sec. Reg. Comm., Aug. 23, 2005), <http://www.csrc.gov.cn/n575458/n4001948/n4002120/4069773.html> (last visited Aug. 20, 2008) [hereinafter Split Share Guidance Notes]; see also Guo et al., *supra* note 106, at 16 (describing split-share structure reform).

¹²⁰ Guo et al., *supra* note 106, at 19.

¹²¹ See Mikael Mattlin, *The Chinese Government's New Approach to Ownership and Financial Control of Strategic State-Owned Enterprises* 31-33 (Bank of Fin. Inst. Econ. Transition, Discussion Papers 10/2007, 2007) (describing government's share ownership policy); Split Share Guidance Notes, *supra* note 119 (stating that level of state control will generally be maintained and may be increased in vital sectors).

¹²² This Note refers to it as the 1998 Securities Law.

¹²³ See WALTER & HOWIE, *supra* note 27, at 51-52, 56-57. Prior to 1998, there was no sole market regulator, and various government agencies regulated the securities markets. *Id.* at 52-54. The CSRC reports directly to the State Council, which is responsible for implementing CCP policies, laws, and regulations adopted by the National People's Congress. *Id.* at 59 fig.3.2; Chinese Government's Official Web Portal, The State Council, http://english.gov.cn/2008-03/16/content_921792.htm (last visited Aug. 13, 2008).

¹²⁴ Chen et al., *supra* note 15, at 458.

and diffuse patchwork of regulations.”¹²⁵ The CSRC’s responsibilities include supervising the primary and secondary securities markets, securities firms, and other organizations in the securities business,¹²⁶ as well as investigating and penalizing those who violate the law.¹²⁷

Prior to the law’s passage, a hodgepodge of national laws and administrative regulations prohibited insider trading, market manipulation, and false disclosures.¹²⁸ While these national laws detailed comprehensive administrative sanctions for securities fraud, civil remedies for investors were limited.¹²⁹ The 1998 Securities Law imposed harsher governmental penalties and enhanced the power of the CSRC,¹³⁰ but did not “strengthen provisions concerning civil liability and civil compensation.”¹³¹ Though the 2005 amendments to the 1998 Securities Law further increased the CSRC’s powers and widened the class of people who could be liable for false disclosures, they did not improve civil remedies.¹³²

D. Private Securities Litigation

As early as 1996, investors repeatedly attempted to file civil suits against listed companies,¹³³ only to see them rejected by the courts. In one instance, an investor sued a company after its chairman and chief financial officer were sentenced to prison for committing financial

¹²⁵ Cai, *supra* note 24, at 135.

¹²⁶ Chen et al., *supra* note 15, at 458.

¹²⁷ See WALTER & HOWIE, *supra* note 27, at 63–64 (providing examples of recent enforcement actions and noting that “[c]ompanies or their managers and directors that have violated the law or committed fraud are now being punished and news of their punishment is being made public”).

¹²⁸ See SANZHU ZHU, *SECURITIES DISPUTE RESOLUTION IN CHINA* 158–59 (2007) (describing various laws).

¹²⁹ *Id.* at 159 & n.12 (“[T]hese laws and regulations have not provided adequate protection for the rights and interests of investors who suffered economic losses as a result of securities fraud.”).

¹³⁰ See Cai, *supra* note 24, at 135 (“[S]eventeen of the [law’s] sections impose criminal liability, which is unusual for a commercial law.”).

¹³¹ ZHU, *supra* note 128, at 159.

¹³² *Id.* at 158–59 (“Compared with the comprehensive administrative sanctions for securities fraud, there are very limited provisions . . . that involve civil liability and civil compensation when dealing with securities fraud.”); cf. *Securities Laws Extensively Revised*, CHINA L. BULL. (Morrison & Foerster LLP, Beijing, China), Nov. 2005, at 3–4, available at <http://www.mofo.com/docs/pdf/ChinaLawBulletin1105.pdf> (making no mention of enhancing civil liability among discussion of amendment’s major changes, while mentioning expanded liability).

¹³³ See, e.g., Hutchens, *supra* note 9, at 604 n.17 (describing examples of shareholder suits in 1996 and 1998); Naomi Li, *Civil Litigation Against China’s Listed Firms: Much Ado About Nothing?* 8–9 tbl.1 (Royal Inst. of Int’l Affairs, Working Paper No. 13, 2004), available at <http://www.chathamhouse.org.uk/research/asia/papers/view/-fid/192/> (providing status of various civil suits at end of 2003).

fraud.¹³⁴ Despite evidence of wrongdoing, as demonstrated by these criminal convictions, the civil court refused to hear the case, stating that the CSRC (and not the courts) was responsible for enforcing China's securities law.¹³⁵ In general, lower courts have refused to hear shareholder cases because they cannot accept new types of private suits until after the National People's Congress¹³⁶ has passed a relevant law *and* the Supreme People's Court (SPC) has issued detailed legal interpretations.¹³⁷ Even after the passage of the 1998 Securities Law, courts refused to hear cases because the SPC had not provided guidance as to whether a private right of action exists under the securities law,¹³⁸ as Chinese courts "have traditionally hesitated to act without sufficient basis" for finding such a right.¹³⁹ The courts were concerned that:

