A Sphinx Riddle? The Multi-party Governance Problems in China’s Securities Market

Chenglong Lu

Ph.D. Candidate, Guanghua Law School of Zhejiang University, China
Grotius Research Scholar, the University of Michigan Law School, U.S.

Draft for the 2015 Summer Institute Student Colloquium at Coase-Sandor
Institute for Law and Economics, July 16-17, Chicago

Please do not cite or circulate without author’s express permission
CONTENT

I. INTRODUCTION ................................................................................................................................................. 2

II. THE CHAOTIC GOVERNANCE PHENOMENA IN CHINA’S SECURITIES MARKET ............ 4
   A. A Brief History of China’s Securities Market and Laws ................................................................. 4
   B. Chaotic Phenomena I: Low Efficiency Administrative Regulation ............................................. 6
   C. Chaotic Phenomena II: Dilemma of China People’s Court and Private Litigation ...................... 7
   D. Chaotic Phenomena III: Lost and Absence of Adequate Market Mechanisms ......................... 9

III. KEY GOVERNANCE VARIABLES OF THE SECURITIES MARKET: THE CORE LAYER .. 11
   A. The Optimism Governance Rationale .............................................................................................. 11
   B. The Core Layer: Microscopic Governance Variables ...................................................................... 13

IV. ANSWERS TO SPHINX: FROM THE PERSPECTIVES OF COMPARATIVE ADVANTAGES 19
   A. Participants of Securities Market Governance .............................................................................. 19
   B. A Tiger without Teeth: Malposition of Public Governance Mechanisms ..................................... 20
   C. Excessive Governmentalization of Quasi-public Players: SE, NAFMII and SAC .................... 26
   D. Absence of Private Litigation and Governance ............................................................................ 33
   E. Shortage of Reputation Mechanism among Market Gatekeepers ............................................. 36

V. CONCLUSION ....................................................................................................................................................... 39
I. INTRODUCTION
In the past thirty years, the securities market in People’s Republic of China has made significant achievements. It effectively promotes the growth of social wealth and a market economy. According to the newest statistics, the total capitalization of the Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) has reached 23.91 trillion Chinese Yuan (hereafter refers to “Yuan” or “RMB”) in 2013, equivalent to 42.03% of China’s Gross Domestic Product. However, its inherent deficiencies namely, the inefficient distribution of governance resources problems, also emerged during the development of the market economy. These deficiencies further limit the securities market to play a significant role in pricing and allocating capital in China.

Backing into the history, China’s securities market was initially designed to serve particular political goals, and thus inevitably was colored with planned economic characters. Even after the year of 1998, China central government has still been trying to bailout the market by promulgating more policies that have no solid standings, while some local governments were also motivated to “protect” their local listed companies. Nevertheless, China’s immature market mechanisms are unable to discover and punish these immoral and illegal behaviors, such as market manipulation, misstatement and insider trading. Moreover, courts in China still lack adequate power and capacities to deal with these securities cases. Particularly in the year of 2001, the Supreme People’s Court of China even issued a release to emphasize that “due to the limitation of the legislative and judicial conditions of the present time, it is not high time to accept and try this kind of cases.” As a result, greed and willingness to take chances sometimes lead to the spread of speculation and misconducts, and further cause the failure of voting by feet mechanism and contribute to the formation of lemon market. Therefore, such historical backgrounds indicate severe potential governance problems for the marketization process of securities market which is like a Sphinx Riddle.

Under the circumstance, there is no doubt that China should improve its governance abilities by new legislation and amendments. But how could China solve this riddle?

What should the rationales be behind such legal reforms? In China’s traditional philosophy of Lao Tze, “the Way bears sensation, sensation bears memory, sensation and memory bear abstraction, and abstraction bears all the world” explained how the world form and evolve.\(^9\) Thus, what could constitute “the Way” in the field of securities regulation now? In fact, there are many key governance variables that could significantly impact the securities market. These include information, supervision, technology, remedy and definition.\(^10\) Meanwhile, different governance entities (governmental branches, self-regulating organizations, courts, etc.) have their respective comparative advantages on different variables.\(^11\) Accordingly, the market governance efficiency would be optimized if the governance resources were allocated to the entities that have comparative advantages over the relevant variables. Therefore, for the sake of achieving an efficient governance structure, China must identify these key governance variables, analyze the comparative advantages of each player, and find an efficient way to re-allocate the governance resources. In further, in order to make the best use of the late-developing advantage, experiences from mature capital markets are of vital importance. Since the early days of twenty century, the U.S. has accumulated lots of experiences on securities regulation, and thus formed a relatively comprehensive and efficient legal system.\(^12\) Though China has many differences compared with the U.S. model, the U.S. rules are at the leading position in the world. Thus, by the comparison with extraneous experiences from mature capital markets, China could be inspired on how to reallocate these governance variables and entities comparative advantages appropriately.

In this article, Part I would briefly retrospect development history of China’s securities market and demonstrate the chaotic phenomena in China’s securities market, namely, the low efficiency of administrative regulation, the absence of adequate market mechanisms and the dilemma of the China People’s Court. On this basis, the article could reveal the misallocation problems of governance resources in the securities market. Part II would clarify that there is a series of key governance variables could shape the market governance greatly. Depending on the extent of relevance and regulation possibilities, these variables could be divided into three layers: the microscopic level, the mesoscopic level and the macroscopic level. The article would focus on the microscopic level, as they are not only the most direct ones, but also the most influential. They also constitute the foundation of securities regulation in China. In Part III, the article would analyze the reasons under the mentioned chaotic phenomena of securities market from the perspectives of comparative advantages. The article argues that different market governance entities should have different comparative advantages. Only when their

---

\(^9\) Lao Tze, Tao Te Ching (道德经), Ch. 42.

\(^{10}\) These variables and entities’ comparative advantages would be discussed detailed later. It is partly inspired by the methodologies and findings from Stavros Gadinis, Howell E. Jackson. In their article, by testing several specific variables, they categorized eight jurisdictions in three distinct models of allocation of regulatory powers. See Stavros Gadinis & Howell E. Jackson, Markets as Regulators: A Survey, 80 Southern California Law Review 1239 (2007).

\(^{11}\) The theory of comparative advantage could also be used to analyze the governance problem of securities market. The history of comparative advantage could be found in Maneschi’s article. See Andrea Maneschi, Comparative Advantage in International Trade: A Historical Perspective, 2 (Edward Elgar Publishing, 1998).

\(^{12}\) As early as 1911, Kansas passed the first blue sky law, and then 47 of 48 states adopted their blue sky laws mainly because of the broad-based political movements from 1911 to 1931. The 1933 Securities Act and 1934 Securities Exchange Act constitute the foundation of American legislation. See Paul G. Mahoney, the Origins of the Blue-sky Laws: A Test of Competing Hypotheses, 46 J.L. & Econ. 229, 249 (2003).
governance merits were exerted adequately, could they achieve their best governance effect. In this part, the article would firstly draw the whole picture of multi-party governance in the securities market, and then analyze how the key governance variables are mismatched with their respective governance entities. In the final Part IV, the article would have a brief summary of the whole discussion, and put forward several legislative suggestions regarding the reallocation of governance resources.

II. THE CHAOTIC GOVERNANCE PHENOMENA IN CHINA'S SECURITIES MARKET

A. A Brief History of China’s Securities Market and Laws

“Securities” is not an original concept in the long history of China. It was transplanted from Japan during the late Qing Dynasty, though they had already existed before. During the period of Beiyang Government (1912–1928), the securities market became more and more prosperous. Especially in the year of 1921, about 136 to 150 exchanges were established in Shanghai. Meanwhile, from 1904 to 1949, many securities related laws were promulgated to regulate the market, including the Qing Corporation Code (1904), Beiyang Government Securities Exchange Law (1914), the Nanjing Nationalist Government Corporation Law (1929, 1946) and the Amended Securities Exchange Law (1935). However, good time doesn’t last long. As the beginning of Anti-Japanese War in 1930s, nearly all of these exchanges were closed and everything were changed because of the unstable social situations. After PRC’s foundation in 1949, though the central government once tried to restore the securities exchanges and bonds markets, they finally let the securities step down from the history stage in the following decades as the establishment of Planned Economy. Thereafter, China stepped into an era which people were flooded with all kinds of distribution certificates except securities.

As the enablement of China Economic Reform, China’s securities market stepped into a Period of Anabiosis and Restarting. Under the guidance of the famous quotation: “It doesn’t matter whether it’s a white cat or a black. A cat that catches mice is a good cat”, Chinese governments and state-owned enterprises (hereafter refers to “SOE”) started to explore new ways of financing. In 1980, Chengdu Industry Exhibition and Selling Trust Company issued the first stock, 24,010,000 non-public shares, which marked the recovery of China’s securities market. In the following year, China restarted its bonds issuance as well. Then, from 1983 to 1985, several companies successively issued their “stocks”, thereof Shanghai Feile Acoustics Equipment Producing Co.’s stocks were the first widely-recognized formal stocks since 1949. Anyway, in the first decade’s experiment, China’s securities market gradually developed, extending to four categories

14 See Bryna Goodman, Questions of Colonialism, Nationalism, and the Early Shanghai Stock Market, 1 Provincial China 1, 1 (2009).
and nineteen types of securities.

After 1991, China entered the Period of Fast Increasing. It particularly worth mentioning that SSE and SZSE were founded in 1990-1, which made centralized trading became possible. From the year of 1991 to 1996, the number of issued shares of China A-share increased from 0.5 billion to 3.839 billion, raising 54.658 billion Yuan totally. Meanwhile, the government bond issuance also increased from 28.125 to 151.081 RMB, and they were allowed to trade at stock exchanges in 1992.\(^{19}\) During the first two periods, China also promulgated several temporary or regional rules.\(^{20}\) These regulations and rules contributed quite a lot to the early development of securities market, providing legality basis to some extent. Since 1997, China’s securities market finally stepped into the new Period of Normative Development, and thus achieved great developments (See Chart 1). Meanwhile, China’s securities legislation gained fast development as well. According to an incomplete statistics, China promulgated more than one hundred securities related laws, regulations and rules between 1997 and 1998,\(^{21}\) which was quite rare since 1978. Among them, Procedures on the Administration of Issuance and Transfer of Enterprise Bonds (1998), Interim Measures on the Management of Securities Investment Funds (1997) and Securities Law (1998) and its 2014 Amendment are of vital importance for China’s capital market. Specifically in the year of 2005, China passed Measures for the Administration of the Share-trading Reform of Listed Companies (2005), and thus invoked a more active securities market.

