PROTECTING INVESTORS IN CHINA THROUGH MULTIPLE REGULATORY MECHANISMS AND EFFECTIVE ENFORCEMENT

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I. INTRODUCTION

The brisk pace of globalization coupled with China's entry to the World Trade Organization (WTO) in 2001 has heightened the international competition faced by Chinese securities market players.[1] In turn, that increased competition has catalyzed both regulation and measured liberalization of China's securities markets.[2] A fair and competitive market needs a well-structured and functional regulatory framework that protects investors and maintains their confidence in the market. Major investors' concerns in Chinese securities markets include honest information disclosure, corporate governance, and effective regulation of listed companies and financial intermediaries.[3]

Previous company and securities laws[4] lacked effective civil remedies for investors and the private right to commence derivative actions.[5] Because the

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1. *See* CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: THE STOCK MARKETS AND THEIR ROLE IN CORPORATE REFORM, ix, 20 (2003); *see also* William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China's Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT'L L. 477, 514-15 (2002).

2. Friedman, *supra* note 1, at 514-15.

3. *See generally* Daniel M. Anderson, Note, *Taking Stock in China: Company Disclosure and Information in China's Stock Markets*, 88 GEO. L.J. 1919 (2000).

4. In China, the Company Law is the general law, and the Securities Law is a special law. The Company Law mainly governs corporate organizational structures and relationships while the Securities Law governs securities issuance and trading. *See* Liu Junhai, Z*henquan falu de zhidu chuangxing* [*Institutional Innovation of the Securities Law*], http://www.iolaw.org.cn/showarticle.asp?id=1739 (last visited Mar. 28, 2007) (P.R.C.).

5. *See* Wenhai Cai, *Private Securities Litigation in China: Of Prominence and Problems*, 13 COLUM. J. ASIAN. L. 135, 143-48 (1999). A shareholder's derivative action is an action brought by a shareholder not on its own behalf, but on behalf of the company. The shareholder brings an action in the name of the company against the parties allegedly causing harm to the company and shareholders. Any proceeds of the action go to the corporation. Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1758 (2004).

laws were inadequate in that area, investors in China's securities markets (particularly minority investors) were susceptible to market manipulation and fraud and were often left without redress.[6] The most significant issue in Chinese securities regulation was insider control and insider trading[7] of listed companies; the ownership structure and agency problems of listed companies—of which the state was often the dominant shareholder—made it difficult to curb widespread insider-trading activities effectively.[8] As a result, investors' interests were not protected, leaving them with a lack of confidence in the securities markets.

Recent amendments to Chinese securities law and company law, which are focused on protecting investors, have improved the regulation of the securities markets. But it remains to be seen whether improved legislation will change practices, as law enforcement has been a long-standing concern in China.[9]

This Article investigates the regulatory and enforcement issues confronting listed companies and stock exchanges in China. Part II traces the history of the current regulatory frameworks for listed companies and stock exchanges. Part III identifies flaws in the regulation of listed companies and stock exchanges caused by the China Securities Regulatory Commission's (CSRC) tight control. Part IV discusses enforcement issues affecting regulators and investors. Part V proposes reforms for regulation that provides effective investor protection.

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6. *See* Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 CHINA ECON. REV. 451, 459-63 (2003).

7. In the Chinese context, an insider refers to directors, officers, employees, or related parties of a company as well as a person who possesses inside information. *See* Zhengquanfa [Security Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999) 1998 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 596, art. 74 (amended Oct. 25, 2005), *available at* http://zhonglunwende.com/english/upload/20061179161926650f.doc (P.R.C.) [hereinafter Securities Law].

8. For more discussion about issues concerning insider control in Chinese companies and the absence of ownership, see Chenxia Shi, *International Corporate Governance Developments: The Path for China*, 7 AUSTL. J. ASIAN L. 60, 60-94 (2005).

9. *See* Liu Junhai, *Legal Reform in China*, *in* GOVERNANCE, DECENTRALIZATION AND REFORM IN CHINA, INDIA AND RUSSIA 373, 373-405 (Jean-Jacques Dethier ed., 2000); Wenhai Cai, *supra* note 5; *see also Law Enforcement Requires More Efforts*, BUS. WKLY. (P.R.C.), Mar. 23, 2003, *available at* http://www.chinadaily.com.cn/bizchina/2006-03/23/content_550581.htm (noting that despite China's comprehensive revision of its intellectual property rights laws and regulations in 2001, there continues to be a "disparity between the actual laws and the authorities' failure to enforce them"); *China's Legislature to Strengthen Law Enforcement Inspection on Major Issues*, PEOPLE'S DAILY (P.R.C.), Mar. 9, 2005, *available at* http://english.people.com.cn/200503/09/eng20050309_176174.html.

II. REGULATORY FRAMEWORKS FOR LISTED COMPANIES AND STOCK EXCHANGES

A. Overview

The major aims of securities regulation are to establish and maintain efficient markets and improve the allocation of resources in the economy.[10] There are three general models of securities regulation: the American model, the English model, and the hybrid model.[11] The American model centers on substantial securities law, which provides regulatory rules for primary and secondary markets, issuers, underwriters, brokers, and investment advisors.[12] The American model's independent regulatory body, the U.S. Securities and Exchange Commission (SEC), protects investors and enforces securities laws and regulations.[13]

In contrast, the English model has, in the past, stressed listing standards and the importance of self-regulation by market players, and did not rely on a comprehensive securities act.[14] However, in 2000, the United Kingdom statutorily authorized the U.K. Financial Services Authority (FSA), an independent regulatory body that stresses principles-based regulation with strong enforcement,[15] as the single financial regulator after the European Union required

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10. *See* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 802 (1985).

11. *See* Wan Meng, *The Securities System in China, in* 14 FINANCIAL REGULATION IN THE GREATER CHINA AREA: MAINLAND CHINA, TAIWAN AND HONG KONG SAR 99, 117 (Joseph J. Norton et al. eds., Kluwer Law Int'l 2000) [hereinafter FINANCIAL REGULATION].

12. *Id.*; *see also* U.S. Securities and Exchange Comm'n [SEC], How the SEC Protects Investors, Maintains Market Integrity: The Laws That Govern the Securities Industry, http://www.sec.gov/about/laws.shtml (last visited Mar. 28, 2007).

13. *See* SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Mar. 28, 2007). *Compare id.* (responsibilities of the SEC), *with* Securities Law, *supra* note 7, arts. 178-79 (functions and responsibilities of China's securities regulatory authority).

14. *See* Wan Meng, *supra* note 11, at 117.

15. The Financial Services and Markets Act 2000 (FSMA)—passed by the British Parliament—designated the Financial Services Authority (FSA) as the regulator for the financial markets. Financial Services and Markets Act, 2000, c. 8 (Eng.), *available at* http://www.opsi.gov.uk/acts/acts2000/20000008.htm.