First, as suits were filed against the same defendants and for the same cause but by different plaintiffs and in different lower courts, it became possible that there would be different rulings . . . which would jeopardize the reputation and credibility of the legal system. . . . Second, if financially injured investors would each file an individual suit, the entire court system would be more than overwhelmed Third, given the lack of prior experience in this area, the lower court judges had no uniform standards yet with regard to who has a standing to sue, what type of evidence is required, how damages are calculated Finally, if . . . private plaintiffs would be awarded rightfully deserved relieves, it would lead to major losses of state assets¹⁴⁰

Even in the face of this situation, the SPC affirmatively took steps to keep private plaintiffs out of court: In September 2001, rather than issue the legal interpretations necessary to clarify the confusion

¹³⁴ WALTER & HOWIE, *supra* note 27, at 61 (citation omitted).

¹³⁵ *Id.*

¹³⁶ The National People's Congress is the highest organ of state power and is responsible for legislation as well as overseeing the election and removal of high government officials. Chinese Government's Official Web Portal, Major Functions and Rights of the NPC, http://english.gov.cn/2005-09/02/content_28450.htm (last visited Aug. 13, 2008).

¹³⁷ Chen, *supra* note 8, at 460. Chen notes that this process can take five years or more. *Id.* In the case of shareholder lawsuits, the National People's Congress passed a securities law in 1998 and the Supreme People's Court issued litigation rules in 2003. *Id.* at 464–66.

¹³⁸ Hutchens, *supra* note 9, at 676 (stating that, although authorized to hear cases, courts waited for "further instructions from the Supreme People's Court concerning the calculation of damages and other particulars").

¹³⁹ See Cai, *supra* note 24, at 144 (noting that securities "acts are proscribed or proscribed without any mention of civil consequences" while courts are divided as to whether a "private cause of action shall be implied").

¹⁴⁰ Chen, *supra* note 8, at 465.

among the lower courts, the SPC instructed all lower courts to refuse to hear private securities litigation cases.¹⁴¹

The SPC lifted the restriction on accepting cases in January 2002 but limited the available causes of action to false disclosure.¹⁴² Still, lower courts continued to refuse to hear shareholders' cases until one year later, when the SPC issued specific rules (2002 Rules) for handling private securities litigation.¹⁴³ In addition to the restriction on available causes of action, the SPC's rules contained strictures that functionally impeded the ability of investors to file suit. Professor Walter Hutchens summarizes these restrictions as follows: Victims of insider trading and market manipulation are denied recovery;¹⁴⁴ in certain instances, it is impossible to prove causation between a company's false disclosure and an investor's loss;¹⁴⁵ imposition of an administrative or criminal penalty is a prerequisite to filing suit;¹⁴⁶ there is no class action mechanism;¹⁴⁷ and jurisdictional requirements favor defendants.¹⁴⁸

China's current legal and political environment does not support a greater role for private securities litigation. The CCP's intent to shape legal reforms and maintain its power makes it unlikely that

¹⁴¹ Hutchens, *supra* note 9, at 606.

¹⁴² *Id.*

¹⁴³ *Cf. id.* at 607 ("Even after Chinese courts were notified that they may accept private securities litigation . . . nearly a year passed before [the SPC] provided lower courts with specific . . . instructions for handling such claims."); *supra* notes 137–40 and accompanying text (noting aversion of courts to decide cases without guiding rules).

¹⁴⁴ See Hutchens, *supra* note 9, at 629–30 (stating that only claims resting on "bad disclosure" (misrepresentations) are exempted from the ban on private claims).

¹⁴⁵ This can occur when an issuer fails to disclose positive news, leading an investor to sell at a lower price than what would have prevailed had the good news been disclosed. Because the sale occurred prior to the revelation of the positive news, the investor would be unable, by rule, to prove reliance on the failure to disclose. *Id.* at 632–34.

¹⁴⁶ *Id.* at 634–36. The 2002 Rules allow that "such action does not have to be specifically from the CSRC" and instead "can be met with criminal findings by a court or with an administrative penalty from some [other] source." *Id.* at 636. Upon receipt of an administrative sanction, a company may either apply for administrative review or litigate the decision. This process is predicted by some to last three to four years, during which time private litigation can be suspended. Such a delay would reduce the time value of any recovery. *Id.* at 652.