Chart 1: The Total Share A and B Market Statistics at SSE by the end of 2014

(The right axis number applies to the index of Trading Share, the left axis number applies to the left three) (Data Source: Shanghai Stock Exchange Website-Market Information, the Chart is drawn by author)\(^{22}\)


\(^{22}\) Shanghai Stock Exchange Website: Market Information, available at http://www.sse.com.cn/market/, last viewed
B. Chaotic Phenomena 1: Low Efficiency Administrative Regulation

As we can see from the above Chart, China’s stock market has made great achievements, but it apparently looks like the Hulk (a roller coaster) in the Orlando Universal Studio. Actually, behind this Hulk is the protuberant chaotic phenomena in China’s securities market governance. First of all, the low efficiency administrative regulation is the most obvious one. According to Securities Law of the People’s Republic of China (2014 Amendment) (hereafter refers to 2014 Securities Law), China Securities Regulatory Commission (CSRC) is authorized to carry out centralized and unified supervision and administration of the national securities market, and to regulate the securities market aiming to ensure its orderly and legitimate operation. Meanwhile, according to the authority, the CSRC also has the responsibility to perform regulation function over the futures market of China, and to maintain an orderly futures market. In the year of 2013, the CSRC closed 86 cases (see Chart 2), including non-compliant information disclosure, insider trading, market manipulation. Moreover, in these limited enforcements, the CSRC enforced its insider trading prohibition function according to a non-legal internal administrative guidance: (Provisional) Guide for the Recognition and Confirmation of Insider Trading Behavior in the Securities Markets. In contrast, in the same year, the U.S. Securities and Exchange Commission (SEC) brought 686 enforcement actions towards the securities market alone and 92% of them were solved.

Chart 2: CSRC Cases Summary

(Source: China Securities Regulatory Commission 2013 Annual Report)

On the other hand, the securities regulation framework is fragmented, and is affected by

path dependence. Apart from the centralized stock market regulation by the CSRC, other securities regulation is complicated. In the market of bonds, the governmental bond is under the control of China Treasure Department, while the enterprise bonds is under the National Development and Reform Commission (NDRC)’s governance. Meanwhile, according to Administrative Measures for Debt Financing Instruments of Non-Financial Enterprises in the Inter-bank Bond Market, People’s Bank of China (PBC) and National Association of Financial Market Institutional Investors (NAFMII) are responsible with the inter-bank bond market of China, authorized to regulate the inter-bank securities, including the medium-term notes, the small and medium sized corporate collective notes, the commercial papers, the private placement notes, the asset backed medium-term notes and the project revenue notes.

More importantly, till now, the regulation approaches over these securities are quite different in different markets, even though they are all “bonds”. For instance, regarding the securities issuance issue, the inter-bank market executes registration approach, the enterprise bonds issuance takes the verification approach, and the corporate bond issuance is under the examination and approval review. Under the circumstance, the issuers, the intermediaries and regulators are faced with quite different regulations, though they are all non-governmental related bonds. Thus, the low regulation and market efficiency become inevitable.

C. Chaotic Phenomena II: Dilemma of China People’s Court and Private Litigation

Courts, should be the final defense and remedy for the securities market. However, when we look back to the Chinese courts, they are still lacking of the adequate abilities to deal with the securities cases. At the very beginning, faced with the investor litigations again Yin Guang Sha who was found to misstated their profit for consecutive years, the Supreme People’s Court of China (SPC) once issued the Notice of the Supreme People’s Court on Refusing to Accept Civil Compensation Cases Involving Securities for the Time Being, which required the courts not to accept securities related cases because of the

28 Path Dependence problem was initially raised by P. A. David, and he used the example of QWERTY array of the computer keyboard, to illustrate the technological dependence phenomenon. In other words, even though the QWERTY keyboard is not the most efficient keyboard, people are still unwilling to try the new ones because of the learning costs. Meanwhile, this kind of dependence also has its self-reinforcement mechanism, and causes the increasing returns. See P. A. David, A. Clio and the Economics of QWERTY, 75 the American Economic Review 332 (1985).


judicial ability limits. Then, under the pressure from the public, SPC released a new Circular, Some Provisions of the Supreme People’s Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market, which finally provides a legal regime for investors to conduct private litigation against the misstatement. Today, though China has allowed courts to accept securities related civil compensation cases, the litigation is still not easy for investors. According to the Some Provisions of the Supreme People’s Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market, the plaintiff should firstly get the “decision on administrative penalty by a relevant organ” or “a criminal order or judgment by the People’s Court” before bringing suits for civil compensation. Meanwhile, as the class action in China is still absent, the legal enforcement become more difficult.

Under the circumstance, the investors have to wait for the administrative or criminal decision firstly. However, the number of administrative or criminal conducted by relevant institutes is very limited, and the waiting time would be relatively longer than the direct private litigation. According to Prof. Hui Huang’s empirical research, the number of private securities litigation against misstatement in China was really small. From 2002 to 2011, there are only 65 cases (see Chart 3). In addition, regarding the market manipulation case, the first case has not appeared in China’s court till 2011, eighteen investors v Whenshui Cheng and Yanze Liu. It is a pity that we could even not get to know the names of the eighteen investors, which also helps to illustrate the judicial dilemma and challenges in China. Even in the most developed city of Shanghai, cases against public company cases are fairly rare, let alone the securities disputes, and let alone the other cities in China.

---

D. Chaotic Phenomena III: Lost and Absence of Adequate Market Mechanisms

In the traditional Chinese culture, mercantilism is not so popular, and quite different from the doctrines since Lutheranism. On contrast, the Confucianism influences China deeply. In the famous *Confucian Analects*, it indicates that “the officer, having discharged all his duties, should devote his leisure to learning. The student, having completed his learning, should apply himself to be an officer.”

Under the coefficients of plan economy before 1990s, China’s securities market was far away from maturity. Since the securities market was established in 1990s, it definitely shows different scenes from mature capital market. The shares of listed company are divided as state shares, legal person shares, individual shares and foreign capital shares, indicating very different transferability. What’s more, the transaction of these stocks were strictly confined within the respective categories originally. Meanwhile, stocks were categorized into four types: A-shares, B-shares, H-shares and N-shares.

Apart from the price roller coaster, the issuance price mechanism of IPO is also confusing. According to a recent research, China’s IPO underpricing has been up to 181.6% averagely in the past two decades, which is much higher than America’s 16.9%, United Kingdom’s 16.3% and Germany’s 25.2 %.

In fact, at the beginning of 1990s, the IPO price was determined by the governments directly. As the establishment of Securities Law in 1998, the issuance price could be theoretically decided by the issuer and the underwriter, but still faced with the review from the CSRC. Even after the Price Inquiry System for IPO was founded in 2004, the CSRC could still influence the pricing by controlling the Price Earning Ratio and the regulation of inquiry investors’ qualification for a long time.

43 See Confucius, *Confucian Analects* (论语), Book XIX: Tsze-Chang
It worth mentioning that Shenzhen has ever allowed the issuance of the so called “stock subscription lottery” to solve the problems of demand exceeding supply. Cooperated with all kinds of administrative measures and bailout policies, China’s stock market was not a normal market. For instance, from 1994 to 2001, the performance of China’s stock market even outpaced several world’s leading indexes, such as Japan’s Nikkei 225, Hong Kong’s Hang Seng Index and the Dow Jones World Emerging Markets Index. More importantly, as the absence of mature institutional investors, China’s securities market looks like an unlevel playing “casino” market. (See Chart 4) From the below chart, it is easy to find the number of institutional investors is quite small compared with individuals, totally 79.91 (Unit: 10,000) on the SZSE and SSE’s stock market, though they controls more than half of the market value. (See Chart 5)

Chart 4: Shareholder’s Accounts at SZSE and SSE

(The right axis number applies to the number of institutional investors, the left axis applies to individuals)
(Data Source: SZSE and SSE 2013-4 Statistics Annual, the Chart is drawn by author)


48 See Sheldon Gao, China Stock Market in Global Perspective, Dow Jones Indexes (Sept. 2002); Also see Jiangyu Wang, Dancing with Wolves: Regulation and Deregulation of Foreign Investment in China’s Stock Market, Asian-Pacific Law and Policy Journal 1, 10 (2004).

49 Nicholas C. Howson, Enforcement Without Foundation?—Insider Trading and China’s Administrative Law Crisis, American Journal of Comparative Law 955, 957 (2012).

Chart 5: Share Hold of Investors at SSE

<table>
<thead>
<tr>
<th>Identity</th>
<th>Hold Value (100 M)</th>
<th>Hold Account (10 T)</th>
<th>Ratio</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual</td>
<td>29609.52</td>
<td>2954.88</td>
<td>21.78</td>
<td>99.78</td>
</tr>
<tr>
<td>&lt;100 T</td>
<td>5435.57</td>
<td>2490.95</td>
<td>4</td>
<td>84.11</td>
</tr>
<tr>
<td>100 T-300 T</td>
<td>5180.36</td>
<td>307.7</td>
<td>3.81</td>
<td>10.39</td>
</tr>
<tr>
<td>300 T-1 M</td>
<td>6095.23</td>
<td>119.18</td>
<td>4.48</td>
<td>4.02</td>
</tr>
<tr>
<td>1 M-3 M</td>
<td>4545.93</td>
<td>28.2</td>
<td>3.34</td>
<td>0.95</td>
</tr>
<tr>
<td>3 M-10 M</td>
<td>3612.39</td>
<td>7.27</td>
<td>2.66</td>
<td>0.25</td>
</tr>
<tr>
<td>&gt;10 M</td>
<td>4740.04</td>
<td>1.58</td>
<td>3.49</td>
<td>0.05</td>
</tr>
<tr>
<td>Ordinary Institution</td>
<td>86517.26</td>
<td>3.89</td>
<td>63.64</td>
<td>0.13</td>
</tr>
<tr>
<td>Professional Institution</td>
<td>19817.31</td>
<td>2.73</td>
<td>14.58</td>
<td>0.09</td>
</tr>
</tbody>
</table>

(Source: Shanghai Stock Exchange 2014 Statistics Annual)  

The chaotic phenomena of the securities market also manifests on the immaturity of market intermediaries who sometimes conspire with companies’ illegal behaviors. For instance, regarding the issue of tunneling, cases like ST Hong Guang, Yin Guang Sha and Zheng Bai were all involved with the illegal behaviors from accounting or auditing firms. Especially in the recent case of In re Longtop Financial Technologies Ltd. Securities Litigation, the low credibility of financial statements were severely criticized. Even though there are plenty of legal liability rules covering the criminal, civil and administrative liabilities on intermediaries, the actual effect was quite limited. According to a rough statistics, there were only 457 settled misstatement cases from 2001 to 2012, but cases regarding intermediaries were only 36. In addition, the Securities Association of China (hereafter refers to “SAC”) is usually like a flower vase, mainly in charge of education and examination. Under the circumstance, the performance of gatekeeper mechanisms is worrying.