The U.K. Financial Services Authority (FSA) takes the view that:

> [I]t is neither possible nor desirable to write a rule to cover every specific situation or need for decision that a regulated firm might encounter. Instead, [the FSA] focuse[s] on the Principles set out in the FSMA [Financial Services and Markets Act]. These set out in more general terms the types of behaviour that we expect of firms and

that its member states use state agencies to supervise securities market activities rather than rely on stock exchanges or other commercial bodies.[16] Hence the role of "self-regulation" in the U.K. markets has diminished.

The hybrid model emphasizes both the regulatory role of securities law (and the presence of an independent enforcement body) and self-regulation.[17] Emerging economies such as China have attempted to introduce both statutory law regulation and self-regulation in developing the regulatory frameworks for their "work in progress" securities markets.[18]

The different models of securities regulation share a common purpose: to safeguard the designed functions of securities markets, which include providing a market for companies to raise capital by raising securities; establishing a share-pricing system to monitor companies and allocate resources; diversifying investment risks; and correcting managerial failure through the market for corporate control.[19] Different historical, social, and economic environments account for the development of various regulatory frameworks from country to country.

Since China adopted economic reform and "open door" policies in 1979, it developed securities markets in a controlled manner to allocate capital efficiently.[20] The shareholding system of the early 1990s constituted an effort to raise capital to transform the debt-ridden and inefficient state-owned enterprises into self-reliant businesses.[21] This was followed by an attempt to convert the

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> individuals (for example – "A firm must conduct its business with due skill, care and diligence").

Financial Services Authority, Essential Facts About the FSA, http://www.fsa.gov.uk/Pages/About/Media/Facts/index.shtml (last visited Feb. 14, 2007). *See generally* Jim Hamilton's World of Securities Regulation, *Strong Enforcement Is Condition Precedent of Principles-Based Regulation*, Sept. 27, 2006, http://jimhamiltonblog.blogspot.com/2006_09_01_archive.html.

16. Hence the listing standards are provided, monitored, and enforced by the state regulator—the U.K. Financial Services Authority. *See* Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience* 26-32 (Georgetown Pub. Law Research, Paper No. 624582, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=624582.

17. *See* Wan Meng, *supra* note 11, at 117.

18. *See* CHINA SEC. REGULATORY COMM'N [CSRC], CHINA'S SECURITIES AND FUTURES MARKET 2004, at 35, *available at* http://211.154.210.238/cms/uploadFiles/introduction2004edition.1087888443500.doc.

19. *See* Colin Mayer, *Stock Markets, Financial Institutions, and Corporate Performance*, *in* CAPITAL MARKETS AND CORPORATE GOVERNANCE 179, 179-81 (Nicholas Dimsdale & Martha Prevezer eds., Oxford Univ. Press 1994).

20. *See* Wan Meng, *supra* note 11, at 103.

21. Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1, 8-9 (2002). *See generally* Liu Junhai, *supra* note 9, at 373-405.

state-owned enterprise system to a company system to increase efficiency, innovation, and profitability.[22] Some state-owned enterprises were transformed and listed on the stock exchanges after meeting certain requirements.[23] China has also opened the doors of its securities markets to foreign investors in a controlled manner, and the pace has been accelerated after China entered the WTO.[24] Gradually, securities markets and market players emerged and developed in China.[25]

The essential features of a securities market—shares, bonds, managed funds, and commodity futures—have developed in China,[26] and derivative products are gradually developing.[27] China's securities market now offers

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22. *See* Schipani & Junhai Liu, *supra* note 21, at 12-27.

23. According to the Securities Law, a company limited by shares applying to list its shares shall satisfy the following conditions: (1) its shares have been publicly issued after check and approval by the State Council's securities regulatory authority; (2) the company's total share capital is not less than RMB 30 million yuan (RMB, or renminbi, is China's official currency); (3) the publicly issued shares account for at least 25% of the company's total shares; or, in the case of a company whose total share capital exceeds RMB 400 million yuan, its publicly issued shares account for at least 10% of the company's total shares; and (4) the company has not committed a major violation of the law nor has had fraudulent entries in its financial accounting reports during the most recent three years. *See* Securities Law, *supra* note 7, art. 50. A stock exchange may specify listing conditions that are more stringent than those above, which it shall submit to the State Council's securities regulatory authority for approval. *Id.*

24. *See* CSRC, *WTO Commitment of China Securities Industry: Schedule of Specific Commitments on Services*, http://211.154.210.238/en/jsp/detail.jsp?infoid=1062637484100&type=CMS.STD (last visited Jan. 8, 2007). *See generally* World Trade Org. [WTO], Protocol on the Accession of the People's Republic of China, WT/L/432 (Nov. 23, 2001) [hereinafter China Protocol].

25. To improve capital markets, China's State Council issued the Guidelines on Promoting Reform, Opening-up and Steady Development of China's Capital Market on February 1, 2004. The Guidelines set the direction of future development of China's capital market based on the review of market experience in the past decade. It is a blueprint document promoting harmonized and stable development of China's capital market. *See* Circular on Issues Relating to the Pilot Reform of Listed Companies Split Share Structure (promulgated by the China Sec. Regulatory Comm'n), http://211.154.210.238/en/jsp/detail.jsp?infoid=1129278553100&type=CMS.STD (last visited Feb. 23, 2007) (P.R.C.).

26. *See* CSRC, CHINA'S SECURITIES AND FUTURES MARKET, *supra* note 26, at 3-4.

27. Han Qimeng & Jiang Qian, *New Regulatory Developments in China's Derivatives Markets*, CHINA L. & PRAC., Feb. 2007, at 34, 36, *available at* http://www.gide.com/front/files/ChinaLawPractice_GLN_Derivatives_feb2007.pdf; *see also China's Nascent Derivatives Market*, ECON. TIMES (India), Mar. 22, 2007, *available at* http://economictimes.indiatimes.com/Chinas_nascent_derivatives_market/RssArticleShow/articleshow/1790699.cms. Derivatives are financial instruments whose value depends on the values of something else, such as a commodity, interest rates, currency exchange rates, securities, or an index. Some derivatives are traded on markets, such as the futures

securities, including "A"-stock shares,[28] "B"-stock shares,[29] treasury bonds, treasury bond repurchases, corporate bonds, convertible bonds, and securities investment funds.[30]

In addition, "H" shares and "N" shares are offered to foreign investors. Mainland Chinese companies listed on the Hong Kong Stock Exchange issue H shares, and Chinese companies listed on the New York Stock Exchange (NYSE) issue N shares.[31] H and N shares may not be traded on the secondary market,[32] in effect limiting the share liquidity and efficient capital flow.[33] Such design of share types directs foreign investment to designated areas of the securities markets, minimizing the control exerted by foreign capital while maintaining the government's control over the markets.[34]

The growth of China's securities markets contributes to macro-level economic development and establishes a modern corporate economic system. The market entry standards and de-listing mechanisms set by the CSRC and stock exchanges have slowly improved the quality of listed companies.[35] The number

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markets. Investorwords, Derivative, http://www.investorwords.com/1421/derivative.html (last visited Feb. 23, 2007).