¹⁴⁷ *Id.* at 640–43. While disallowing U.S.-style class actions, the rules permit a form of multi-plaintiff joint action in which plaintiffs must opt in prior to commencement of litigation. This differs from a U.S.-style class action, in which the outcome of the litigation may bind all class members unless they have opted out. *Id.*

¹⁴⁸ *Id.* at 645–46. The rules require plaintiffs to sue in court located in a "provincial capital, specially designated city, or special economic zone" near the defendant's location. *Id.* (noting that if "plaintiff sues multiple defendants . . . then the suit must be brought in the . . . court where the defendant is located"). This may disadvantage plaintiffs because it is likely that the local government will be a majority shareholder in the defendant. If so, the fear is that the government will utilize its leverage over the adjudicating court to compel a decision in the defendant's favor in order to protect its financial interest. *Id.*

courts will be given the independence and authority needed to improve the effectiveness of private securities litigation. This, coupled with the limited availability of civil remedies and the difficulty of bringing legal claims, effectively stifles private enforcement. The next Part argues that, given the positive effects that strong public enforcement of securities laws has on financial market development, a more viable strategy for improving investor protection and deterring securities fraud in China is to strengthen public enforcement. In that vein, the next Part offers proposals for doing so.

III

STRONG PUBLIC ENFORCEMENT AS A VIABLE ALTERNATIVE TO PRIVATE ENFORCEMENT

This Part describes recent studies that show a positive relationship between strong public enforcement and financial market development in support of the argument that, in China's current legal and political environment, stronger public enforcement vis-à-vis private enforcement is more likely to deter securities fraud and affect market development. With these thoughts in mind, this Part concludes by offering proposals for improving the CSRC's effectiveness.

A. *Strong Public Enforcement Has Positive Effects on Stock Market Development*

In *What Works in Securities Laws?*, LLS analyzed the effects of three different regulatory approaches—leaving markets unregulated, standardizing and improving private litigation by promulgating disclosure and liability rules, or supplementing private enforcement with public enforcement—on various measures of stock market development.¹⁴⁹ For each country, they compiled indices of legal rules that they had quantified:¹⁵⁰ the strength of disclosure requirements;¹⁵¹ the procedural ease with which investors can seek recovery of losses;¹⁵²

¹⁴⁹ *What Works in Securities Laws?*, *supra* note 54, at 1–3.

¹⁵⁰ LLS analyzed the forty-nine countries with the largest stock market capitalizations in 1993. *Id.* at 5. The indices reported a higher value for factors supporting private enforcement. *Id.* at 6 tbl.I.

¹⁵¹ *Id.* at 6 tbl.I, 10–11. This index assessed whether a number of disclosures were required, such as directors' and key officers' compensation; equity ownership by directors and key officers; the identities of shareholders who own more than ten percent of the firm's shares; and all transactions between the firm and its directors, officers, or large shareholders. For each category of disclosure, higher values were used to indicate stronger disclosure requirements. *Id.*

¹⁵² *Id.* at 7 tbl.I, 11. This "liability standard" index assessed the number of legal elements that shareholders are required to prove in court. *Id.*

the public enforcer's level of independence and focus,¹⁵³ the scope of its rulemaking authority,¹⁵⁴ and the extent of its investigative powers;¹⁵⁵ and the strength of criminal and noncriminal sanctions.¹⁵⁶ They then sought to determine the legal rules' impact on various financial development indicators: the ratio of market capitalization of listed firms to gross domestic product (GDP),¹⁵⁷ the ratio of the number of listed companies to population size,¹⁵⁸ the ratio of total capital raised through IPOs to GDP,¹⁵⁹ the median premium paid for acquiring controlling blocks of shares,¹⁶⁰ the ease with which firms can raise capital on stock markets,¹⁶¹ the average level of ownership concentration,¹⁶² and stock market liquidity.¹⁶³

LLS made several findings: “[M]arkets do not prosper when left [unregulated]”;¹⁶⁴ extensive disclosure requirements and the ease with which investors can recover losses in private actions are associated

¹⁵³ *Id.* at 7 tbl.I, 12. This index assessed the manner in which the majority of the regulatory agency's members are appointed and dismissed. It also addressed the agency's sphere of regulatory responsibility, including for example, whether the agency regulates only securities markets or banks as well. *Id.*

¹⁵⁴ *Id.* This index assessed the regulator's ability to issue regulations without the prior approval of other governmental authorities. *Id.*

¹⁵⁵ *Id.* at 8 tbl.I, 12. This index assessed the regulator's ability to command documents and subpoena testimony during the course of an investigation, as well as from whom the regulator may compel such documents or testimony. *Id.*

¹⁵⁶ *Id.* at 8–9 tbl.I, 12–13. These indices assessed the applicability of sanctions to securities laws violations, to whom the sanctions apply, what conduct invokes them, and their severity. For example, the non-criminal sanction index was assigned a higher value if the regulator could order issuers and distributors of securities to perform or refrain from a broad range of actions, but a lower value if the regulator could only order an issuer to refrain from a limited range of actions. *Id.*

¹⁵⁷ *Id.* at 9 tbl.I, 13.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* Controlling blocks of shares trade at a premium to noncontrolling blocks because they allow the owner to authorize “actions designed to increase their own wealth at the expense of minority public shareholders.” Choi, *supra* note 49, at 1660. LLS interpreted higher median premiums as being indicative of greater private benefits of control, “which are higher in countries with weaker shareholder protection.” *What Works in Securities Laws?*, *supra* note 54, at 13.