III. KEY GOVERNANCE VARIABLES OF THE SECURITIES MARKET: THE CORE LAYER

A. The Optimism Governance Rationale

Even though China’s securities market has made greatly progress, these chaotic phenomena could not be ignored. How could these phenomena happen? How to enhance the governance efficiency? In my views, these questions rely on the fundamental improvement of governance power allocation. But what would influence the governance power allocation? I hypothesize that there are some key governance variables could shape the stock market greatly, such as information, supervision and remedy. Meanwhile, different governance entities, said government branches, self-regulating institutions and courts, have respective comparative advantages on specific respective variables. For instance, the stock exchange usually has more comparative advantages on information

54 See Jun Zhao and Chenglong Lu, Prevention of Self-interest Acquisition of Holding Shareholder of Listed Companies, 34 Modern Law Science 83, 94 (2012).
supervision, while the governmental institutions have more capacities on legal sanctions. Thus, if the governance resources could be allocated to the entity which has comparative advantages over relevant variables, the market governance would be optimized. Thereafter, governmental departments, self-regulating institutions and courts, could take their most suitable responsibilities, and achieve an optimal governance structure. Moreover, if this new governance could be achieved, China’s capital markets could be further developed, providing more financing opportunities for the increasing SMEs and enhancing global competitiveness.

Thus, based on the literature review and market observation, I further hypothesize that there are three levels of governance variables in the securities market, and organize them according to the level of relevance as Chart 6. According to the effect extent and the legislation possibility, the variable of information, supervision, remedy, technology and securities definition. They have the most influence on securities market. Then, liquidity, concentration, scale, coupling and fashion, constitute the second layer of key variables. Even though they could be arranged by legislation, they fundamentally belong to the market mechanism which could not be controlled by authorities in a mature market economy. Finally, internationalization, macro economy policies, fiscal policies, monetary policies and the GDP scale would contribute to the development of securities market as well. This level of variables could not easy be controlled by laws. The article collectively refers layer 2 and layer 3 as non-core layer, and layer 1 as the core layer. Therefore, according to the legislation controllability, the article would focus on the core layer.

Chart 6: Key Governance Variables in Securities Market

**Chart 6: Key Governance Variables in Securities Market**

<table>
<thead>
<tr>
<th>Layer 1</th>
<th>Layer 2</th>
<th>Layer 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information</td>
<td>Supervision</td>
<td>Technology</td>
</tr>
<tr>
<td>Enforcement</td>
<td>Information</td>
<td>Definition</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Coupling</td>
<td>Fashion</td>
</tr>
<tr>
<td>Concentration</td>
<td>Scale</td>
<td>GDP</td>
</tr>
<tr>
<td>Monetary Policy</td>
<td>Internationalization</td>
<td>Fiscal Policy</td>
</tr>
<tr>
<td>Scale</td>
<td>Real Estate Policies</td>
<td>Internationalization</td>
</tr>
<tr>
<td>GDP</td>
<td>Fiscal Policy</td>
<td>Monetary Policy</td>
</tr>
</tbody>
</table>

**Layer 1:**
* Information means all information that could influence the entities in the securities markets.
* Supervision means the measures to discover the violations and prevent illegal behaviors.
* Technology means the trading innovation and professional knowledge and experience, including the trading productions, platforms and professional personnel which could contribute to increase efficiency.
* Enforcement means the legal mechanisms to punish illegal behaviors in the market
* Definition means to the products of securities which would influence the market scale and regulation costs.

---

55 These literature basis would be shown and clarified later in the Part III.
LAYER 2:
* Coupling means the extent of cooperation between different entities under securities laws.
* Liquidity, Scale and Concentration are concerned with the ownership and transferability in securities markets, strongly influencing the collective action, governance structure and law reforms.
* Fashion means the social culture and investment psychology regarding securities trading.

LAYER 3:
* Internationalization means the influence by foreign securities laws, such as America’s FCPA.
* Macro Policies include the economic policies concerned with the securities markets.
* GDP, fiscal and monetary situation will impact the cash supplement of securities markets profoundly.

B. The Core Layer: Microscopic Governance Variables

a. Information is still the lifeblood of securities market. Since the research of George Stigler, information as a key variable in the market, came into the view of modern economics. As the establishment of the Asymmetric Information Theory, the information economics was gradually accepted and developed by scholars, including George Akerlof, Herbert Simon, Kenneth Arrow, Henri Theil, Michael Spence, Sanford Grossman and James Mirrless. Through these efforts, they drew the outline of information economics and then applied it for the securities market. Earlier before the information economics, information, as a key governance variable, had been already used in the securities regulation. Like Justice Brandeis (1856-1941) ever said “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”

When the Securities Act of 1933 (hereafter refers to “1933 Act”) was drafted, there had been a philosophy debate regarding the regulation approach. In the earlier Huston Thompson’s bill draft, it proposed “the Commission may revoke the registration of any security” based on their examination on the soundness of the business and public welfares. Shortly afterwards, Thompson’s draft met fierce criticism as its strictness. In the view of Landis, the bill’s proposal of “controls through the requirement for the registration of securities” contributed to its integral disadvantage. Because of President Franklin Roosevelt’s personal inclination to the Brandeis approach, namely, the information disclosure regulation, “information” start to influence the securities market greatly at the aspect of legislation. Thus, in the following competition between the two draft bills, Frankfurter’s version won and was accepted by the President. In this draft, Frankfurter draft bill fully embodied Roosevelt’s opinions regarding the information

60 See Louis D. Brandeis, Other People’s Money and How the Bankers Use it, 62 (Cosimo Inc., 2009).
disclosure approach, and did not authorize the Federal Trade Commission the power of merit review.

Even though the debating regarding the effect of mandatory information disclosure has lasted for a long time, these criticism have no actual effect on the Senate and Congress so far. For instance, in Stigler’s 1964 article, he argued “the S.E.C. registration requirements had no important effect on the quality of new securities sold to the public.” George Benston also doubted the effect of information disclosure requirements of 1934 Securities Exchange Act. Nevertheless, when Prof. Eugene F. Fama put forward the Efficient Markets Hypothesis, information disclosure and market efficiency gained great attention. Thus, how to improve the information disclosure becomes a key issue to securities market governance. Moreover, the variable of “information” could be further divided into more specific categories, such as trading information (transaction anomalies, transaction prices, market amounts, stock indexes, turnovers, etc.), corporation information (financial statements, business operations, main shareholders, board of directors, lawsuits, etc.), punishment information (judgments, administrative penalties, self-regulating punishments) and other relevant information.

b. Definition is the very starting variable to understand the whole academic building, particularly in the civil law countries (Ignoratis terminis artis ignoratur et ars). Inspired by Wesley N. Hohfeld’s analysis on legal concepts, “definition” is the logic start in securities market governance. As the central mission of securities regulation is to balance the governmental function needs with the capital demanding from the industries, the definition of securities would determine the financing channels of enterprises, especially for the small and medium enterprises (SME). Moreover, the definition of securities would contribute to shape the regulation scope as well. As the case of State v. Gopher Tire & Rubber Co. ever stated, "It is a proper and needful exercise of the police power of the state, and should not be given a narrow construction; for it was the evident purpose of the legislature to bring within the statute the sale of all securities not specifically exempted. The commission is better qualified than the average investor to ascertain whether any real values lie behind mere paper evidences of value.” Meanwhile, among the state laws, the definitions of securities are drafted sufficiently broad to cover as many as types. Therefore, since the earlier days, the definition of

---

70 It is a legal maxim which means if the term of a subject is unknown, the subject is unknown as well.
71 See Wesley N. Hohfeld, Some Fundamental Legal Conceptions as Applied in Judicial Reasoning, 23 Yale L. J. 16 (1913).
73 See State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920).
securities in the U.S. is always growing spontaneously like the growth of corals. In a series of cases, several important tests were also established by the Supreme Court to define the meaning of “security” within the 1933 Act,\textsuperscript{75} including \textit{SEC v. W. J. Howey Co.,}\textsuperscript{76} \textit{Landreth Timber Co. v. Landreth},\textsuperscript{77} and \textit{Reves v. Ernst & Young}.\textsuperscript{78}

On the other hand, in China, the definition would influence the regulation approach. There is a correlation between the definition of securities and the according regulation approaches. For instance, if the CSRC enlarged the definition of securities, the issuance scale and market amount would definitely rocket. Meanwhile, enterprises would have more financing channels, and not excessively depend on the stock markets or the bond markets. They could issue various new securities, and expand their financing abilities. The whole capital market structure would be changed. Moreover, the CSRC could not merit review every securities issuance substantially anymore because of the ability limits,\textsuperscript{79} and the issuance regulation approaches would be modified accordingly. Next, if this reform got quite a lot positive market feedbacks, the capital market would be activated further. Finally, the definition of securities may be widened again to provide more flexible financing channels for enterprises. Conversely, if this new capital market was flooded with speculation or opportunistic behavior, these negative feedbacks would lead the government take stricter issuance regulation approaches again, and thus reduce the issuance scale and securities types accordingly. As a result, it would affect the market activity and economy development. This process is similar to photosynthesis and respiration if we regard the securities market as a banyan tree. Therefore, the definition of securities is a key variable for the securities market governance in China.