28. "A"-stock shares are denominated in renminbi yuan (official Chinese currency) and can only be issued to Chinese investors. "A" shares are further divided into tradable and non-tradable shares; the non-tradable shares are mainly owned by the government. "Legal person shares" are held by domestic institutions such as industrial enterprises, securities companies, trust and investment companies, various foundations and funds, banks, construction companies, transportation and power companies, and research institutes. STOYAN TEVEV ET AL., CORPORATE GOVERNANCE AND ENTERPRISE REFORM IN CHINA: BUILDING THE INSTITUTIONS OF MODERN MARKETS 76 (World Bank & Int'l Finance Corp. 2002).

29. Domestically listed "B" shares are quoted in U.S. dollars or Hong Kong dollars. They were issued to foreign investors. In February 2001, Chinese investors were allowed to trade B shares in foreign currencies. Therefore, the B-share market enables Chinese companies to raise foreign currencies from both Chinese and international investors. By the end of 2005, 109 companies issued a total of 19.47 billion B shares, raising RMB 38.08 billion yuan. CSRC, CHINA'S SECURITIES AND FUTURES MARKETS 2006, at 10 (2006), http://211.154.210.238/en/jsp/detail.jsp?infoid=1153810173100&type=CMS.STD [hereinafter SECURITIES AND FUTURES].

30. *See id.* at 3.

31. *See* Wan Meng, *supra* note 11, at 103-04.

32. In a secondary market, investors purchase securities from another investor rather than from the issuer, after the securities were originally issued. For more details, see London Stock Exchange, Secondary Markets, http://www.londonstockexchange.com/en-gb/products/consultancy/secondarymarkets.htm (last visited Feb. 14, 2007).

33. Philip Bowring, *Share Structure Gives Foreigners Better Deal: China Market Boom Is Raising Questions*, INT'L HERALD TRIB., Jan. 2, 2001, *available at* http://www.iht.com/articles/2001/01/02/yrchistox.t.php.

34. *See* Friedman, *supra* note 1, at 496-97.

35. To improve the corporate governance of listed companies, the State Council, the CSRC, and stock exchanges issued a series of regulations and rules in a bid to normalize

of listed companies has increased rapidly, from 10 in 1990 to 1381 by the end of 2005.[36] Among those 1381 listed companies, 1240 issue A shares only, 23 issue B shares only, 86 companies issue A and B shares, and 32 companies issue A and H shares.[37] By the end of 2005, 762 billion shares were issued with an aggregate market capitalization of RMB 3.24 trillion yuan[38] (U.S. $414 billion), equivalent to 17.79% of China's GDP.[39] Seventy-three million securities investment accounts were opened, mostly by individual investors.[40] Participation by institutional investors also grew, with 116 securities companies, 53 securities investment fund management companies, 34 Qualified Foreign Institutional Investors (QFIIs), and a number of insurance companies (including the China National Social Security Fund) all investing by the end of 2005.[41]

Meanwhile, 122 domestic companies issued H shares overseas, raising $55 billion.[42] Of these companies, 103 listed on the Hong Kong Stock Exchange, 2 listed on the Singapore Stock Exchange, 12 dual-listed on the Hong Kong and New York Stock Exchanges, 4 dual-listed on the Hong Kong and London Stock Exchanges, and 1 triple-listed on the Hong Kong, New York, and London Stock Exchanges.[43]

Market intermediaries consolidated and reorganized, reducing the number of securities companies from 199 in 2003 to 109 in June 2006.[44] The

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governance practices of listed companies—for example, the CSRC issued the Code of Corporate Governance for Listed Companies in 2002. In the same year, the CSRC conducted a comprehensive campaign on corporate governance. The CSRC aimed to eradicate bad corporate practices and enhance the overall quality of corporate governance of listed companies through this intensive "regulation storm" campaign. Multi-departmental coordination and multi-facetted regulations were effective in conducting the review of corporate governance practices of listed companies and investigating the wrongdoers. About fifty listed companies received an inspection, warning, criticism, and fine as a result of investigation. *See Gong si zhi li zhong chuang wei gui gong si*, *gu shi jian guan jin ru shou gong jie duan* [*Wave of Corporate Governance Measures Taking on Companies Breaching Rules*, *Regulation of Securities Market Enters to the Final Stage*], Can jin shi bao [FIN. TIMES] (P.R.C.), Oct. 25, 2002. *See generally* SHANGHAI STOCK EXCH., CHINA CORPORATE GOVERNANCE REPORT 2003, at 7.

36. SECURITIES AND FUTURES, *supra* note 29, at 17.

37. *Id.*

38. Renminbi (RMB) yuan is the official currency in China.

39. SECURITIES AND FUTURES, *supra* note 29, at 3, 14, 17.

40. *Id.* at 26.

41. *Id*. at 3.

42. *Id.* at 54.

43. *Id.* at 20-21.

44. China Research Society on WTO, *The Number of Securities Companies in Shenzhen Takes Lead in the Country*, http://www.chinawto.org.cn/sanji.jsp?id=35635. China's securities brokerage companies suffered from a protracted slump and poor liquidity in the domestic stock market, with the benchmark Shanghai Composite Index hitting an eight-year low in mid-2005. *See generally China Issues Securities Rules; Sector Overhaul*

CSRC issued rules to clean up and revitalize the securities brokerage sector and "bring it in line with international standards."[45] As a result of China's fulfilling its WTO commitments concerning securities markets, foreign investors' market participation has increased. By November 2006, eight Sino-foreign joint securities companies and twenty-four Sino-foreign joint managed fund companies were set up;[46] four representative offices of foreign securities firms became special members of Shanghai and Shenzhen Stock Exchanges, and thirty-nine foreign securities firms were engaged in B-share trading in the Shanghai Stock Exchange while nineteen traded in the Shenzhen Stock Exchange.[47] According to Assistant Chairman of the CSRC Liu Xinhua, the securities industry not only fulfilled its WTO commitments over the past five years, but went beyond the commitments by partially opening up its capital market.[48] All of these developments posed regulatory challenges. How to regulate securities markets effectively in a rapidly changing environment has been the major task for legislators and regulators.