¹⁶¹ *What Works in Securities Laws?*, *supra* note 54, at 9 tbl.I, 13. To measure this indicator, business executives in each country were asked to assess the extent to which they agree with the statement “Stock markets are open to new firms and medium-sized firms.” *Id.*

¹⁶² *Id.* at 9 tbl.I, 13.

¹⁶³ *Id.* This variable represents “[t]he average total value of stocks traded as a percentage of GDP” and is used to predict growth in per-capita income. *Id.*

¹⁶⁴ *Id.* at 27.

with larger stock markets;¹⁶⁵ and “[p]ublic enforcement plays a modest role at best in the development of stock markets.”¹⁶⁶

LLS has been criticized, however, for failing to measure fully public enforcement’s impact on financial markets. By measuring the regulator’s formal characteristics—its “legal status and powers”—they ignored the possibility that a regulator may be empowered by law to act but fail to do so because it is “disinclined” to, “lack[s] an adequate budget,” or is “constrained by political forces.”¹⁶⁷

An alternative method of measuring the impact of public enforcement on financial markets is to assess, in conjunction with formal legal characteristics, the intensity of public enforcement as indicated by the securities regulator’s budgetary resources and staffing levels. These measures may be particularly appropriate in evaluating the impact of public enforcement because, regardless of a country’s legal origin, contemporary approaches to securities regulation are statutory.¹⁶⁸ Further, the substantive protections provided to investors are converging,¹⁶⁹ and in particular “United States securities law has influenced the development of [China’s] securities law.”¹⁷⁰ This is evidenced by China’s provisions being both “comprehensive” and generally “at the same level as many developed markets.”¹⁷¹ The CSRC has also sought advice from regulators in other countries.¹⁷² Because the “regulatory tools” are becoming the same across countries, then, what is most important for analyzing financial markets is whether the tools are applied in a manner that protects investors

¹⁶⁵ *Id.* at 28.

¹⁶⁶ *Id.* at 20. The results concerning public enforcement were mixed. Although public enforcement has a large and significant impact on the ratio of market capitalization to GDP and the number of IPOs, it does not influence the number of listed firms, the premium paid for acquiring controlling blocks of stock, or ownership concentration. *Id.*

¹⁶⁷ Coffee, *supra* note 28, at 244.

¹⁶⁸ Roe, *supra* note 26, at 481 (“[M]odern securities law revolves around a regulatory agency operating through a comprehensive regulatory code . . .”).

¹⁶⁹ John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 8–9 (1999) (noting international “functional convergence” of securities regulations); Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 832–33 (2006) (describing convergence in Europe and Asia towards enforcement by strong central regulatory agency); *see also* Robert A. Prentice, *Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred*, 66 OHIO ST. L.J. 1155, 1223–24 (2005) (“Virtually all developed nations have . . . banned insider trading [and] required more disclosure by issuers . . .”).

¹⁷⁰ Hutchens, *supra* note 9, at 603.

¹⁷¹ Huawei Ling & Xiaohui Qiao, *Empower Regulators To Fight Securities Crime*, CAIJING, Aug. 24, 2007, available at <http://english.caijing.com.cn/20071225/42912.shtml> (interviewing Chen Shun, CSRC’s Director of Inspection).

¹⁷² Chen et al., *supra* note 15, at 460 (“The CSRC has sought advice from regulators in the US and other parts of the world so as to improve regulatory enforcement in China.”).

effectively.¹⁷³ To this end, the intensity of public enforcement may explain differences in the level of financial development.¹⁷⁴

In a recent paper, Professors Howell Jackson and Mark Roe sought to analyze the effects of enforcement on stock market development.¹⁷⁵ They used the relationship between securities regulators' budgetary resources and staffing levels as a proxy for the intensity of public enforcement, while also looking at formal characteristics.¹⁷⁶ The authors aimed to capture what focusing solely on formal characteristics misses—a securities regulator's actual ability to enforce the law. Higher budgets and staffing levels indicate that a securities regulator is better able to deter securities fraud by thoroughly conducting investigations, surveilling the market, writing detailed regulations, and punishing wrongdoing.¹⁷⁷ Higher levels also indicate that even if the regulator has limited powers or lacks independence, political authorities—by providing adequate resources—fully support the regulator's efforts to enforce securities laws.¹⁷⁸

Proceeding on this basis, Jackson and Roe concluded, contrary to LLS's findings, that public enforcement positively influences measures of financial market development.¹⁷⁹ They found that “resource-based enforcement variables are . . . substantially more strongly associated with robust capital markets” than formal indices of public enforcement powers such as “liability rules and anti-director rights.”¹⁸⁰ Having greater resources does not necessarily mean that the regulator will use them wisely, if at all. Conversely, a regulator with limited resources may still be effective if it “knows how to pick battles and impose severe penalties.”¹⁸¹ Although budget and staffing levels may therefore be a “noisy proxy,” they provide a useful starting point for

¹⁷³ See Roe, *supra* note 26, at 481 (“What counts is whether the system can protect investors; either set of [legal origins] tools can be deployed to do the job.”).

