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

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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, China’s remarkable economic growth has improved the lot of hundreds of millions of its citizens and has made it an influential player...
on the world stage. The Chinese Communist Party (CCP), China’s ruling political party, has accomplished these results by gradually implementing reforms rather than using “shock therapy”—an approach that some Eastern European countries applied after the breakup of the Soviet Union. Still, the majority of China’s citizens remain poor and many aspects of the country’s economic and legal systems 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). 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. Although the markets currently list over 1079 companies—the majority of which are SOEs—they are still small compared to markets by half—and it had done so 14 years ahead of the 2015 target date for the developing world as a whole.

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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/NUMUL9UNAH0 (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).


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. Furthermore, as a result of the stock markets’ youth, the time and effort required to develop a formal legal system “virtually from scratch,” and the government’s gradual approach to implementing reforms, the stock markets’ “legal and institutional framework . . . is still relatively primitive by Western standards.”

In a series of influential papers, a group of financial economists commonly known as LLSV (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. 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.

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 influential and provides support for the argument that strengthening private securities litigation should be a necessary element of development strategies in transition economies. 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,” and bases decisions to provide

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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.
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 . . . .”)
financial assistance to developing countries on their “success at implement-
ing the reforms recommended by LLSV.”

Given the influence of the legal origins theory, it is not surprising that commentators invariably suggest that the Chinese government improve private enforce-
ment and “protection of private ownership” by allowing minority shareholders to “raise a private cause of action against a listed com-
pany and its officers and directors.” Experience indicates, however, that “attempts to ‘transplant’ law . . . have usually failed because the legal rules so adopted are incongruent with local customs and traditions.” It is therefore important that the government choose cultur-
ally and institutionally appropriate strategies, lest it waste “scarce developmental resources” on reforms that are “less efficacious than alternative strategies.”

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 litiga-
tion—and to account for the risk that choosing inappropriate strate-
gies will possibly harm development and have negative repercusions. This Note argues that, given China’s history, culture,

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22 Thompson, supra note 20.


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 deter-
rence” 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 Deriva-
tive 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.”).


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. 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. This 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, LLSV sought to determine whether certain legal rules influence the size of financial markets. 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 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), the number of listed companies relative to population size, and the number of initial public offerings (IPOs) relative to population size. 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.” Finally, they measured “rule of law” by asking investors to rate the quality of law enforcement in each country. 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. 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.”

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.

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.

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.

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 foursome, 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.

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

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

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.\textsuperscript{38} It further states that differences in legal rules influence economic outcomes.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{44} Civil law countries also tend to overregulate markets, hindering their development.\textsuperscript{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.

\textbf{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,\textsuperscript{46} it

\begin{itemize}
  \item \textsuperscript{38} \textit{Economic Consequences}, supra note 34, at 4.
  \item \textsuperscript{39} \textit{Id.} at 64.
  \item \textsuperscript{40} \textit{See} Roe, \textit{supra} note 26, at 470–75 (describing effects of common law institutions on financial outcomes as posited by legal origins theory).
  \item \textsuperscript{41} \textit{Id.} at 469–70.
  \item \textsuperscript{42} \textit{Cf. id.} at 470–72 (“Shareholders buy stock more comfortably when they know that a judge will protect them later from insider overreaching.”).
  \item \textsuperscript{43} \textit{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.”).
  \item \textsuperscript{44} \textit{Id.} at 470, 473–74.
  \item \textsuperscript{45} \textit{Id.} at 471.
  \item \textsuperscript{46} \textit{See} Coffee, \textit{supra} note 25, at 5 (“[T]he implications . . . seem profoundly pessimistic for parts of the world seeking to develop deeper, more liquid securities markets.”).
\end{itemize}
has been criticized on numerous fronts—none of which can be detailed completely in this Note. In recent papers, LLS have dismissed some criticisms and acknowledged others, while maintaining that the legal origin theory’s findings are still valid. 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. In response, LLS have argued that because legal origins “shape legal rules protecting investors, these rules cannot be just responding to market development.”

Critics have also argued that, in practice, securities regulation in common law countries is primarily statutory and more intense than in civil law countries; 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.”

Finally, critics have argued that LLS’s studies do not support the conclusion that public enforcement is relatively unimportant compared to private enforcement. 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

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

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.” 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.” 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.

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).
China’s governments traditionally have been large centralized bureaucracies that are vested with executive, legislative, and judicial authority. The concept of judicial independence was never a characteristic of the legal system. For example, during the Qing dynasty—China’s last dynasty, which ruled from 1644 to 1911—magistrates who received no formal legal training 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.” They were subject to strict rules in the exercise of their powers and their “actions were subject to review” by their superiors. They therefore had no meaningful adjudicative power. Adjudication primarily consisted of magistrates proposing decisions to their superiors, subject to revision before being approved.

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.” The judiciary is a part of the bureaucratic hierarchy, with courts 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.

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).

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”).