As legislative actions react to regulatory needs, China gradually has developed a multilevel legal framework for securities markets. The Company Law and the Securities Law are the main legislative components; the State Council, CSRC, and other regulatory bodies supplement the Laws with administrative regulations and rules.[49] This Article focuses on the regulatory framework for stock exchanges and listed companies.

B. China's Regulatory Framework for Stock Exchanges and Listed Companies

The regulatory framework for securities markets and listed companies began a path of development in the early 1990s.[50] Since then, the National People's Congress (NPC), State Council, CSRC, and other relevant government agencies have promulgated laws and regulations governing securities markets, stock exchanges, and listed companies. Recent major laws and regulations include:

Could Create Delays for Foreign Investors, WALL ST. J. (Eastern ed.), Jan. 10, 2006, at C12 [hereinafter *China Issues Security Rules*].

45. *China Issues Securities Rules, supra* note 44, at C12.

46. Zhou Chong, *China Fulfilled Securities Market Commitments Under WTO*, SHANGHAI SEC. POST, Dec. 12, 2006, *available at* http://www.cnstock.com/paper_new/html/2006-12/12/content_50766674.htm.

47. *Id.*

48. *Id.*

49. *See* SECURITIES AND FUTURES, *supra* note 29, at 45-50.

50. *See id.* at 3.

- Securities Law of the People's Republic of China;[51]
- Company Law of the People's Republic of China;[52]
- Securities Investment Fund Law;[53]
- Criminal Law;[54]
- Administrative Measures on the Separation of Equity Ownership and Trading Rights of Listed Companies;[55]

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51. The Securities Law regulates securities registration and clearing institutions, stock intermediaries, the issuing and trading of securities, and the establishing and operating of stock exchanges. The Securities Law does not apply to overseas share listings of Chinese companies, such as the listing of B shares, H shares, L shares, and N shares. Nor does it apply to government bonds. These two areas are regulated by specific regulations of the CSRC and the State Council. The Securities Law applies to the issuing and trading of shares, bonds, and other forms of securities as recognized by the State Council. *See* Securities Law, *supra* note 7.

52. Gongsi fa [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994) (amended 1999 & 2005), *available at* http://www.chinadaily.com.cn/bizchina/2006-04/17/content_569258.htm (P.R.C.) [hereinafter Company Law].

53. Zhenquan touzi jijing fa [Law on Securities Investment Fund] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2003, effective June 1, 2004) 2003 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 565 (P.R.C.).

54. Xing fa [Criminal Law] (amended by the 8th Nat'l People's Cong., Mar. 14, 1997, effective Oct. 1, 1997) 1997 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 138, pt. 2, chs. 3-4 (P.R.C.). The Criminal Law was originally promulgated by the National People's Congress (NPC) in 1979 and penalizes unlawful activities in relation to securities. *Id*.

55. The CSRC issued the Administrative Measures on the Separation of Equity Ownership and Trading Rights of Listed Companies on October 14, 2005. "A" shares were previously divided into tradable and non-tradable shares, based on their tradability on stock exchanges. Non-tradable shares were mainly state-owned shares and legal person shares. The bifurcated share structure negatively impacted the markets in several ways. It distorted share pricing; did not align shareholders' interests with the corporate governance of listed companies; affected maintenance, appreciation, and transferability of state-owned assets (as well as the restructuring of the management system for state assets); and hindered the internationalization process and product innovation. In response, the CSRC reformed the program in April 2005 to change the share structure of listed companies. Now, holders of non-tradable shares pay a goodwill price to the holders of tradable shares in return for the right to trade. In principle, tradable and non-tradable shareholders negotiate the price of the right to trade, and the shareholders then vote on it. The paid price for the right to trade is neither a gift nor a form of compensation for the listed company. By the end of March 2006, 768 listed companies had completed or engaged in the reform, accounting for 57% of the 1349 listed companies eligible for the non-tradable shares reform. *See* SECURITIES AND FUTURES, *supra* note 29, at 5, 6; *see also* Handling of the Transfers of Non-tradable Shares of Listed Companies Rules (issued by the Shanghai Stock Exch., Shenzhen Stock Exch., & China Sec. Depository & Clearing Corp. Ltd., Dec. 15, 2004, effective Jan. 1 2005), CHINA L. & PRAC., Mar. 2005.

- The Measures on the Administration of Stock Exchanges;[56]
- Shanghai Stock Exchange Guidelines on Internal Control of Listed Companies;[57]
- Code of Corporate Governance for Listed Companies;[58] and
- Guidelines for Introducing Independent Directors to the Boards of Directors of Listed Companies.[59]

The Securities Law and Company Law regulate the issuing of securities and shares.[60] Specifically, the Securities Law regulates the establishment and

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By January 4, 2007, 1303 companies (representing 98% of the total market) have undertaken the share reform, 1143 companies have completed the reform, and 40 companies have not yet undertaken the share reform. *See* Huang Jintao & Wang Lu, *S gu Zhangdie fu xia zhouyi tiao wei 5%* [*The Fluctuating Rate of S Share To Be Adjusted to Five Percent*], SHANGHAI SEC. NEWS, Jan. 4, 2007, *available at* http://www.cnstock.com/paper_new/html/2007-01/04/content_51681164.htm.

56. Measures on the Administration of Stock Exchanges (promulgated by the State Council Sec. Comm'n, Dec. 10, 1997) (amended 2001), *available at* http://www.szse.cn/main/en/rulseandregulations/lawregulations/200312083189.shtml (P.R.C.).

57. SHANGHAI STOCK EXCH., GUIDELINES ON INTERNAL CONTROL OF LISTED COMPANIES (2006), *available at* http://www.sse.com.cn/ps/zhs/fwzc/jbywgz.shtml.

58. Code of Corporate Governance for Listed Companies (promulgated by the China Sec. Regulatory Comm'n & State Econ. & Trade Comm'n, Jan. 7, 2001, effective Jan. 7, 2001), *available at* http://www.csrc.gov.cn (follow "English" hyperlink, then follow "Laws and Regulations" hyperlink, then follow "Code of Corporate Governance" hyperlink) (P.R.C.). The Code regulates overall corporate governance of listed companies, covering shareholders and shareholders' meetings; controlling shareholders; directors and the board of directors; supervisory boards; performance assessments, incentives, and discipline; stakeholders; information disclosure and transparency; and supplementary articles. *Id.* It requires that independent directors comprise at least one-third of the board of directors. *See generally id.*

59. The CSRC and the State Economic and Trade Commission (SETC) issued the Guidelines for Introducing Independent Directors to the Boards of Directors of Listed Companies in 2001. Chinese-listed companies adopt two-tier board system for the internal governance: the board of directors and the board of supervisors. The board of supervisors assumes a monitoring role in the listed companies, but has consistently failed to perform that role effectively. Unlike the German system where the board of supervisors is involved in decisions of fundamental importance to the company and has the power to appoint and dismiss management board members, the Chinese counterpart does not have strategic decision-making power, and has no power to appoint or dismiss the board of directors and management. Hence, directors and management could not be effectively monitored. The independent director system was introduced by the CSRC to listed companies in a bid to improve supervision and board independence. Guidelines for Introducing Independent Directors to the Boards of Directors of Listed Companies (promulgated by the China Sec. Regulatory Comm'n, Aug. 16, 2001), *available at* http://www.csrc.gov.cn/n575458/n776436/n804965/n3300690/n3300837/n3330750/3330851.html (P.R.C.).