¹⁷⁴ Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 274–75 (2007) (putting forth hypothesis that “[i]t is not law, but enforcement that matters”).

¹⁷⁵ Jackson & Roe, *supra* note 53, at 1.

¹⁷⁶ *Id.* at 1–2, 10–11, 15.

¹⁷⁷ *Id.* at 10.

¹⁷⁸ *Id.*

¹⁷⁹ See *id.* at 31–33, 36 (finding “significant correlation” between intensity of public enforcement and “stock market capitalization, trading volumes, the number of domestic firms, and the number of IPOs”). Still, the authors cautioned that their study's results do not show public enforcement as necessarily “more important than private enforcement,” noting that some financial indicators correlate more closely with private enforcement. *Id.* at 37.

¹⁸⁰ *Id.* at 15. The authors nevertheless point out that “resource-based enforcement variables are consistently as strongly associated with robust capital markets as the best performing index of private enforcement (disclosure).” *Id.*

¹⁸¹ *Id.* at 11.

measuring the effectiveness of public enforcement.¹⁸² For the purposes of this Note, the value of Howell and Roe's findings on the intensity of public enforcement lies with their conclusion that improving the regulator's resources has positive effects on financial market development.¹⁸³ This Note's proposals are predicated on the assumption that increased investment in the CSRC's resources represents the government's commitment to securities regulation and enforcement, and in turn financial market development.

Similarly, a study analyzing the relationship between the existence and enforcement of insider trading laws with the cost of equity¹⁸⁴ across many countries found that merely prohibiting insider trading does not affect the cost of equity. Instead, it is the *enforcement* of those laws that is associated with a significant reduction in the cost of equity.¹⁸⁵ Using a sample of 103 countries, Bhattacharya and Daouk analyzed the effects on cost of equity¹⁸⁶ after a country institutes insider trading laws and after they are first enforced.¹⁸⁷ This finding that enforcement of insider trading laws lowers the cost of equity is important for financial market development because a lower cost of equity means that more companies will choose to raise capital, thereby increasing the number of listed firms. Additionally, with less risk of losing their investment to securities fraud and more confidence in the market's integrity, more people will invest.

My assumption that the relationships above apply in China is validated by a study of the CSRC's effectiveness, which found that the regulatory agency's enforcement actions impact stock prices, signaling

¹⁸² See *id.* (“[T]hese variables still improve our understanding here”); cf. Coffee, *supra* note 28, at 258 (relying on budget and staffing data as proxy for intensity of enforcement in order to evaluate effect of intensity of public enforcement in United States on cost of capital).

¹⁸³ Jackson & Roe, *supra* note 53, at 18 (stating that evidence illustrates “significant relationship between national financial outcomes and basic resource-based public enforcement”); *supra* notes 177–80 and accompanying text.

¹⁸⁴ A company's cost of equity is “the expected return to equity investors includ[ing] compensation for the market risk in the investment.” ASWATH DAMODARAN, *INVESTMENT VALUATION* 182 (2002).

¹⁸⁵ Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 76, 78 (2002). Insider trading is thought to raise a company's cost of equity because investors demand a higher return “to protect themselves.” *Id.* at 76. If a country has laws prohibiting insider trading and enforces them, thereby reducing the cost of equity, a company would prefer to list its stock in that country rather than in a market where “insiders trade with impunity.” *Id.*

¹⁸⁶ *Id.* at 79, 85–86.

¹⁸⁷ *Id.* The first prosecution of insider trading laws is “an event of paramount importance” because it signals that the probability of future prosecutions has increased. *Id.* at 85.

that investors do not ignore them.¹⁸⁸ The authors analyzed the effects of the CSRC's enforcement actions from 1999 to 2003 on the stock prices of firms that were subject to those actions and found that the majority of those firms lost value.¹⁸⁹ This loss in value represented either a loss of confidence in the firms, a recognition that they were actually worth less than expected due to less profits or more sanctions, or a negative reputation resulting from the enforcement action.¹⁹⁰ In addition to the negative impact on stock prices, the study also found that companies subject to enforcement actions were more likely to change auditors¹⁹¹ and chief executive officers,¹⁹² indicating that these companies were "taking actions to improve governance."¹⁹³ These results show both that Chinese investors "take heed"¹⁹⁴ of the CSRC's enforcement actions by selling the stock and depressing its market value, and that companies subject to enforcement actions take steps to improve corporate governance.