See generally Spence, supra note 56 (providing comprehensive historical account of China’s dynastic period).

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

Id. at 9.

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.”).


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, \textit{supra} note 1, at 29; Ignazio Castellucci, \textit{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.").


\(^{69}\) \textit{Id.}

\(^{70}\) 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, \textit{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, \textit{Empirical Research into the Chinese Judicial System}, in \textit{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, \textit{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, \textit{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, \textit{Putting China’s Judiciary into Perspective: Is it Independent, Competent, and Fair?}, in \textit{Beyond Common Knowledge: Empirical Approaches to the Rule of Law}, \textit{supra} note 71, at 193 ("[T]he majority of judges have little or no legal education . . .”); Lubman, \textit{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, \textit{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, \textit{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, \textit{supra} note 68, at 71–72, 78–80.
fifty percent of civil judgments go unenforced. This is a result of various factors, including insufficient personnel, unwillingness to enforce against a powerful local party, and the refusal of other agencies to provide assistance.

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

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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.
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.\textsuperscript{85} Policies still trump laws, as exemplified by the CCP’s extralegal interference with “day-to-day governance,”\textsuperscript{86} the use of internal CCP rules instead of judicial sanctions to punish party members for legal violations,\textsuperscript{87} and judges’ use of “ideological discretion” when deciding cases.\textsuperscript{88}

The Chinese legal system also traditionally placed greater emphasis on penal laws and “control and discipline,”\textsuperscript{89} hindering the development of civil laws\textsuperscript{90} 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.\textsuperscript{91} Instead, village mediation committees dealt with disputes between individuals and used “customary law” to resolve them.\textsuperscript{92} In modern China extrajudicial means, such as mediation, continue to play an important role\textsuperscript{93} due to government encouragement\textsuperscript{94} as well as the “expensive and time-consuming” nature of litigation.\textsuperscript{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.\textsuperscript{96}

\textsuperscript{85} Peerboom, 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”).
\textsuperscript{86} Id. at 214.
\textsuperscript{87} Id.

\textsuperscript{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.”).
\textsuperscript{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).
\textsuperscript{91} Id. at 11–13.
\textsuperscript{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).

\textsuperscript{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”).
\textsuperscript{94} Fu, supra note 73, at 198 (stating that mediation is “actively promoted and organized by the government”).
\textsuperscript{95} Lubman, supra note 7, at 220.
\textsuperscript{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 markets\(^ {103}\) in

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\(^{97}\) 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.


\(^{102}\) 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*
Shanghai and the southern city of Shenzhen. 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 SOEs with private savings, to end their reliance on borrowing from state-owned banks, and to improve their efficiency and long-term prospects. 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 banks and the real estate market to the stock markets, the government could reduce the extent of social instability in the event of bank

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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 Henrietta B. pmb. (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.
failures and relieve inflationary pressures in the real estate market. 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. The state ensured that it maintained control by establishing that state and legal-person shares—constituting the majority of SOEs’ outstanding equity—were not publicly tradable.

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


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 & Howe, supra note 27, at 43.

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 & Howe, 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.


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 & Howe, 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.\textsuperscript{118}

In 2005, the government began reforming the split-share structure by converting nontradable shares into tradable shares.\textsuperscript{119} By the end of 2006, listed companies representing 97.9\% of the stock markets’ capitalization had completed the reforms.\textsuperscript{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.\textsuperscript{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),\textsuperscript{122} made the China Securities Regulatory Commission (CSRC) the principal market regulator.\textsuperscript{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”\textsuperscript{124} caused by a “confused

\textsuperscript{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.


\textsuperscript{120} Guo et al., supra note 106, at 19.

\textsuperscript{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).

\textsuperscript{122} This Note refers to it as the 1998 Securities Law.

\textsuperscript{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).

\textsuperscript{124} Chen et al., supra note 15, at 458.
The CSRC’s responsibilities include supervising the primary and secondary securities markets, securities firms, and other organizations in the securities business, as well as investigating and penalizing those who violate the law. Prior to the law’s passage, a hodgepodge of national laws and administrative regulations prohibited insider trading, market manipulation, and false disclosures. While these national laws detailed comprehensive administrative sanctions for securities fraud, civil remedies for investors were limited. The 1998 Securities Law imposed harsher governmental penalties and enhanced the power of the CSRC, but did not “strengthen provisions concerning civil liability and civil compensation.” 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.

**D. Private Securities Litigation**

As early as 1996, investors repeatedly attempted to file civil suits against listed companies, 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

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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”).
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 (“Seventeen 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).
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. 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 Congress has passed a relevant law and the Supreme People’s Court (SPC) has issued detailed legal interpretations. 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, as Chinese courts “have traditionally hesitated to act without sufficient basis” for finding such a right. 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 assets . . . . 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.
137 Chen, supra note 8, at 464–66. Chen notes that this process can take five years or more.
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 prescribed 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

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141 Hutchens, supra note 9, at 606.
142 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).
143 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).
144 Id. at 632–34. 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.
145 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 of 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.
146 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.
147 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. For each country, they compiled indices of legal rules that they had quantified: the strength of disclosure requirements; the procedural ease with which investors can seek recovery of losses; the strength of disclosure requirements; the procedural ease with which investors can seek recovery of losses; the number of legal elements that investors are required to prove in court. Id.