\textbf{c. Supervision} means the measures to discover the violations and prevent illegal behaviors. Adam Smith ever said, “He [every individual] intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.”\textsuperscript{80} However, when the 1929 Great Crash happened, the failure of market was well recognized, and the ideal spontaneous order could not satisfy the socio-economic needs.\textsuperscript{81} Thus, governmental intervention becomes necessary, because of the general jurisdiction and coercive power.\textsuperscript{82}

Why supervision could be a key variable? In fact, the method of administrative regulation and law system of privately enforced rights have their respective pros and cons. It is necessary to weigh their strengths and weakness when we try to solve many social

\textsuperscript{76} SEC v. W. J. Howey Co., 328 U.S. 293 (1946)
\textsuperscript{78} See Reves v. Ernst & Young, 494 U.S. 56 (1990).
\textsuperscript{79} See the China’s Taiwan Legislative History of Securities and Exchange Act, 0760321, Vol. 76, No. 45-2052, 17.
\textsuperscript{80} See Adam Smith, \textit{The Wealth of Nations}, 258-269 (Simon & Brown, 2014).
\textsuperscript{82} See Joseph E. Stiglitz, \textit{The Economic Role of the State}, (Blackwell Pub., 1989).
problems.\textsuperscript{83} According to the research of Katharina Pistor and Chenggang Xu, law is usually incomplete because it could not forecast everything in the past and in the future. Meanwhile, as the expression of law language is opening and ambiguous or the intended aims of legislators, law itself could not solve everything of our society. Therefore, the passive law enforcement alone is not sufficient, we need to place special emphasis attention on the allocation of law enforcement and lawmaking especially when the socioeconomic changes exist.\textsuperscript{84} Securities market is a typical public regulation problem, how to distribute the powers between administrative institutions and courts is of vital importance.\textsuperscript{85} Due to the lacking of litigation motivation and compensation possibilities, administrative regulation could provide \textit{ex ante} measures compared with law enforcement system.\textsuperscript{86}

Supervision, could be executed by almost anyone in the market. Investors could supervise the behaviors of the issuer, the brokers, the dealers and the investment advisors by their personal experiences and skills. Administrative agencies could monitor the market by their granted powers, and Self-regulatory Organizations (SRO) could also do so by internal measures and expertise. In the U.S., SEC could achieve the monitoring function by its own detections and inspections before the illegal actions reaching the media, which constitute the most powerful oversight tool.\textsuperscript{87} These investigation includes the inspections of regulated firms, preliminary inquiries, informal and formal investigations.\textsuperscript{88} For instance, based on the Foreign Corrupt Practices Act (FCPA), SEC and DOJ of the United States have initiated the domestic and global governance in anti-corruption efforts. Through empirical de-construction of the cases related to FCPA, we can clearly see that with the development of the U.S. regulation practices. In the cases of \textit{SEC v. ABB Ltd., SEC v. AB Volvo, SEC v. Eni, SEC v. Techip}, it is easily to find the efforts from SEC. Thus, by FCPA, SEC has been moving beyond traditional territorial jurisdiction and personal jurisdiction According to the newest report, in 2011, the number of investigations or cause exams from tips is 349.\textsuperscript{89}

\textbf{d. Technology} is becoming more and more important in today’s securities market. It has not only changed the trading mechanism greatly, but also brought new challenges to traditional securities market. In the early days, brokers and dealers worked busily in the streets or physical stock exchange rooms in London, New York City, or Amsterdam.\textsuperscript{90} These brokers and dealers have great expertise, skills and experiences on all kinds of securities transaction.


Nowadays, as the fast development of computer and internet technologies, the scenes of securities market have greatly changed. Paperless immediate trading becomes common, and geniuses from mathematics, computer science and physics appear in the finance market. As we can see, “modern finance is becoming cyborg finance—an industry that is faster, larger, more complex, more global, more interconnected, and less human.”91 In the views of Prof. Grundfest, the structure of the capital market would be greatly shaped by the computer and information technologies, because it not only could bring the immediate incorporation of information into securities prices, but also could provide adequate mathematical techniques to calculate and implement the trading.92

Therefore, how to face the artificial intelligence and the mathematical models is a great challenge for today’s securities market participants. The High Frequency Trading is a good example, which could enforce front running and affect the volatility abnormally. Based on the extraordinarily high-speed and sophisticated computer program, traders usually submit numerous orders and then cancel them extreme shortly. In this case, even if one microsecond would produce an information advantage over its competitors.93 For another example, the appearance of the Electronic Communication Network (ECN) also challenged the status of stock exchanges, and the regulation regimes. Therefore, as early as in 1996, the National Securities Markets Improvement Act has raised the concerns on information and technology development in securities market,94 and requested the Commission to study and report to Congress on the impact of technological advances on the securities markets.95

Balancing the new software development and the trading technology safety is more and more important. Today, in the emerging securities market, technology advances also become a key concern for all of the participants. In China, SSE and SZSE both have established particular website pages regarding technology support and introduction. Conversely, if the technical variable was ignored, it would bring unexpected disasters. The recent accident of Everbright Securities Company is the best proof. In the case, a trading error caused by a software triggered a surprising spike of SSE, placing accidental buy orders for billions of yuan and huge market volatility.96 Therefore, the technology is a new key variable.

e. Enforcement presents the public, quasi-public sanctions and the private litigation remedies against market violators. Law could only achieve optimal deterrence if the possibilities to catch illegal behaviors and the extent of enforcement are high.97 Gary

Becker and George Stigler have ever divided the enforcement into public enforcement and private enforcement. When the public mechanism is not easy to achieve the best efficiency, private enforcers could contribute to it.\footnote{See Gary S. Becker and George J. Stigler, \textit{Law Enforcement, Malfeasance, and Compensation of Enforcers}, 3 the Journal of Legal Studies 1(1974).} As the old maxim says, \textit{“Ubi jus, ibi remedium”}, where there is a right, there must be a remedy. Thus, the “enforcement” must be a core variable in securities market governance, and courts should definitely play an important role. Actually, according to the author’s observation, enforcement is the very core variable in the securities market governance in the U.S. No matter the administrative measures or the judicial approaches, enforcement is at the center of all.

On one hand, hundreds of years ago, with the introduction of England legal culture, the U.S. inherited the tradition of common law as well. Thus, like the growth of corals, the common law gradually formed a broad array of judicial precedents, and provide powerful enforcements.\footnote{See generally Roscoe Pound, \textit{The Spirit of the Common Law} (Nabu Press, 2014).} Especially the mechanism of class action, the amount of securities class action settlements exceeds all of the public monetary sanctions.\footnote{See Howell E. Jackson, \textit{Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications}, 24 Yale Journal on Regulation 253 (2007).} Even though the class action mechanism is sometimes criticized by its costs and opportunism, it nevertheless perform admirably as a form of high effective deterrence.\footnote{See John C. Coffee, Jr., \textit{Reforming The Securities Class Action: An Essay on Deterrence and Its Implement Action}, 106 Columbia Law Review 1534, 1547 (2006).} Beside the enforcement by private litigation, as mentioned above, administrative agencies could also provide public enforcement. Especially when the damage and violation could be standardization and the level of expected harm (externality) is huge, administrative enforcement would be better.\footnote{See Katharina Pistor and Chenggang Xu, \textit{Incomplete Law}, 35 NYU Journal of International Law and Politics 931 (2002-2003).} In the U.S., SEC is the most powerful regulation institute. In the aspects of sanctions alone, it could issue administrative cease order against federal securities acts, impose monetary penalties, issue temporary suspension or bar from engaging securities trading, stop the IPO and prohibit accounts, lawyers and other participants in securities business to practice again. Meanwhile, it could achieve the monitoring function by its own investigation and administrative proceedings.\footnote{See Richard M. Phillips et al. ed., \textit{the Securities Enforcement Manual: Tactics and Strategies}, 7-8 (American Bar Association2nd ed., 2007).} “The federal securities laws allow the SEC to suspend trading in any stock for up to ten trading days when the SEC determines that a trading suspension is required in the public interest and for the protection of investors.”\footnote{See SEC, Trading Suspensions, http://www.sec.gov/litigation/suspensions.shtml, last viewed on February 15, 2015.}

In addition, the enforcements from the quasi-public institutes, like the stock exchanges and SROs, contribute to securities market’s governance as well. Prof. Benjamin Liebman and Prof. Curtis Milhaupt demonstrated the reputational sanctions in China’s securities market, emphasizing the obvious effect from the stock exchanges’ self-regulating criticism mechanism in governance. Such indirect market mechanisms could also help the investors and strengthen the enforcement power in the market.
IV. ANSWERS TO SPHNIX: FROM THE PERSPECTIVES OF COMPARATIVE ADVANTAGES

A. Participants of Securities Market Governance

As rational investors, companies always seek opportunities where compliance costs are low and capital benefits are high. The global competition among different capital markets is much fiercer than before.\textsuperscript{105} The correlation between enforcement intensity and market competitiveness is become more and more obvious.\textsuperscript{106} By comparing several governance variables across countries, Prof. Howell Jackson recognized the variation in intensity of regulation.\textsuperscript{107} Combined with the research of LLSV, the global market competition is coming nearer and nearer, but the civil law countries have their own internal deficiencies.\textsuperscript{108} In the past decades, as the economic globalization has made countries’ rule of law interrelated,\textsuperscript{109} the U.S. is making efforts to export its rules to foreign countries surreptitiously, taking advantages of its market status.\textsuperscript{110}

However, as demonstrated before, following the regulation philosophy of legal paternalism,\textsuperscript{111} China’s securities market has not yet fully achieved the transformation of marketization. The government is still inclined to take direct administrative intervention measures, and the key governance variables have not been allocated efficiently. Around sixty percent of the listed companies are still directly or indirectly controlled by the State-Owned Assets Supervision and Administration Commission (SASAC) till 2008.\textsuperscript{112} It still provided room for government to take some concealed measures to interfere the market. This historical background indicates a potential problem for the marketization process of securities market. In this case, Market participants, like the SROs, courts and gatekeepers, have not executed their best governance advantages yet.

Therefore, in order to achieve optimal allocation of governance resources, the next work is to allocate these key governance variables to the entity which has comparative advantages. According to the observation on mature capital market and the situation in China, there are three kinds of governance entities: the Public Governance Entities, Quasi-public Governance Entities and the Private Governance Entities. Furthermore, these entities could be divided into more specific ones as shown in the below chart.

\textsuperscript{105} See Hal S. Scott, Internationalization of Primary Public Securities Markets, 63 Law and Contemporary Problems 71 (2000).
\textsuperscript{108} Even though there are many critics regarding LLSV’s research, they still release some advantages of the common law system, See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, Law and Finance, 106 Journal of Political Economy 1113 (1998).
\textsuperscript{109} See M. O. Chibundu, Globalizing the Rule of Law: Some Thoughts at and on the Periphery, 7 Indiana Journal of Global Legal Studies 79 (1999).
\textsuperscript{111} See Joel Feinberg, Legal Paternalism, 1 Canadian Journal of Philosophy 105 (1971).
B. A Tiger without Teeth: Malposition of Public Governance Mechanisms

When the securities market was originally established, due to the political goals and plan economy requirements, earlier securities market regulation was lack of unification and stable. Taking the stock issuance regulation as an example, from 1981 to 1985, the Treasure Department was in charge of the securities market, but it was soon replaced by the PBC from 1986 to 1992. Meanwhile, the State Planning Commission, the State Commission for Restructuring the Economic System (SCRES) and local governments actively participated in the process as well. Like Deng Xiaoping, the chief designer of China Economic Reform, has ever said in 1992, “Whether securities and the stock market are good or evil, danger or secure, and whether they exclusively belong to Capitalism or could also be utilized by Socialism, depend on experiment stoutly. If they are proved to be good after several years’ attempt, we could open the door for them. If not, we could correct them or close the door. Even if we decide to close them, we could also choose to do that in a minute or years, or even still leave some room. We should not dare to try if we could keep this attitude all the time.” It is with this guidance that Chinese enterprises and different levels of governments launched a series of experiments as mentioned above, even though many of them were regarded as illegal, or suspended by governments.