60. *See* Securities Law, *supra* note 7, chs. 2, 4; Company Law, *supra* note 52, ch. 5.

operation of stock exchanges and market intermediaries, information disclosure, insider trading, and market manipulation.[61] Additionally, State Council and CSRC regulations govern aspects of the securities markets and listed companies outside the scope of the Securities Law and the Company Law. These supplemental regulations are necessary because the laws lag behind China's rapid development; new situations arise which are not covered by existing laws or regulations.[62] To remedy this, the Chinese government established a unified regulatory body (the CSRC) for the securities market with rule-making powers that reports to the State Council.[63]

China's accession to the WTO in December 2001 catalyzed the development and regulation of its securities markets. China made several commitments to the WTO: It would allow foreign securities institutions to trade B shares without a Chinese intermediary; allow offices of foreign securities institutions to become special members of Chinese stock exchanges; permit foreign service suppliers to invest up to 33% in joint ventures for managing domestic securities investment funds; and, within three years of accession (December 2004), permit foreign securities institutions to invest up to 33% in joint ventures to underwrite A, B, and H shares and to trade B and H shares, government bonds, and corporate bonds.[64]

To help fulfill China's securities services commitments, the CSRC and both the Shanghai and Shenzhen Stock Exchanges issued the following rules and regulations[65]:

- *Provisional Rules on the Administration of Overseas Special Members*, issued by the Shanghai and Shenzhen Stock Exchanges in July 2002, which grants special membership to foreign securities firm offices based in China;[66]
- *Rules on B Share Trading Seats for Overseas Institutions*, issued by the Shanghai Stock Exchange in June 2002 and

61. *See* Securities Law, *supra* note 7, chs. 3-7.

62. *See* Schipani & Liu, *supra* note 21, at 28-69.

63. *See* SECURITIES AND FUTURES, *supra* note 29, at 50.

64. *See WTO Commitment of China Securities Industry: Schedule of Specific Commitments on Services, supra* note 24; *see generally* China Protocol, *supra* note 24.

65. ORG. FOR ECON. CO-OPERATION & DEV. [OECD], CHINA'S SECURITIES MARKET 1, *available at* https://www.oecd.org/dataoecd/5/32/18469881.pdf (last visited Feb. 21, 2007).

66. The Shanghai and Shenzhen Stock Exchanges had four overseas special members by November 2006. *See* Zhou Yu, *Zhenquan ye chaoer wancheng rushi chennuo* [*Securities Markets Exceedingly Fulfilled WTO Commitments*], SHANGHAI SEC. NEWS, Nov. 12, 2006, *available at* http://www.cnstock.com/paper_new/html/2006-12/12/content_50766651.htm.

by the Shenzhen Stock Exchange in July 2002, which allows overseas institutions to directly trade B shares;[67]

- *Rules on Establishing Securities Companies with Foreign Shareholding*, issued by the CSRC in June 2002;[68]
- *Rules on Establishing Fund Management Companies with Foreign Shareholdings*, issued by the CSRC in June 2002;[69] and
- The *Qualified Foreign Institutional Investor (QFII)*[70] scheme, introduced by the CSRC in December 2002, which opened the domestic A shares market to foreign investors.[71] The QFII scheme is a transitional measure aimed at attracting foreign portfolio investment.

These rules made the markets more internationally competitive by encouraging further liberal regulation of the securities markets and foreign investment.

C. Post-WTO Foreign Investment in China's Securities Markets

Separate laws govern foreign investment companies and domestic investment companies in China. When the Company Law conflicts with specific laws governing foreign investment, specific laws prevail over the Company Law.[72] Consequently, the Company Law applies to foreign investors only where the foreign investment laws are silent.

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67. By November 2006, special B-share trading seats were granted to thirty-nine and nineteen overseas securities companies by the Shanghai and Shenzhen Stock Exchanges, respectively. *Id.*

68. Eight joint venture securities companies were set up by November 2006. *Id.*

69. Twenty joint venture fund management companies had been established by the end of 2005, managing sixty-nine funds (representing 31.7% of all funds) with a total of 121.6 billion units (representing a 25.8% share of the market). SECURITIES AND FUTURES, *supra* note 29, at 56.

70. "QFII" is defined as "overseas asset management institutions, insurance companies, securities companies and other asset management institutions" approved by the CSRC and granted a foreign exchange quota by the State Administration of Foreign Exchange. Hege jingwai jigou touzizhe jingnei zhengquan touzi guanli zanxing banfa [Provisional Measures on Administration of Securities Investments in China by Qualified Foreign Institutional Investors] (promulgated by the China Sec. Regulatory Comm'n & People's Bank of China, Nov. 5, 2002, effective Dec. 1, 2002), CHINA L. & PRAC. (last visited Mar. 28, 2007) (P.R.C.).

71. Fifty-two foreign financial institutions were licensed as QFIIs by November 2006, with a total investment quota of $86.45 billion, while five foreign banks were licensed as the custodians of QFIIs. *See* Zhou Yu, *supra* note 66.

72. Company Law, *supra* note 52, ch. 1, art. 18.

To facilitate foreign investment in Chinese companies, the CSRC issued special regulations allowing Chinese companies to offer shares to overseas investors.[73] Chinese companies may list on foreign stock exchanges if relevant regulatory bodies approve them and they satisfy the requirements for issuing domestic shares.[74] These share issues can be made only on foreign stock exchanges with which China has entered into a Memorandum of Understanding to jointly supervise listing and share issuing.[75] These special requirements for overseas listings allow the CSRC to regulate listed companies in foreign markets.