B. Improving Public Enforcement Is More Appropriate in China's Current Legal and Political Environment

For several reasons, it is unlikely that private enforcement can be strengthened in China's current legal and political environment. Strengthening public enforcement, however, is a more appropriate and viable solution for improving market regulation.

First, Chinese courts are severely handicapped in their ability to fairly and competently adjudicate securities cases. The judiciary's limited independence and authority¹⁹⁵ and the SPC's rules' jurisdictional requirements¹⁹⁶ create opportunities for protectionist interests to inappropriately influence court proceedings. Most prospective defendants would be SOEs because they compose the lion's share of listed companies.¹⁹⁷ It is therefore likely that a local government, as both

¹⁸⁸ See Chen et al., *supra* note 15, at 453–54 (noting that "CSRC's investigations have economic consequences and its actions do have teeth").

¹⁸⁹ *Id.* at 463, 470 ("More than 60% of the sample has negative stock returns.").

¹⁹⁰ *Id.*

¹⁹¹ *Id.* at 475, 478 tbl.7 (finding that 32% of firms subject to enforcement actions change auditors in year of enforcement action, while approximately 9% of firms not subject to enforcement actions change auditors each year).

¹⁹² *Id.* at 478 tbl.7, 479 (finding that 52.1% of firms subject to enforcement actions change CEOs in year before enforcement action and 48.3% change CEOs in year of enforcement action, while approximately 30% of firms not subject to enforcement actions change CEOs each year).

¹⁹³ *Id.* at 479.

¹⁹⁴ *Id.* at 480.

¹⁹⁵ See *supra* notes 66–77 and accompanying text.

¹⁹⁶ See *supra* note 148 and accompanying text.

¹⁹⁷ See *supra* notes 9–15 and accompanying text.

majority shareholder in the defendant SOE and court supervisor, would influence the court to refuse the case or to rule in the defendant's favor.¹⁹⁸

One possible criticism is that the CSRC, as a government agency, faces its own conflict of interest in regulating SOEs and would therefore be hesitant or unwilling to actively bring enforcement actions against them.¹⁹⁹ This would not necessarily be the case, however, because although there is a potential conflict of interest, the “policy dynamics [in the CCP] are complex” and “hardly monolithic.”²⁰⁰ While there certainly are officials who would wish to interfere with or block enforcement actions, there are also others who are “reform-minded,” or focused on developing China's stock markets,²⁰¹ and who can be expected to support the CSRC's actions. Furthermore, because the CCP has staked the legitimacy of its rule on sustaining economic growth,²⁰² it has an interest in fully backing the CSRC's efforts to deter securities fraud. This would further its goals of attracting capital for SOE reforms, advancing stock market development, and reducing the risk of jeopardizing economic development.²⁰³ The CCP should therefore leverage its authority over the government²⁰⁴ to remove obstacles to enforcement as they arise. Finally, it is encouraging to note that the CSRC does not appear to “favor firms with high state ownership.”²⁰⁵

Second, judges may lack the necessary competence to correctly decide complex securities cases.²⁰⁶ Although local governments are responsible for supervising courts, they contain only a small number

¹⁹⁸ *Id.*

¹⁹⁹ See Daniel M. Anderson, Note, *Taking Stock in China: Company Disclosure and Information in China's Stock Markets*, 88 GEO. L.J. 1919, 1934–35 (2000) (hypothesizing that political forces may have hindered CSRC's investigation of one company's financial fraud).

²⁰⁰ Hutchens, *supra* note 9, at 639.

²⁰¹ *Id.*

²⁰² See PEERENBOOM, *supra* note 65, at 172 (discussing CCP's “heavy reliance on economic development as a source of legitimacy”).

²⁰³ Cf. Pistor & Xu, *supra* note 10, at 206 (noting that State Council, which directly monitors CSRC, is “fearful of any repercussions a market collapse might have”).

²⁰⁴ See Hutchens, *supra* note 9, at 640 (noting that CCP “retains macro-level authority over both provinces and agencies,” and that “[i]t could squash . . . internecine warfare”).

²⁰⁵ Chen et al., *supra* note 15, at 469 (stating that mean/median state ownership was 59.8%/62.0% in firms that faced enforcement actions, 60.8%/62.7% in firms that did not face enforcement actions, and that “[t]here is no statistically significant difference in the means and medians”).