After 1993, as the establishment of quota system, the pre-approval of local or central governments became the prerequisite of stock issuance, and the proposed issuance should be uniformly reviewed by the State Council Securities Committee, the predecessor of the CSRC. According to Article 7 of the Securities Law (2014), “The securities regulatory authority under the State Council shall carry out centralized and unified supervision and administration of the national securities market.” However, as described in Part I, the characteristics of experiment are still very obvious. The low efficiency of the administrative regulation is closely related with its governance function, namely, the designed missions, powers and governance resources. By contrasting the missions of SEC and the CSRC described on their websites, it is not hard to find that the SEC and the CSRC have different emphasis on securities regulation. The differences are mainly reflected on two aspects: a. the overemphasis on ex ante regulation; and b. the overregulation on self-governing affairs.

a. The Overemphasis on Ex Ante Regulation

Based on the research of Pistor and Xu, the success of economic reforms is determined by the efficiency to respond to the new challenges caused by socio-economic conditions and the adaptability to this new system over time. As their legal institutions are far away from developed and fully tested, plus the inexperienced and corrupted enforcement agents, deterrence from courts has a high possibility to fail. Thus, the formal legal enforcement approach is not the exclusive way to govern the securities market. On the contrary, the residual lawmaker and enforcement power should be empowered to administrative agencies. In fact, apart from the court litigation mechanism, agencies’ advantages of coercive enforcements are the advantages that other players don’t have. Therefore, to what extent could we execute the comparative advantages of coercive enforcement will determine the governance efficiency of the market.

At this aspect, the SEC did a good job. In the past eighty years, SEC paid more attention on enforcement, and the Division of Enforcement became the biggest department in all SEC divisions. Especially since the publish of Advisory Committee on Enforcement Policies and Practices’ report in 1972, the philosophy of SEC regulation started to transform from remedial to punitive in nature. This process made SEC more powerful than before, and enjoy a panoply of enforcement choice. Today, the SEC has many

---

kinds of civil actions, including injunction, civil monetary penalties, returning of illegal profits, bar or suspend an individual and additional fines or imprisonment. More importantly, it has strong administrative mechanisms to enforce its rules, such as appropriate cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry, civil monetary penalties and disgorgement. Since the 2008 financial crisis, it further introduce a whistleblower program which is mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. From the following Chart 8, we could find SEC not only took more enforcement actions, but also had more specific division.

Chart 8: SEC Enforcement Actions Statistics

![SEC Enforcement Actions Chart](image)

(Chart 8: SEC Enforcement Actions Statistics)

However, as described in the Part I, the actual performance of the CSRC now is far away from satisfaction. What caused the huge gap? Is it solely because the scale of China’s securities market is smaller than the market of U.S., or because of the staff is less than that of the U.S.? On one hand, till the end of last year, the SEC had employed 4,023 full-time equivalents, while the CSRC had 3,183 staff among which 2386 worked in local branches. Thus, the total staff number doesn’t lead to a huge human capital gap. On the other hand, according to the statistics of the World Bank, till now, China has 2,494 domestically listed companies, while the U.S. has 4,102. Taking the governance of listed companies alone as an example, the total capitalization of the SSE and SZSE has

---

ranked number four in the world, and the proportion of staff and the listed companies is near, putting aside the wide definition of securities in the U.S. and the regulation on futures market in China. Thus, the governance task and effect should be similar to some extent, and the enforcement gap may not mainly be caused by the differences of market scale and human resource. So the core reason may lay on the regulation focuses and emphasis: the ex ante regulation approach.

Since the early days, China central government was obviously inclined to take direct administrative intervention measures, especially the control over securities categories, Initial Public Offering (IPO) and securities prices.\(^{127}\) Taking the stock IPO as an example, Article 10 of the 1998 Securities Law ruled “Public offers of securities …… shall, in accordance with law, be reported to the securities regulatory authority under the State Council or the department authorized by the State Council for verification or examination and approval” (*Shenpi Huo Hezhun*).\(^{128}\) It particularly worth mentioning that since the Amendment of 2005, Article 10 was changed as “…… for examination and approval according to law” (*Hezhun*). Though only one word (verification) was canceled, it brought an entirely different meaning.\(^ {129}\) It opened a new era of securities issuance, an era without quota limits. However, the words “examination and approval” represent a merit review issuance approach, which is quite different from U.S.’s issuance approach (the article refers to “registration approach”). According to the current law, without the examination and approval from the CSRC, any entity or individuals’ public issuance of any securities is illegal.

Taking the stock issuance as an example, according to *Administrative Measures for the Issuance of Securities by Listed Companies* (2008),\(^ {130}\) companies plan to list shall have sustainable profit-making abilities, namely, they should have “favorable balance for the recent three consecutive fiscal years”, and don’t “substantially rely on its controlling shareholder or actual controller.”\(^ {131}\) Moreover, the CSRC would review the prospects of the companies to determine whether they have “a sound business operation mode and investment plan, and has a good market prospect for its main products or services. There is no seriously unfavorable imminent or foreseeable change in the business operation environment and market demands.”\(^ {132}\) Besides, they should meet all the other material business requirements by the CSRC and comply with the rules of Company Law (2013 Amendment). When a company is qualified with these requirements, it then will need to hire a qualified securities company (investment banks) with recommendation eligibility to

---

129 More accurately, Procedures of the CSRC for the Stock Issuance Examination (2000) was the beginning of cancelling the word of “verification”. This rule actually changed the meaning of article 10 of 1998 Securities Law, which brought a transformation from “verification” review to pure merit review.
be its recommender. After submitting the required IPO application documents, the issuer should disclose related documents in advance. Then the CSRC’s Issuance Examination Committee (CSRC IEC), which is in charge of the stock issuance, would examine the IPO application.\(^\text{133}\) Then the CSRC IEC would work according to *Measures for the Issuance Examination Committee of China Securities Regulatory Commission (2009)*.

During the process, the CSRC would estimate company’s governance structure, the qualification of senior management members, profit-making abilities and prospective as mentioned above, the financial situation, accounting histories, assets qualification, the amount and utilization of the funds (such as whether the utilization is in line with the China’s industrial policies), the illegal action histories.\(^\text{134}\) Without the approval of CSRC, the illegal issuance would lead to a lot of civil, administrative or even criminal liabilities.\(^\text{135}\) Therefore, it’s obvious that Chinese companies’ securities issuance is faced with a lot of merit reviews, which means the merit evaluation of companies’ value. However, there are several deficiencies regarding this kind of ex ante regulation: Firstly, from the perspective of institution abilities, the CSRC IEC has only 25 members of the Main Board, thereof five members are from CSRC and the others are from outside.\(^\text{136}\) In the same year, there were 99 companies’ IPO, 116 private placements by listed companies and 14 following-on offering by list companies.\(^\text{137}\) Under the circumstance, it is hard to imagine how the 25 IEC members and their assistants could handle such huge merit review works. Secondly, there is a great need of company financing, and thus the long merit review process could not satisfy the financing requirements from the enterprises. Thirdly, it is impossible for the CSRC to review every application accurately in fact, but the investors would regard these as implicit guarantees. As there were strict merit reviews, investors may severely rely on these reviews in their minds, and would directly condemn the government when fraud happened.\(^\text{138}\) Therefore, merit review emphasized on *ex ante* regulation instead of *ex post* supervision. In this case, listed companies are more likely to fraud or misstatement, which would bring investor protection more challenges.

**b. The Overregulation on Self-governing Affairs**

Another reason for the low efficiency of the administrative regulation in China is that they pay over attention to self-governing affairs or things they are not so good at. Moreover, these matters really distract the CSRC from its comparative advantages


execution. On the contrary, the CSRC should have enough adaptability on the adjustment of securities definition, as it has the power of regulation and rule making. Even though China claimed there were “other securities as are lawfully recognized by the State Council”, it was a technically provision during the first four years after the 1998 Securities Law in the views of Prof. Zhipan Wu.\textsuperscript{139} For instance, from the statistics of SSE,\textsuperscript{140} there were no warrants during the past three years. Moreover, we could not find any laws or government rules regarding the warrant trading, even though there were some industry rules by SSE and SZSE. The situation of the transactional monetary fund is the same, as we could not found the related laws or regulations. Therefore, Prof. Wu’s observation is still applicable today. Thus, the CSRC seems to have given up the comparative advantages on definition.

However, within the current Chinese securities and futures law regime, there are at least 63 types of administrative approval matters.\textsuperscript{141} Among them, quite a lot are related to self-governing affairs. The below six examples are typical, and could draw some basic pictures of the CSRC’s overregulation on self-governing affairs.

(1) Supervision on shareholders. The CSRC should “supervise the securities market behaviors of the listed companies and their shareholders who shall fulfill the relevant obligations according to the relevant laws and regulations.”\textsuperscript{142}

(2) Qualification approval of senior officers. “The directors, supervisors and senior managers of a securities company and persons in charge of the domestic branch institutions of the company shall have the post-holding qualifications approved by the securities regulatory agency of the State Council before assuming their posts. No securities company may appoint or select persons without post-holding qualifications to assume the aforesaid posts. For a securities company which has done so, the related resolutions or decisions shall be deemed as invalid.”\textsuperscript{143}

(3) Business of listed companies. “Major purchase, sale or exchange of assets by listed companies” should be examined and approved by administrative agencies.\textsuperscript{144}

(4) Business of futures companies. “Where a futures company intends to handle the following affairs, it shall be subject to the approval of the futures regulatory institution of


\textsuperscript{142} See the Website of the CSRC: About CSRC. Available at http://www.csrc.gov.cn/pub/csrc_en/about/intro/200811A20081130_67718.html, last viewed on February 20, 2015.


\textsuperscript{144} See Guowuyuan Dui Quexu Baoliu De Xingzheng Shenpi Xiangmu Sheding Xingzheng Xuke De Jueding [Decision of the State Council on Establishing Administrative License for the Administrative Examination and Approval Items Really Necessary To Be Retained] (Promulgated by the State Council Jun. 29, 2004, amended at Jan. 29, 2009), Item 400.
the State Council: The merger, split-up, suspension of business, dissolution or bankruptcy; The change of its business scope; The modification of registered capital and adjustment of equity structure; (4) The addition of a shareholder holding 5% or more of equity or modification of the controlling shareholder; (5) The establishment, acquisition, taking shares, or termination of any overseas futures institution”.

(5) Appointment of fund officers. “The appointment or modification of the legal representative, chief executive officer or chief compliance officer of a fund management institution for a publicly offered fund shall be subject to the approval of the securities regulatory authority of the State Council.”