To cater to the demands of foreign securities companies and investors, the National People's Congress recently amended the Securities Law and showed a cautious embrace of international securities law principles and practices. According to the amendments, foreign companies may trade A shares and other listed securities through the QFII scheme, and domestic B-share-issuing companies are subject to special regulations of the State Council.[76] Domestic companies that directly or indirectly issue or list any securities abroad for trading are still subject to regulatory oversight by the CSRC.[77]

After China entered the WTO, registered foreign companies were permitted to apply to issue and list their shares in China. These companies are accorded national treatment as long as their business plans are consistent with China's national industrial development guidelines for foreign investment.[78] Additionally, the CSRC and Ministry of Commerce must approve the foreign securities offering. For example, the Interim Measures for the Administration of the Issuance of Renminbi-denominated Bonds allowed international development institutions such as the International Finance Corporation and Asian Development Bank to issue Renminbi bonds (so-called Panda Bonds).[79]

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73. *See, e.g.*, State Council Regulation on Foreign Capital Stocks of Companies Limited by Shares Listed in China (promulgated by the St. Council, Dec. 25, 1995), *available at* http://211.154.210.238/cn/jsp/detail.jsp?infoid=1059896202100&type=CMS .STD&path=ROOT%3ECN%3E%B7%A8%C2%C9%B7%A8%B9%E6%3E%D0%D0% D5%FE%B7%A8%B9%E6 (P.R.C.).

74. *See* I.A. TOKLEY & TINA RAVN, COMPANY AND SECURITIES LAW IN CHINA 82-85 (Sweet & Maxwell Asia 1998).

75. These include the Hong Kong Stock Exchange, the London Stock Exchange, and the New York Stock Exchange. *Id.* at 84.

76. Securities Law, *supra* note 7, art. 239.

77. *Id*. art. 238.

78. For example, the catalogue of encouraged foreign investment industries includes farming, forestry and fishery industries, and mining industries. *See* Catalogue for the Guidance of Foreign Investment Industries (promulgated by the State Dev. & Reform Comm'n & Ministry of Commerce, Nov. 30, 2004, effective Jan. 1, 2005), *available at* http://english.mofcom.gov.cn/aarticle/topic/lawsdata/chinaforeigntradelaw/200501/200501 00015843.html (last visited Jan. 8, 2007) (P.R.C.).

79. The People's Bank of China, the Ministry of Finance, the National Development and Reform Commission, and the CSRC jointly issued them on February 18, 2005. *See*

In late 2002, another important post-WTO change allowed state-owned shares and legal person shares to be transferred to foreign investors.[80] Twenty-six of these transfers occurred by the end of 2005.[81] As of January 2006, foreign investors may also become medium- or long-term strategic investors of companies that listed after 2002 or listed companies that completed non-tradable-share reform.[82]

While China's markets are being opened to foreign investors, the CSRC still carefully controls overseas listings and the issuing of shares to foreign investors by Chinese companies. Until the CSRC's ongoing cleanup of securities companies is complete, foreign companies may still encounter difficulties while investing in Chinese brokerage firms.[83]

III. CHINA'S STOCK EXCHANGES AND LISTED COMPANIES IN THE REGULATORY FRAMEWORK

While stock exchanges were traditionally not-for-profit organizations that promoted mutual cooperation between members, a process called demutualization has transformed many exchanges around the world.[84] Since the Stockholm Stock Exchange first demutualized in 1993, stock exchanges in the United Kingdom, United States, Australia, Singapore, and Japan have followed suit.[85]

Yang Tiecheng, Alan Xu & Allen Zhong, *Steady as She Goes: China's New Securities Law*, CHINA L. & PRACT., Dec. 2005 (last visited Mar. 28, 2007).

80. "Legal person shares" are held by domestic institutions, such as industrial enterprises, securities companies, trust and investment companies, various foundations and funds, banks, construction companies, transportation and power companies, and research institutes. TEVEV ET AL., *supra* note 28, at 76.

81. *See* SECURITIES AND FUTURES, *supra* note 29, at 55.

82. Measures for Administration of Strategic Investments of Foreign Investors in Listed Companies (promulgated by the Ministry of Commerce & the China Sec. Regulatory Comm'n, Dec. 31, 2005, effective Feb. 1, 2006), *available at* http://english.mofcom.gov.cn/aarticle/policyrelease/domesticpolicy/200604/20060401971375.html (last visited Jan. 26, 2007) (P.R.C.).

83. *See* Samuel Shen, *China Market Regulator Orders Cleanup*, INT'L HERALD TRIB., June 16, 2005, *available at* http://www.iht.com/articles/2005/06/15/bloomberg/sxbrokerage.php.

84. *See* Zenyi Xie, *Zhengquan jiaoyisuo zuzhi jigou he gongsi zhili de zuixing fazhang* [*The New Developments of Organizational Structure of the Stock Exchange and Corporate Governance*], 2 HUANQIU FALU PINGLONG [GLOBAL L. REV.] (Beijing 2006).

85. Jennifer Elliott, *Demutualization of Securities Exchanges: A Regulatory Perspective* 3 (Int'l Monetary Fund, Monetary & Exch. Affairs Dep't, Working Paper No. 02/119, 2002), *available at* http://www.imf.org/external/pubs/ft/wp/2002/wp02119.pdf. The NASDAQ, London, and Toronto Stock Exchanges were demutualized in 2000. The Singapore Stock Exchange was demutualized in 1999, and the Tokyo Stock Exchange was demutualized in 2001. WORLD FED'N OF EXCHS., COST AND REVENUE SURVEY 2004

Demutualization transforms a traditional not-for-profit mutual stock exchange[86] into a profit-driven, demutualized company, with exchange members becoming shareholders in the new company.[87] Demutualization maximizes shareholders' interests by improving corporate governance and accounting practices, enhancing professional managers' decision-making efficiency, and increasing innovation and competitiveness.[88] Demutualized stock exchanges in developed economies themselves have also become listed companies to benefit fully from the demutualization.[89] Stock exchanges in emerging economies such as the Philippines and Malaysia have also been demutualized.[90]

Chinese stock exchanges adopted a membership system,[91] and the members' council plays a small decision-making role.[92] In this sense, Chinese stock exchanges are not traditional mutual-help organizations owned and run by members. The board of directors (*lishihui*) is the decision-making organ and is comprised of both member (securities companies)[93] and non-member directors.

(2005), *available at* http://www.world-exchanges.org/publications/2004%20Cost%20&%20Revenue%20Survey.pdf; Pamela S. Hughes, *Background Information on Demutualization*, *in* DEMUTUALIZATION OF STOCK EXCHANGES: PROBLEMS, SOLUTIONS AND CASE STUDIES 33 (Shamshad Akhtar ed., Asian Dev. Bank 2002), *available at* http://www.adb.org/Documents/Books/Demutualization_Stock_Exchanges/default.asp#contents.

86. A mutual stock exchange promotes mutual help and cooperation between members and is not a legal person with limited liability. *See* Elliott, *supra* note 85, at 4.

87. *Id.*

88. *See id.* at 13.