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, the scope of its rulemaking authority, and the extent of its investigative powers; and the strength of criminal and noncriminal sanctions. 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), the ratio of the number of listed companies to population size, the ratio of total capital raised through IPOs to GDP, the median premium paid for acquiring controlling blocks of shares, the ease with which firms can raise capital on stock markets, and stock market liquidity.

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

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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 . . . .”).


\(^{170}\) Hutchens, supra note 9, at 603.


\(^{172}\) 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.\textsuperscript{173} To this end, the intensity of public enforcement may explain differences in the level of financial development.\textsuperscript{174}

In a recent paper, Professors Howell Jackson and Mark Roe sought to analyze the effects of enforcement on stock market development.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{178}

Proceeding on this basis, Jackson and Roe concluded, contrary to LLS’s findings, that public enforcement positively influences measures of financial market development.\textsuperscript{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.”\textsuperscript{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.”\textsuperscript{181} Although budget and staffing levels may therefore be a “noisy proxy,” they provide a useful starting point for

\textsuperscript{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.”).
\textsuperscript{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”).
\textsuperscript{175} Jackson & Roe, supra note 53, at 1.
\textsuperscript{176} Id. at 1–2, 10–11, 15.
\textsuperscript{177} Id. at 10.
\textsuperscript{178} Id.
\textsuperscript{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.
\textsuperscript{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.
\textsuperscript{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 equity\(^{184}\) 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 equity\(^{186}\) 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

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\(^{182}\) 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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 auditors\textsuperscript{191} and chief executive officers,\textsuperscript{192} indicating that these companies were “taking actions to improve governance.”\textsuperscript{193} These results show both that Chinese investors “take heed”\textsuperscript{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.

\textbf{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 authority\textsuperscript{195} and the SPC’s rules’ jurisdictional requirements\textsuperscript{196} 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.\textsuperscript{197} It is therefore likely that a local government, as both

\textsuperscript{188} See Chen et al., \textit{supra} note 15, at 453–54 (noting that “CSRC’s investigations have economic consequences and its actions do have teeth.”).
\textsuperscript{189} \textit{Id.} at 463, 470 (“More than 60\% of the sample has negative stock returns.”).
\textsuperscript{190} \textit{Id.}
\textsuperscript{191} \textit{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).
\textsuperscript{192} \textit{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).
\textsuperscript{193} \textit{Id.} at 479.
\textsuperscript{194} \textit{Id.} at 480.
\textsuperscript{195} See \textit{supra} notes 66–77 and accompanying text.
\textsuperscript{196} See \textit{supra} note 148 and accompanying text.
\textsuperscript{197} See \textit{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.\textsuperscript{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.\textsuperscript{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.”\textsuperscript{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,\textsuperscript{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,\textsuperscript{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.\textsuperscript{203}

The CCP should therefore leverage its authority over the government\textsuperscript{204} 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.”\textsuperscript{205}

Second, judges may lack the necessary competence to correctly decide complex securities cases.\textsuperscript{206} Although local governments are responsible for supervising courts, they contain only a small number
of legally trained officials, many of whom are “often overburdened” with drafting and interpreting legislation.\footnote{Peerenboom, supra note 68, at 76.} 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 government\footnote{See supra note 123 (explaining that CSRC reports directly to State Council).} 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,\footnote{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).} a focus on improving its resources would be a less time-consuming endeavor,\footnote{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”).} consistent with the CCP’s preferred approach to implementing legal reforms that are “easiest to achieve.”\footnote{Peerenboom, supra note 65, at 320.}

Third, because the “interests of private individuals” have traditionally been protected only as an indirect result of the government advancing its own interests,\footnote{Jones, supra note 57, at 15–16.} 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.\footnote{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).} 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.

\footnote{Peerenboom, supra note 68, at 76.}
\footnote{See supra note 123 (explaining that CSRC reports directly to State Council).}
\footnote{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).}
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, and courts cannot quickly respond to claims that are not expressly covered by law in the absence of the SPC’s guidance. 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, 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, 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

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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.
to increase its regulatory activity without imposing unnecessary burdens on the markets.\textsuperscript{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.”\textsuperscript{219} It does not impose liability for refusing to cooperate or for providing untruthful statements.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{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.\textsuperscript{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 “plag[ue]s” China’s stock markets\textsuperscript{224}—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

\textsuperscript{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.


\textsuperscript{220} Ling & Qiao, supra note 171.

\textsuperscript{221} Id.


\textsuperscript{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.”).

\textsuperscript{224} Ling & Qiao, supra note 171.
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. 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.