(6) Leaders of foreign securities institutes. These administrative license for the administrative examination and approval items should be persisted, including “ratification of the Qualifications for the Chief Representatives and General Representatives of Foreign Securities Institutions' Representative Offices in China.”

On the contrary, the SEC has done a much better job on these aspects, especially before the Sarbanes-Oxley Act of 2002 (hereafter “SOX”) and the Dodd-Frank Act. The best example is the SEC lacks the power to intervene internal corporate governance. As the principles in the seminal Business Roundtable v. SEC case released, the SEC didn’t have the authority to initiate corporate governance rules, and intervene against these rules. Even though the SEC regulates all of the important participants in the securities market, all of these affairs are mainly on promoting the disclosure of important market-related information, rather than the self-governing matters. For instance, even in the controversial SOX and Dodd-Frank Act, the SEC only played as a rule maker instead of the “boss” of corporate. Under the circumstance, it is also hard to imagine how the 3,183 CSRC staff could handle these detailed self-governing affairs. Furthermore, as the CSRC doesn’t have adequate expertise on business operation, the regulation effectiveness is really doubtful. Therefore, the overregulation on self-governing affairs not only distract the CSRC from its core mission of enforcement and supervision, but also did not achieve the expected effectiveness.

C. Excessive Governmentalization of Quasi-public Players: SE, NAFMII and SAC

On the contrary, as governmental regulators do not require market entities to report all of the trading data and the other market information, especially for the bulk of the complex financial transactions from the over-the-counter markets, it is unnecessary and impossible

151 See the Website of SEC: what we do. Available at http://www.sec.gov/about/whatwedo.shtml#.VOenWvnF-Go, last viewed on February 20, 2015.
for the governmental regulators to collect all the information.\footnote{See Saule T. Omarova, \textit{Rethinking the Future of Self-regulation in Financial Industry}, 35 Brook Journal of International Law 665, 687 (2010).} Therefore, apart from the public governance mechanisms described above, there are many quasi-public governance mechanisms as well, like the stock exchanges and industry associations. Meanwhile, these quasi-public entities are usually SROs.\footnote{See the later part of this article.}

From the perspective of institutional theory, as information is difficult to communicate and the nature of dispersal, the most local levels have the advantages on economic decision-making.\footnote{Alan Morrison and William Wilhelm, Jr., \textit{Investment Banking: Institutions, Politics and Law}, 62 (Oxford University Press, 2007).} Theoretically speaking, the comparative advantages of the SROs' superior ability are to access and evaluate the important market data and information in a very timely and efficient way.\footnote{See Saule T. Omarova, \textit{Rethinking the Future of Self-regulation in Financial Industry}, 35 Brook Journal of International Law 665, 682 (2010).} Moreover, they have the adequate expertise and technology advantages to analyze these information in this incredibly sophisticated and specialized economy.\footnote{See James J. Park, \textit{Rules, Principles and the Competition to Enforce the Securities Law}, 100 California Law Review 115 (2012).} Namely, they have the “much more nuanced and intimate understanding of how all pieces of this highly complicated puzzle fit together”, and thus could detect the potential systemic risk accumulation.\footnote{See Saule T. Omarova, \textit{Rethinking the Future of Self-regulation in Financial Industry}, 35 Brook Journal of International Law 665, 688 (2010).} In particular, the stock exchanges work as the central producers and disseminators of information, as they are at the central physical locations where the price and trading information complied as the trading occurs.\footnote{See Jonathan Macey and Hideki Kanda, \textit{Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges}, 75 Cornell Law Review 1086 (1990).} Thus, to which extent the SROs could execute their comparative advantages would influence the market efficiency accordingly. In fact, the chaotic phenomena of low efficiency of administrative regulation and the failures of market mechanisms are both related to the absence of quasi-public governance mechanisms.

\textbf{a. A Second CSRC? The Governmentalized Stock Exchanges}

Generally, the primary function of stock exchanges is to save traders’ cost on finding the other side of possible transactions,\footnote{See Daniel R. Fischel, \textit{Organized Exchanges and the Regulation of Dual Class Common Stock}, 54 The University of Chicago Law Review 119, 121 (1987).} and to enhance the value of stocks by improving the liquidity.\footnote{See Liufang Fang, \textit{Legal Statues of Stock Exchanges: Retrospect on the “Hook-up with International Practices” (证券交易所的法律地位——反思“与国际惯例接轨”)}, 25 Tribune of Political Science and Law 63 (2007).} In further, liquidity is all for the market.\footnote{See Yakov Amihud and Haim Mendelson, \textit{Liquidity, Volatility, and Exchange Automation}, 3 Journal of Accounting, Auditing and Finance 369, 369 (1988).} This kind of liquidity would facilitate the securities being sold quickly and at low costs, and thus improve the market efficiency, especially in emerging countries.\footnote{See Chauhan, Poonam, \textit{Are Institutional Investors an Important Source of Portfolio Investment in Emerging Markets?} (Washington, DC: The World Bank Press, International Economics Department, 1994).} Thus, the performance of stock exchanges would definitely influence the market governance. It is worth noticing that even though stock exchanges have some regulatory powers, as a self-regulatory organization,\footnote{Section 2 (26), 1934 “The term “self-regulatory organization” means any national securities exchange, registered as a self-regulatory organization under section 6(c) of the Exchange Act.” 15 U.S.C. § 78p(c).} they
are still regarded as business instead of governmental entities or agencies. Thus, this article regard it as a kind of quasi-public governance mechanism.

Since the first modern securities issued in Amsterdam in 1602, securities have developed for more than four hundred years. In the U.S., the first formal stock exchanges is the Philadelphia Stock Exchange which traded bank and government stocks. When the traders met in 1791 in a coffee house, the Buttonwood Agreement opened a new giant of stock exchanges inadvertently. They set the basic of trading rules for the organization, and thus the forerunner of New York Stock Exchange (NYSE) was almost founded. During the following years, they then set and revised a series of rules, including the information disclosure, listing standards, creditworthiness mechanisms and rules against fictitious trades and other fraudulent acts. During the early periods, stock exchanges are unregulated, as held in the case of Gordon v. N.Y. Stock Exch., Inc. said “the exchanges remained essentially self-regulating and without significant supervision until the adoption of the Securities Exchange Act of 1934.” At the same time, stock exchanges were also the primary regulators in the market. Namely, they could set up the information disclosure rules, determine the trading structure and rules, and the qualification of brokers.

Only after the Great Crash, the U.S. government required NYSE to accept the 1933 Act and 1934 Act, and revise its governance model. Like the chairman of SEC said, NYSE had been run as a "Private Club.” Also in the words of Justice William Douglas: “[Self-Regulation] is letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.” In the 1934 Act, the exchanges are granted the authority to set listing requirements and standards. For instance, if a company plans to list on NYSE, it should satisfy all of the requirements regarding market valuation, public traded stocks, corporate governance standards, series of financial and non-financial information, etc. It also has to obey all the NYSE Rules, covering dealings and settlements, admission of members, operation of member organizations, communications with the public, disciplinary rules, listing and delisting, arbitration rules, etc. According to the 1934 Act, the stock exchanges are in charge of membership regulation and market surveillance. “The rules of the

---


See generally Lodewijk Petram, the World’s First Stock Exchange, 1-34 (Columbia University Press, 2014).


See Paul G. Mahoney, the Exchange as Regulator, 83 Virginia Law Review 1453 (1997).


exchange provide that (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of this title, the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.”

Thus, from the very beginning, the stock exchanges are enjoying a wide independent and autonomy powers.

On the contrary, even though SSE and SZSE theoretically adopt the membership system under the 2014 Securities Law, and theoretically enjoyed limited autonomy, such as allocation of its income. However, more fundamental matters, like its establishment and dissolution, formulation and revision of its constitution and appointment of the general manager, are directly controlled by the State Council or the CSRC. In fact, according to the registration record, SSE and SZSE are separately state owned enterprise and institutional organization. Such legal arrangement makes the stock exchanges de facto subsidiaries of the CSRC instead of an independent self-regulating institution and a truly meaning membership self-regulatory organization, putting the self-regulating power and autonomy of the stock exchanges at risk. The lack of independence of the stock exchanges to make its own rules proves as a hurdle of them to realize its inherent functions. Meanwhile, as SSE and SZSE are the only national wide stock exchanges, the competition between them is very limited now. This lacking of competition and the nature of quasi-governmental institute further obstruct the reputation mechanism and racing to the top. One Chinese scholar, Yu Zheng, has criticized the institution supplement of China’s securities regulation was determined by the subjective understanding of administrative agencies instead of the market. Under the circumstance, the innovation of securities market was led by the government, obstructing the market’s natural development.

Moreover, because of this kind of special nature and position, the role and functions are obscure for a long time. Further, stock exchanges could not execute their expertise, skills and information advantages properly. For instance, regarding the information disclosure

---

177 Securities Exchange Act of 1934, Sec. 6 (b) (6)
179 Id. Art. 102.
180 Id. Art. 103.
181 Id. Art. 107.
182 Id. Art. 102. According to Article 102 of 2014 Securities Law, a stock exchange is a “legal person that provides the relevant place and facilities for concentrated securities trading, organizes and supervises the securities trading and applies a self-regulated administration.”
supervision, the stock exchange’s role is unclear. According to Art. 105 of 2014 Securities Law, “a stock exchange shall carry out supervision over the information as disclosed by the listed companies or the relevant obligor of information disclosure, supervise and urge them to disclose information in a timely and accurate manner according to law.”185 In the specific regulation of information disclosure, Administrative Measures for the Disclosure of Information of Listed Companies,186 the boundaries of regulation power between the CSRC and stock exchanges is extremely obscure, as there is also only one article governing this issue. Article 9 rules, “The CSRC shall supervise the information in the information disclosure documents and announcements, management of the information disclosure, as well as the acts of the controlling shareholders, actual controllers and information disclosure obligors. A stock exchange shall supervise the information disclosed by listed companies and other information disclosure obligors, urge them to disclose information in a timely and accurate manner, and exercise a real-time monitoring of the dealings of securities and the derivatives thereof. The listing rules and other information disclosure rules formulated by the stock exchange shall be submitted to the CSRC for approval.” In the circumstance, how could the two regulators distribute the regulation power regarding information disclosure? To what extent have the two regulators been faced with the duplicative regulation and the respective inefficiency? Therefore, under the circumstance, how could the stock exchanges execute their expertise and information advantages with such unclear regulation authorities?

b. An Exam Organizer? The Vase SAC and Governmental NAFMII

As mentioned before, in China, the current Securities Law is designed to fulfill the government’s aims, and thus allowed governments to play a more important role in the securities market rather than the securities market. According to article 174 of Securities Law, the SAC is the self-regulating securities industrial association and adopt the administration.187 Like the Financial Industry Regulatory Authority (FINRA) in the U.S., the SAC is made of “(1) securities exchanges, financial futures exchanges, securities depositary and clearing institutions, securities investor protection funds, and margin refinancing institutions; (2) law firms, accounting firms and such other intermediary institutions that are engaged in securities businesses; (3) securities associations in all the provinces, autonomous regions, municipalities directly under the central government, and cities with independent planning status; (4) representative offices of overseas securities institutions established with approval of the competent regulatory authorities; and (5) any other institutions which are licensed by CSRC to engage in any securities-related businesses.”188 However, the SAC’s functions are quite limited actually, mainly in the fields of educating and organizing its members, keeping the CSRC informed of the suggestions and requirements from the members, and the qualification examinations and

practice registration for the practitioners in the related securities industry.\textsuperscript{189} Regarding the information disclosure regulation, the SAC is only responsible of “to collect and process information on securities and render services to its members”. Thus, the comparative advantages of information, technology and expertise was almost absent for the SAC.