89. *See generally* Shamshad Akhtar, *Demutualization of Asian Stock Exchanges – Critical Issues and Challenges*, *in* DEMUTUALIZATION OF STOCK EXCHANGES: PROBLEMS, SOLUTIONS AND CASE STUDIES, *supra* note 85, at 3.

90. *See* PHIL. SEC. & EXCH. COMM'N, OECD ROUND TABLE ON CAPITAL MARKET REFORM: COUNTRY REPORT OF THE PHIL. 2 (2003), *available at* www.oecd.org/dataoecd/5/34/18470633.pdf.

91. *See* Securities Law, *supra* note 7, art. 105:

> The gains as accumulated by a stock exchange that adopts a membership system shall belong to its members. The rights and interests of a stock exchange shall be jointly shared by its members. No accumulated gains of a stock exchange may be distributed to any member within the holding term.

92. ZHOU LINJIE, ZHENGQUAN JAIOYI SUO HUIYUAN JIANGUAN ZHIDU YANJIU BAOGAO [A REPORT ON THE SUPERVISION SYSTEM OF MEMBERS OF STOCK EXCHANGES] *available at* http://www.szse.cn/main/research/cograduate/researchreport/200312315449.shtml (last visited Mar. 29, 2007) (P.R.C.).

93. Securities companies include underwriters, brokers, dealers, and investment management companies. Securities companies are generally members of a stock exchange. *See* Securities Law, *supra* note 7, arts. 112, 123, 125. Only a member of a stock exchange may engage in aggregated trading of securities on the exchange. *Id.* art. 110.

The members elect member directors and the CSRC appoints non-member directors.[94] In addition, the CSRC nominates the chairman and deputy chairman, who are then elected by the board.[95] The CSRC also appoints, and may dismiss, the general manager and deputy general manager of a stock exchange.[96] Hence the CSRC maintains control of the stock exchange's board of directors and management.

Examining the history of Chinese stock exchanges and the major factors of their development helps to understand the current status of stock exchanges and listed companies.

A. Brief History of China's Stock Exchanges

The first stock exchange in China, the Shanghai Stock Exchange (Shanghai *Gupiao Jiaoyisuo*), was the largest Asian stock exchange until 1941.[97] The exchange was established in 1905, after the Shanghai Stock & Stockbrokers' Association was formed in 1898.[98] Cotton and rubber trading boomed in this exchange as did highly speculative share trading caused by political and social unrest from the 1911 Revolution until 1929.[99] Political uncertainty and military activities in and around the International Settlement in Shanghai in the 1930s shook the "security and economic integrity of China's premier port and financial centre," and resulted in a long period of share market depression.[100] Although

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94. *See* Measures on the Administration of Stock Exchanges, *supra* note 56, art. 20.

95. *See id*. art. 21.

96. *See id*. arts. 24-25, 100.

97. *See* W.A. THOMAS, WESTERN CAPITALISM IN CHINA: A HISTORY OF THE SHANGHAI STOCK EXCHANGE 231-32 (2001).

98. The demand for company securities began well before the Qing government officially introduced the company system to China through the First Chinese Company Regulation in 1904. Chinese merchants subscribed to the shares of foreign insurance companies and banks as early as the 1830s. After the Treaty of Nanjing in 1842, Chinese investment in foreign companies increased because of the greater gain of share trading and limited liability protection, features not available to indigenous Chinese enterprises until 1904. The increased volume of transactions created a need for standardized practices and regulated prices, which justified establishing a formal body. The Stock & Stockbrokers' Association had forty-seven members at the time of its establishment. *See id.* at 86-97; William C. Kirby, *China Unincorporated: Company Law and Business Enterprise in Twentieth Century China*, 54 J. ASIAN STUDIES 43 (1995); CONRAD SCHIROKAUER & MIRANDA BROWN, A BRIEF HISTORY OF CHINESE CIVILIZATION (Wadsworth Publ'g 1991).

99. This period was both politically and militarily eventful. The 1911 Revolution brought down the Qing dynasty, and soon after, war between powerful warlords tore the country apart. This was followed by the May Fourth Movement in 1919 and the Northern Expedition (BeiFa) in 1926. All of this political and military activity disturbed the share market and the Shanghai Stock Exchange. *See* THOMAS, *supra* note 97, at 145-208.

100. *See id*. at 211.

general and rubber price surges momentarily relieved the depression, the share market and the Shanghai Stock Exchange were forced to close in 1941.[101] After the Nationalist Government took full control of Shanghai, and in the spirit of eliminating the occupation by foreign powers, the government indicated that foreign interests would be subservient to Chinese needs and would be subject to the regulation of the 1946 Company Law.[102] The old Shanghai Stock Exchange would not be re-opened, and a new exchange (Shanghai *Zhenquan Jiaoyisuo*), which allowed only Chinese citizens to be members, opened in 1946.[103] This short-lived exchange closed when the Communist Party defeated the Nationalist Government in 1949.[104]

After the founding of the People's Republic of China in 1949, the government nationalized all private property and abolished capitalist economic features, including securities markets.[105] In the 1950s and early 1960s, socialist economic development was interrupted by the political campaigns of the "Three Antis" (*San Fan*),[106] the "Five Antis" (*Wu Fan*),[107] and the "Great Leap Forward" (*Da Yue Jing*).[108] The Cultural Revolution completely halted economic development from 1966 to 1976.[109]

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101. *Id.* at 211-32.

102. *See id*. at 233.

103. *Id.*

104. *See id.* at 231-32.

105. *See* SCHIROKAUER & BROWN, *supra* note 98.

106. The "Three Antis" (*San Fan*) campaign "was directed against the evils of corruption, waste and bureaucratism, and aimed to eliminate incompetent and politically unreliable officials and bring about an efficient, disciplined, and responsive bureaucratic system." *See Chinese Cultural Studies: Concise Political History of China*, http://academic.brooklyn.cuny.edu/core9/phalsall/texts/chinhist.html (last visited Feb 15, 2007).