²⁰⁶ See PEERENBOOM, *supra* note 65, at 290 (“The overall low level of competence of the judiciary has resulted in many incorrectly decided cases.”); Fu, *supra* note 73, at 210 (stating that judges who preside over economic cases tend to be “the least competent at what they do” because commercial laws are developing and judges need time to study them).

of legally trained officials, many of whom are “often overburdened” with drafting and interpreting legislation.²⁰⁷ It is therefore not only probable that outside interests will improperly influence the judicial process, but also possible that even well-meaning judges will decide cases incorrectly either because of a lack of understanding of legal principles or an inability to devote sufficient time to supervising cases. The CSRC, on the other hand, answers only to the central government²⁰⁸ and is thus better able to enforce the securities laws. While the CSRC has its own problems with the quality and quantity of its employees,²⁰⁹ a focus on improving its resources would be a less time-consuming endeavor,²¹⁰ consistent with the CCP’s preferred approach to implementing legal reforms that are “easiest to achieve.”²¹¹

Third, because the “interests of private individuals” have traditionally been protected only as an indirect result of the government advancing its own interests,²¹² strengthening investor protections must be accomplished in a manner that is palatable and beneficial to the government. Strengthening private enforcement would require the government to grant courts independence from the administrative system in order to reduce external influence and allow for fair adjudication. But greater independence for courts is an unlikely step because it would shift power away from the CCP, local governments, and the procuratorates, thus potentially threatening the CCP’s authority.²¹³ On the other hand, a greater role for the CSRC aligns the interests of, and is mutually beneficial to, the government and individual investors. Through a more active CSRC, the government would maintain its role in regulating the stock markets and guiding their development, while investors would be less likely to be victims of securities fraud.

²⁰⁷ Peerenboom, *supra* note 68, at 76.

²⁰⁸ See *supra* note 123 (explaining that CSRC reports directly to State Council).

²⁰⁹ See Chen et al., *supra* note 15, at 460 (stating that, although the CSRC’s senior executives have “considerable expertise[,] . . . middle and lower level executives lack experience); *Shame Fills a Vacuum in China’s Financial Law Enforcement*, *ECONOMIST*, Mar. 1–7, 2008, at 82 (stating that CSRC seems overwhelmed).

²¹⁰ See PEERENBOOM, *supra* note 65, at 330 (noting that “[i]t will take years” to improve judiciary’s competence); Jackson & Roe, *supra* note 53, at 10 (stating that developing countries “seeking to strengthen financial markets . . . may find it *easier* to build up specialized regulators” rather than courts because courts deal with a “broad array of issues,” and mechanisms for strengthening regulators are “probably better developed and more effective” than assistance programs for judicial reforms); Pistor & Xu, *supra* note 10, at 193 (stating that judiciary’s “expertise in securities matters will take a long time to build”).

²¹¹ PEERENBOOM, *supra* note 65, at 320.

²¹² Jones, *supra* note 57, at 15–16.

²¹³ See PEERENBOOM, *supra* note 65, at 329–30 (describing expected sources of resistance towards judicial independence); Grimheden, *supra* note 71, at 129 (arguing that granting greater judicial independence is sensitive issue and unproductive idea in China).

Finally, the CSRC is better suited than the courts to enforce China's Securities Law. This is because the law is primarily focused on administrative penalties and provides investors with limited civil remedies,²¹⁴ and courts cannot quickly respond to claims that are not expressly covered by law in the absence of the SPC's guidance.²¹⁵ The CSRC would be able to respond quickly even in the absence of express legal rules because it can issue regulations to cover new situations as they arise,²¹⁶ and would be able to translate the government's policy preferences into regulatory and enforcement actions.

In sum, China's current legal and political environment contains various impediments that prevent private enforcement from effectively regulating the stock markets. Still, while the CSRC is better positioned to overcome the obstacles that private enforcement faces, its resources, investigative powers, and the consistency with which it imposes liability need to be improved. The next section advances several proposals for strengthening public enforcement in China in order to facilitate the development of financial markets.

C. *Proposals for Strengthening Public Enforcement*

Given the prevalence of securities fraud,²¹⁷ it is clear that the current level of public enforcement in China is ineffective in deterring much fraud. A higher budget and greater investigative powers would enable the CSRC to increase the probability of detecting securities fraud, and consistent imposition of liability would in turn increase the probability of punishment, thereby improving deterrence. Thus, the government should increase the CSRC's budget so that the agency is better able to hire and train employees, write necessary regulations, conduct market surveillance, and investigate violations. Because it is impossible to make an *ex ante* determination of the optimal level of additional investment, the government should take a gradual approach—observing the effects on the markets of increased regulatory activity, while increasing the CSRC's resources such that it is able

²¹⁴ See *supra* notes 128–32 and accompanying text.

²¹⁵ See *supra* notes 137–40 and accompanying text.

²¹⁶ Shi, *supra* note 24, at 461.