On the other hand, FINRA in the U.S., is a new established self-regulatory organization. In 2007, the SEC approved the merge of the National Association of Securities Dealers (NASD) and the member regulation, enforcement and arbitration departments of the NYSE, and thus founded the FINRA, eliminating much overlap and redundancy.\textsuperscript{190} It is authorized to supervise the market players, such as broker-dealers, stock exchanges, listed companies and other securities intermediaries.\textsuperscript{191} Therefore, the FINRA sets up a series governance rules focused on the day-to-day business conduct on its members, including deterrence against broker-dealers’ misconduct, punishment on rule violations, detection on wrongdoings, education regarding investor protection and disputes settlements.\textsuperscript{192} Moreover, equipped with the powerful enough securities related technology innovations, it could detect the misconducts in the market effectively: processing 14 to 20 billion transactions every day.\textsuperscript{193} It even contributes to develop new software to support the securities market, such as DataGenerator, Extensions for WebDriver and Mock Service Layer (MSL).\textsuperscript{194} The comparative advantages of information expertise and technology innovations are executed properly. Meanwhile, like the stock exchanges, FINRA is also a SRO under the 1934 Act, by which the SEC could exert extensive oversight of SROs by various mechanisms, from the review and approval of SROs’ rules and their respective revise to their operations. In the words of Prof. Roberta Karmel, the FINRA is “a peculiar mix of private sector self-regulation and delegated governmental regulation.”\textsuperscript{195} Therefore, compared with FINRA, China’s SROs like the SAC should be granted more power in the securities market governance,\textsuperscript{196} and the governmental agencies should participate in the continuous dialogs with the SROs. The SRO should also relocate its position internally, sparing efforts to transform from the exam organizer to a market monitor, a technology provider and a regulator.

It worth mentioning another SRO in China, the NAFMII, which is a better SRO compared with the SAC. In 1997, due to the debt repurchase irregularities caused by systemic risk at the exchange markets, the State Council ordered the commercial banks to withdraw from exchange bond market collectively. After that, the central bank established

\textsuperscript{189} Id.


\textsuperscript{192} See the Website of FINRA, http://www.finra.org/AboutFINRA/WhatWeDo/, last viewed on February 21, 2015.

\textsuperscript{193} See the Website of FINRA, http://www.finra.org/AboutFINRA/technology/, last viewed on February 21, 2015.

\textsuperscript{194} Id.


\textsuperscript{196} In fact, as introduction of The Securities Acts Amendments of 1975 and the process of governmentalization, scholars found several mechanisms are driving the “self” out of regulation, and the SROs are transforming into a “fifth branch” of government. Recently, with the development of new technologies, the FINRA is losing its market monopoly position, and faced with the loss of regulation efficiency. See William A. Birdthistle and M. Todd Henderson, \textit{Becoming a Fifth Branch}, 99 Cornell Law Review 1 (2013).
the center on the basis of the establishment of the inter-bank market. Because of the implementation of strict control, the market vitality was quite limited at the beginning until the introduction of super & short term commercial papers. Thereafter, this SRO passed the *Administrative Measures for Debt Financing Instruments of Non-Financial Enterprises in the Inter-bank Bond Market*,¹⁹⁷ and NAFMII then made a lot of the so-called self-regulatory rules and guidelines, to provide the legitimacy of their note transaction. These notes are traded only on the inter-bank market, including medium-term notes, small and mediumsized corporate collective notes, commercial papers, super & short-term commercial papers, private placement notes, asset backed medium-term notes and project revenue notes.¹⁹⁸ Till now, the scale of the inter-bank market is much huger than the exchange market. These notes are transferred among the maturity of investors in the inter-bank market.¹⁹⁹ but strangely we could not find any laws or government rules regarding the specific legitimacy sources of these securities.

Even though the NAFMII has achieved great development, it actually has many potential problems as well, and these problems may affect its comparative advantages on information and technology. First of all, why the PBC established the NAFMII in 2007? The official explanation is to maintain market order, to strengthen market discipline management, and to better promote the sustained and healthy development of the inter-bank market. However, some industry insiders believed that the reason was not this. It may the rapid rise in the short financial bonds led to pressure enhance from other regulatory authorities, as PBC’s direct management of the bonds market was controversial. Thus, the PBC established this new institute to handle the inter-bank market.²⁰⁰ However, as the constitution of NAFMII, it is under direct business guidance, supervision and management by the PBC and the Ministry of Civil Affairs as well. Thus, its self-regulatory status is also doubting, as the election of its presidents, secretary general and the amendment of its constitution all depend on PBC’s approval. Secondly, the NAFMII’s information disclosure rules are just internal association rules rather than laws or regulations, which would affect the powerful enforcement from the courts. The *Rules for Information Disclosure on Debt Financing Instruments of Non-financial Enterprises in the Inter-bank Bond Market* only has thirty-nine preliminary articles, which is far away from enough to effectively regulate the market.²⁰¹ Moreover, from the website of NAFMII, there are only 51 self-regulation sanction which is an extremely small number compared with its market scale. Under the circumstance, it is reasonable to suspend its market regulation efficiency.

D. Absence of Private Litigation and Governance

Courts are the most prominent and influential institution in the society. They could not only provide the most powerful but the most ultimate enforcement. In the views of Richard Posner, in common law countries, courts could also contribute to the increase of wealth maximization. Especially when faced with new kinds of securities frauds, courts in common law countries could protect investors much better when the formal rules are absent, contributing to the socio-economic needs. For instance, regarding the fiduciary duties of managerial personnel, Katharina Pistor and Chenggang Xu argued that the residual lawmaking powers should be left to the courts, because of the difficulty in standardization, the limited externality and the costly monitoring actions. This kind of adaptability is regarded one indicators of the mechanisms of law and finance. In the field of securities class action, even though it has some internal problems in the U.S., it has already become a powerful deterrence on market players. (See Chart 9)

Chart 9: Annual Number of Securities Class Action Filing

On the other hand, American state courts and federal courts have the authority to create doctrines to determine whether some kind of investment belongs to the definition of securities or not, whether certain actions belong to insider trading, or whether the information disclosure duty breaches exist. In the U.S, only regarding the scope of insider

---

Available at http://www.nber.org/papers/w10126, last viewed on February 21, 2015.
trading, several important cases, including, *Chiarella v. United States*, 210 *SEC v. Texas Gulf Sulphur*, 211 *Cady, Roberts & Co.* 212 and *United States v. O”Hagen* 213 have developed many influential principles which could provide appropriate guidance to different levels of courts.

Regarding the comparative on the definition of securities, American courts also have done a better job. For instance, the evolution of investment contracts is one of the reflections. Investment contracts appeared in many Blue Sky Laws even before the 1933 Act. The meaning of the investment contract diverged among different state courts, 214 though it was “broadly construed by state courts so as to afford the investing public a full measure of protection.” 215 When the 1933 Act was drafted, under the philosophy to regulate more securities, 216 investment contracts were included in the Article of 77b. However, the meaning of invest contracts was still obscure till the Supreme Court got the first opportunity in the case of *SEC. v. Joiner Leasing Corp.* in the year of 1943. 217 The court found “The reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as ‘investment contract’.” 218 Unfortunately, because of the excessive elasticity, Joiner test was then quickly replaced by Howey test in 1946, which became an effective method to test “veiled and devious” schemes including variable annuities, withdrawable capital shares of savings and loan associations. 219 Since then, federal and state courts finally have a relatively explicit standard to decide whether some kinds of securities are in the scope of the 1933 Act. In 2004, the Supreme Court’s case of Edwards further construed the “investment contracts” broadly. 220 Thus, the U.S. court could develop the definition of “securities” and other issues according to the social development, keeping pace with times. Like Holmes said, “the life of the law has not been logic: it has been experience.” 221

When we look back on China as a whole, the modest growth in litigation, including civil, criminal and administrative cases from 1994 to 2006, implies that courts have not yet played a significant role compared with other dispute resolutions. 222 For instance, public company cases in Shanghai courts are almost absent. 223 In the field of securities, since 2002, even though the courts are allowed to accept cases arising from misrepresentation
on the securities market, China is still on its way to achieve an efficient court governance mechanism which would discount the total governance efficiency.

On one hand, regarding the issue of insider trading, till now, except the general rules in 2014 Securities Law, only the “(Provisional) Guide for the Recognition and Confirmation of Insider Trading Behavior in the Securities Markets” and the “Interpretation of the Supreme People’s Court and the Supreme People’s Procuratorate on Several Issues Concerning the Specific Application of Law in the Handling of Criminal Cases of Engaging in Insider Trading or Leaking Insider Information” could provide some specific limited introduction regarding insider trading. However, they are just non-legal rules or indirect related interpretation, not the formal laws and regulations. More importantly, not until 2008 was the first insider trading related case, Chen Ningfeng v. Chen Jianliang, appeared in the court. Even since then, only countable cases could be found in the data base and the media. On the other hand, regarding the aspects of misrepresentation, as mentioned before, according to the statistics of Prof. Huang Hui, during the similar period, the civil cases against misrepresentation is quite limited. Therefore, we can find that the Chinese courts are still unable to play their roles properly. Aside from the issue of lawmaking (like the creation and clarification of securities definition), the private enforcement in China has already been a big problem.

In fact, except the political economy context and the judicial independence problem, the phenomenon origin from the incompetence of Chinese commercial courts. In further, it is related to the selection mechanism of China’s judges. No matter the judges who were from demobilized soldiers or these older judges, they barely had formal systematic legal education. Even for these young judges who graduated from law schools, and even though they were well educated, they still couldn’t handle such complicated securities disputes because of the lacking of securities expertise. As a result, it became difficulty for Chinese judges to differ legal and illegal behaviors when they were faced with sophisticated professional securities derivative cases. Besides, the Chinese courts are sometimes influenced by certain local governments or other institutions based on the consideration of maintaining social order and stability. However, these consideration also lead to the failure of enforcement. Thus, the comparative advantages on

---

229 See Laifan Lin, Judicial Independence in Japan: A Re-Investigation for China, 13 Columbia Journal of Asian Law
enforcement are extremely limited in China.

Therefore, China firstly needs to revise the “Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market”, canceling the pre-requisition of “a decision on administrative penalty by a relevant organ” or “a criminal order or judgment by the people's court” before civil compensation.\(^{230}\) This is one of the perquisites to encourage private enforcement in China. The next step is to establish the class action mechanism with Chinese characteristics. As there are worries regarding the huge suit costs on individuals, China could consider Chinese Taiwan’s class action model. In Taiwan, the Securities and Futures Investors Protection Center (SFIPC) was founded in the year of 2003, and the Securities Investors and Futures Traders Protection Act authorized SFIPC to carry out class actions for investors. According to Article 28 of this act, “the protection institution may submit a matter to arbitration or institute an action in its own name with respect to a securities or futures matter arising from a single cause that is injurious to multiple securities investors or futures traders, after having been so empowered by not less than 20 securities investors or futures traders.”\(^{231}\) Meanwhile, according to the Article 16 of the Act, SFIPC could also “request issuers, securities firms, securities service industries, futures enterprises, or relevant bodies in securities and futures markets to assist with the following matters or to provide relevant documents or materials”.\(^{232}\) In this way, investors could reduce the litigation costs hugely, and overcome the collective action problems.\(^{233}\) China might as well consider this model so that the comparative advantages could be properly executed by Chinese courts with fairly acceptable cost-benefits.

\section*{E. Shortage of Reputation Mechanism among Market Gatekeepers}

In the long history development, Adam Smith’s invisible hand has become the basis of the liberal capitalism in this new country, and the spirit of adventure is power of economic development. Specifically in the field of securities market, securities in the U.S. are originally imported from England as the colony’s economic development,\(^ {234}\) while the U.S. securities regime was truly established after the 1776 American Revolution.\(^ {235}\) During the earlier periods of securities history, speculation was popular in the securities market, and the connections between speculative financing and politics were obvious. For instance, A Senator Kimble even manipulated the legislation to achieve his personal speculative object.\(^ {236}\) Like the description from Max Weber, “capitalist acquisition as an adventure has been at home in all types of economic society”,\(^ {237}\) and “they [merchants]
have been speculators in chances for pecuniary gain of all kinds".\textsuperscript{238} In a word, the U.S. securities system embodies “the spirit of hard work, of progress, or whatever else it may be called, the awakening of which one is inclined to ascribe to Protestantism.”\textsuperscript{239}

In the securities market in the U.S., there are several important market intermediaries, including underwriters, lawyers, auditors, securities analysts and rating agencies. As they are at the lowest level of market, the intermediaries actually have low-cost access to firms’ delict information.\textsuperscript{240} They could use their information, experience and expertise comparative advantages to help investors to reduce the information asymmetric, to signal values,\textsuperscript{241} and to finance themselves.\textsuperscript{242} For instance, the central function of investment banking is to generate, retail and interpret the price-relevant information.\textsuperscript{243} Meanwhile, as the independent professionals and reputational producers, intermediaries could provide duplication verification and certification services as well.\textsuperscript{244} In one word, these intermediaries are working as market certifiers and could influence the market equilibrium both on the market and investment sides.\textsuperscript{245} Theoretically, they profit from lending their reputation and protecting investors.\textsuperscript{246} Like the decision of DiLeo v. Ernst & Young, the judge held that “an accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work.”\textsuperscript{247} However, because of the differences on market structure and the conflicts of interests, the failure of intermediaries sometimes happens. Thus, since the scandal of Enron and 2008 Financial Crisis, a series new rules was established to prevent the failures of intermediaries. For instance, the SOX thus established the Public Company Accounting Oversight Board to oversee the auditing profession, and try to solve some interest conflicts problems.\textsuperscript{248} Apart from the Dodd-Frank Act, scholars also come up with new proposals, such as Financial Statement Issuance,\textsuperscript{249} Voucher Financing\textsuperscript{250} and Disclosure Counsel.\textsuperscript{251} Nevertheless, because of

\textsuperscript{244} See John C. Coffee, Jr., \textit{Understanding Enron: “It's About the Gatekeepers, Stupid”}, 57 Business Lawyer 1403 (2002).
\textsuperscript{245} See Stephen J. Choi, \textit{Market Lessons for Gatekeepers}, 92 Northwestern University Law Review 916, 934-49 (1998);
\textsuperscript{247} See DiLeo v. Ernst & Young, 901 F.2d 624 (1990).
\textsuperscript{251} See John Coffee, \textit{Gatekeepers: The Role of the Professions and Corporate Governance} (Oxford University Press, 2006).
the reputation mechanism and its respective incentives, the intermediaries still have more comparative advantages on information and technology.

However, in China, the securities intermediaries are far away from maturity. On one hand, these intermediaries could not always function effectively, and sometimes become the conspirators with violators. Even in the mature market like the U.S, Enron Scandal could happen, the failure of intermediaries in China isn’t hard to imagine. In the practices of China, many conspiracy behaviors by intermediaries encouraged securities issuers to take illegal risks. As mentioned before, cases such as \textit{ST Hong Guang, Yin Guang Sha} and \textit{Zheng Baiwen} are typical examples.\footnote{See Jianping Wang, \textit{On Structural Risk Control of the Listed Companies in China's Stock Market} (上市公司风险结构控制研究——以法律控制为核心), 164 (China Law Press, 2007).} Like the Supreme Court’s opinion in \textit{United States v. Arthur Young & Co.} held, “this ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.”\footnote{United States v. Arthur Young & Co., 465 U.S. 805 (1984)} Thus, China should really enhance its enforcement abilities to truly transform the “law in book” to the “law in action”. This is the pre-condition to properly exert the comparative advantages of intermediaries.

On the other hand, even excluding these illegal behaviors, the role setting of intermediaries is still not satisfactory. Players that have comparative advantages over specific variables could not exert their according advantages, but waste on the other affairs. For instance, in the process of stock IPO, the accuracy, logicality and popularity of the prospectus are of vital importance. But the prospectus in China are far away from satisfaction compared with these in the U.S. From the perspectives of law requirements and the pages of prospectus, we could not find huge differences, but the quality differs actually. One of the possible reason is that the prospectus in the U.S. are the work of lawyers not underwriters, while Chinese lawyers are busy with the tedious legal opinions which usually consist of tens or hundreds of pages, covering twenty-three aspects of the potential issue. On the contrary, the task of prospectus are left to underwriters who are not good at writing. Thus, though there are a lot of information disclosure requirements, the quality of these documents is worrying.\footnote{Yingmao Tang, \textit{How Far is China from the Registration Approach? And the Measures China Should Take towards A Registration Approach} (我国离注册制还有多远——兼论推进我国股票发行注册制改革的措施), 7 Shanghai Finance 37 (2014).} The comparative advantages of lawyers are not properly exerted.

Moreover, the competitiveness between these intermediaries is significant for the securities market and for the comparative advantage exertion. However, according to the statistics, during the year from 2006 to 2010, there were 76 qualified recommendation institutes and recommender, namely, qualified securities companies. But among them, 76.31% were controlled by central or local governments directly or indirectly.\footnote{See Zhaohui Shen, \textit{The Market Decentralization Theory of Regulation and the Evolving Administrative Governance} (监管的市场分权理论与演化中的行政治理), 23 Peking University Law Journal 849 (2011).} Almost during the same time, regarding the total performance of securities companies, economics also found the efficiency of state-owned securities companies is lower than private companies as well. Due to the market reduction since the year of 2007, securities companies are
faced with the surplus productivity problem, and they were trapped by the low level virulent price competition with commission fee falling from 0.3% in 2002 to 0.087% in 2010. Moreover, as it is the CSRC not the market who would rate these underwriters, the core competitive advantage of securities companies thus come from the political connections rather than their comparative advantages on information, skills and experiences. Therefore, the weak competition among them is not hard to imagine. Nevertheless to say, the regulation on securities intermediaries is a world problem. But if China wants to make the best use of the gatekeeper mechanism, it’s necessary to improve the competition mechanisms of underwriters, lawyers and other gatekeepers.

V. CONCLUSION

According to the newest statistics, China has a population of more than 1.3 billion with the 51,894.21 billion GDP. Meanwhile, China has 8,286,654 all kinds of business entities, and thereof 138,698 entities are joint-share companies. Needless to say, under this circumstance, if China couldn’t maintain the securities market healthily, the consequences would be severe. China, as an emerging country, has achieved greatly in the rule of law during the past decades, especially in the fields of securities regulation. As a fast transitional country, everything is changing rapidly, and the securities market governance is no exception. Fortunately, China is also a country good at learning from developed countries, and these late-developing advantages have helped China to avoid detours.

Under the influence of path dependence, an incrementalism approach is more appropriate for China namely, taking the successive limited comparisons method regarding different policies and achieved the goals by incremental changes. Like Kahn Freund has ever said, “its [comparative method] use requires a knowledge not only of the foreign law, but also of its social, and above all its political, context.” Therefore, when we learn from the U.S. experiences and alter the path dependence, we could not forget the social context of China as well. In the context of China, the key governance variables and entities’ comparative advantages must have their particularity. Some successful mechanisms in the U.S. may not work well in China. As argued in the article, the mismatch between comparative advantages and governance variables is one of the reasons of the relatively low market efficiency. Therefore, the next step is to reallocate the governance resources to the appropriate entities based on the key governance variables. As the ancient Chinese poet Qu Yuan has ever said, “[T]he journey is long but I will continue to search for the right way and then tread along that path with unbending perseverance.”

256 Scholars out of China also found the state-owned enterprise has inherent lower efficiency compared with private ones. See Armen Alchian Some Economics of Property Rights, 30 II Politico 816 (1965); See Cong Wang and Huiying Song, An Empirical Research on the Relationship among the Ownership Structure, Market Structure and Cost Efficiency of Securities Companies in China (中国证券公司股权结构、市场结构与成本效率的实证研究), 5 Journal of Financial Research 80 (2012).


261 Yuan Qu, Li Sao (离骚), Sentence 97. Translation is from President Xi Jinping Talking with Members of the 21st Century Council at the Great Hall of the People in Beijing on Nov. 12, 2013.