²¹⁷ See Michael A. Lev, *Chinese Like Idea of Stock Market; But Cleaning It Up Will Test Beijing's Capitalist Leanings*, CHI. TRIB., May 29, 2002, at 4 (noting that stock markets are “rife with fraud and insider trading”); Sarah Schafer, *The Shanghai Tell: Last Week's Dip in China's Markets Has Left Beijing More Anxious About Its Economic Control*, NEWSWEEK, Aug. 21, 2007, <http://www.newsweek.com/id/36492> (stating that “fraud, weak corporate governance, [and] poor transparency” plague China's stock markets).

to increase its regulatory activity without imposing unnecessary burdens on the markets.²¹⁸

The CSRC should also be given the power to subpoena witnesses so that it can more thoroughly conduct investigations. Currently, the Securities Law only requires parties under investigation to “offer assistance” and to provide documents in a “faithful manner.”²¹⁹ It does not impose liability for refusing to cooperate or for providing untruthful statements.²²⁰ Without the specter of liability, it is not surprising that parties under investigation do not cooperate, provide untruthful testimony, and recant their earlier statements “[i]n nearly every case.”²²¹ Imposing liability for stymieing CSRC investigations would encourage greater cooperation and improve investigatory efficiency and effectiveness. The benefits of having subpoena power can be illustrated by the difficulty of prosecuting insider trading cases, where the nature of the crime makes it burdensome to gather the evidence necessary for successful prosecutions.²²² Because parties under CSRC investigation are generally uncooperative, the CSRC’s inability to command cooperation compounds the evidentiary difficulties. Public enforcement is particularly important because private enforcement, even when available, does not adequately deter insider trading.²²³ The CSRC, armed with the benefits of a larger budget and the power to issue subpoenas, would be better able to investigate securities crimes—particularly insider trading, which “plague[s]” China’s stock markets²²⁴—thereby increasing the probability of apprehending violators.

Even if armed with a higher budget and subpoena power, the CSRC will not improve deterrence unless it consistently imposes liability for securities fraud. However, the CSRC currently imposes few penalties for securities violations, and those it does impose are rather

²¹⁸ Of course, the amount of money available to the CSRC will depend on overall budgetary considerations. Ideally, the CSRC should receive additional funding that would allow it to increase enforcement intensity up to the point of diminishing returns, where additional regulatory activity would burden the market more than help.

²¹⁹ Securities Law (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 27, 2005, effective Jan. 1, 2006), art. 183, LAWINFOCHINA (last visited Aug. 17, 2008) (P.R.C.).

²²⁰ Ling & Qiao, *supra* note 171.

²²¹ *Id.*

²²² *Id.*; see also Thomas C. Newkirk, Assoc. Dir., & Melissa A. Robertson, Senior Counsel, Sec. Exch. Comm’n, Insider Trading—A U.S. Perspective (Sept. 19, 1998), <http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm> (stating that evidence in insider trading is “almost entirely circumstantial,” and that “[i]nsider trading is an extraordinarily difficult crime to prove”).

²²³ See Coffee, *supra* note 28, at 310 (“[P]rivate enforcement seems to have had little, if any, impact on clearly criminal behavior such as insider trading.”).

²²⁴ Ling & Qiao, *supra* note 171.

weak.²²⁵ Thus, the CSRC needs to improve these aspects of enforcement. The CSRC utilizes three types of administrative sanctions: correction orders, formal warnings or fines, and bans from participation in securities markets and from serving as a senior manager or director of a listed company.²²⁶ The infrequent imposition of these sanctions weakens deterrence because those committing securities fraud reason that they are unlikely to face liability even if caught. Thus, individuals are more likely to engage in securities fraud. For enforcement to effectively reduce the incidence of securities fraud, then, it is imperative that the CSRC actively and consistently impose administrative penalties and refer cases for criminal prosecution.

CONCLUSION

In recent years, financial economists have authored an influential series of articles that link strong minority shareholder protection—exemplified by private enforcement of securities regulations—to greater financial market development. Their findings suggest that transition economies seeking larger financial markets should reform their legal institutions so as to strengthen private enforcement. In the context of China's current legal and political environment, however, various obstacles preclude private enforcement from playing a significant role in market regulation. A more viable strategy for China is to strengthen public enforcement by increasing the CSRC's budget and staffing levels and by granting it greater investigative powers.

This strategy is more likely to be effective in China's legal and political environment. Courts are too institutionally weak to effectively provide relief to aggrieved investors, the CSRC is administratively better positioned to address securities violations, and reforms that do not require a stronger, independent judiciary will not threaten the CCP's political power. This approach to securities regulation will improve investor protection and has been shown to have positive effects on market development. Thus, it will provide long-term benefits for the Chinese stock markets unattainable by the impractical alternative of shoring up private enforcement.

²²⁵ See Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 COLUM. L. REV. 929, 942 (2008) (stating that "number of sanctions seems rather modest given the ubiquity and severity of the problems" with securities violations); Ling & Qiao, *supra* note 171 (noting criticism that "penalties [are] light"); Pistor & Xu, *supra* note 10, at 193 (stating that administrative fines and other sanctions are weak).

²²⁶ Liebman & Milhaupt, *supra* note 225, at 941. A correction order is the least severe sanction and requires a company or individual to "correct certain behavior." *Id.* The CSRC also must refer securities crimes to law enforcement agencies for criminal prosecution. Ling & Qiao, *supra* note 171.