107. The "Five Antis" (*Wu Fan*) campaign was aimed at "eliminating recalcitrant and corrupt businessmen and industrialists, who were in effect the targets of the Party's condemnation of tax evasion, bribery, cheating in government contracts, thefts of economic intelligence, and stealing of state assets." *Id.*

108. The stated goal of the "Great Leap Forward" (*Da Yue Jing*) was to hasten the pace with which China was embracing communism. *Id.*

109. *See generally* TANG TSOU, THE CULTURAL REVOLUTION AND POST-MAO REFORMS: A HISTORICAL PERSPECTIVE (1986). The Cultural Revolution was a struggle for power within the Communist Party of China, which grew to include large sections of Chinese society and eventually brought China to the brink of civil war. Party Chairman Mao Zedong launched the Revolution on May 16, 1966, to regain control of the party after the disasters of the Great Leap Forward caused him to lose power to his deputies Liu Shaoqi and Deng Xiaoping. During the ten-year period, Mao's supporters organized the "Red Guards," a mass youth militia, to overthrow his enemies and seize control of the government. Millions died and millions more were injured or imprisoned during the chaotic period. *See generally id.*

Not until the 1980s did the Chinese government prioritize the development of securities markets as a part of its economic reform and liberalization program.[110] Unlike stock exchanges in Western countries, which emerged from a long history of development of securities markets,[111] Chinese stock exchanges emerged after only ten years of economic reform aimed at restructuring the national economy in the wake of ill-conceived economic policy failures and political disruptions of the previous decades.[112]

China's modern experience with securities started with the State Council's issuance of a national treasury bond in 1981.[113] The People's Bank—the central bank of China—authorized the opening of the first over-the-counter market in Shengyang in 1986.[114] The Shanghai Stock Exchange was established in December 1990, and the Shenzhen Stock Exchange was established in July 1991.[115] Shanghai and Shenzhen are China's two major exchanges.

By the end of 2005, 834 companies with 878 securities were listed on the Shanghai Stock Exchange, and market capitalization totaled RMB 2.31 trillion yuan ($295 billion).[116] Five hundred forty-four companies with 586 securities, including fifty companies listed in the Small and Medium Enterprises (SME) Segment,[117] were listed on the Shenzhen Stock Exchange, and market capitalization of the exchange totaled RMB 933 billion yuan ($119 billion).[118]

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110. *See* WALTER & HOWIE, *supra* note 1, at 22-24; Zhang Wenkui, Dev. Research Ctr. of the State Council (P.R.C.), *The Role of China's Securities Market in SOE Reform and Private Sector Development*, at 1, *available at* http://www.tcf.or.jp/data/20020307-08_Wengkui_Zhang.pdf (last visited Mar. 29, 2007).

111. For example, the London Stock Exchange was established in 1801 after the gradual development of securities markets over approximately a century. RANALD C. MICHIE, THE LONDON STOCK EXCHANGE: A HISTORY 15-35 (1999). The New York Stock Exchange also emerged after a long history of share trading. *See* Stuart Banner, *The Origin of the New York Stock Exchange, 1791-1860*, 27 J. LEGAL STUD. 113 (1998).

112. *See* WALTER & HOWIE, *supra* note 1, at 21-30.

113. LI CHANGJIANG, THE HISTORY AND DEVELOPMENT OF SECURITIES MARKETS IN CHINA 61 (Wuzi Press 1998).

114. *See id.* at 61. An over-the-counter market trades securities that are not traded on an exchange, usually due to an inability to meet listing requirements. Investorwords, Over-the-Counter, http://www.investorwords.com/3557/over_the_counter.html (last visited Feb. 23, 2007).

115. THOMAS, *supra* note 97, at 278-81.

116. *See* SECURITIES AND FUTURES, *supra* note 29, at 35.

117. The Small and Medium Enterprises (SME) Segment was launched at the Shenzhen Stock Exchange on May 27, 2004. *The Small & Medium Enterprise Board Approved*, SEC. TIMES (Beijing), May 28, 2004, *available at* http://www.szse.cn/main/en/smeboard/aboutsmeboard/200409026295.shtml. This segment observes the same initial public offering (IPO) criteria as other segments of the main board. *See* Shenzhen Stock Exch., *Briefing of Small and Medium Enterprises Board*, Aug. 31, 2004, http://www.szse.cn/main/en/smeboard/aboutsmeboard/200408316286.shtml.

118. *See* SECURITIES AND FUTURES, *supra* note 29, at 36.

<u>B. The Role and Functions of Stock Exchanges in China</u>

The Securities Law regulates the overall operation of stock exchanges. The Law defines a "stock exchange" as "a legal person that provides venue and facilities for securities trading, organizes and supervises trading of securities, and practices self-regulation."[119] However, the Law does not specifically define what securities are.[120] A stock exchange is required to adopt a constitution, and the CSRC must approve the constitution and any alterations.[121] The board of governors is the major organ of a stock exchange.[122] The CSRC appoints, and may dismiss, the general manager.[123]

The major functions of a stock exchange include:

1. providing a venue and facilities for the trading of securities;
2. formulating business rules;
3. receiving listing applications and handling listing issues;
4. organizing and supervising the trade in securities;
5. supervising the conduct of members of the exchange and listed companies; and
6. managing and disclosing market information.[124]

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119. Securities Law, *supra* note 7, art. 102. This definition is different from that of the 1999 Securities Law, which simply defined a stock exchange as a non-profit organization with a legal personality that provides a venue for the trading of securities. *See* Securities Law 1999, art. 95, *available at* http://www.novexcn.com/securities_law_99.html (last visited Mar. 21, 2007) (P.R.C.).

120. Securities Law, *supra* note 7, art. 2, states:

> [T]he Law applies to the issuance and transaction of stocks, corporate bonds as well as any other securities as lawfully recognized by the State Council within the territory of the People's Republic of China. Where there is no such provision in the Law, the provisions of the Company Law and other relevant laws and administrative regulations shall apply. Any listed trading of government bonds and shares of securities investment funds shall be governed by this Law. In case there is any special provision in any other law or administrative regulation, the special provision shall prevail. The measures for the administration of issuance and transaction of securities derivatives shall be issued by the State Council in accordance with the principles of this Law.

121. Securities Law, *supra* note 7, art. 103.

122. *See id*. art. 106.

123. *Id*. art. 107.

124. SECURITIES AND FUTURES, *supra* note 29, at 33-34.

Stock exchanges must adhere to requirements outlined in the Securities Law to execute the functions above. For example, Article 103 of the Securities Law requires a stock exchange to formulate rules on listing, trading, and membership, and submit these rules to the securities regulatory authorities under the State Council for approval.[125] Additionally, the Securities Law requires that a stock exchange ensure a fair environment for trading securities, instantly announce quotations, and publish a day-to-day quotation table of the securities market.[126] A stock exchange also supervises information disclosure by listed companies and encourages accurate and timely disclosure.[127]

If an emergency interrupts day-to-day securities trading, a stock exchange may suspend trading and must timely report the suspension to the CSRC.[128] Similarly, a stock exchange must monitor securities trading at all times and report any abnormalities to the CSRC.[129] An exchange may also restrict trading through a securities account if any major abnormal trading occurs, such as manipulating stock prices, and must report the abnormality to the CSRC for filing.[130] The Law requires exchanges to timely announce their decisions regarding suspending or terminating securities trading of listed companies and also to lodge their decisions with regulatory authorities.[131]

In reality, the stock exchanges' monitoring functions and those of the CSRC are not clearly delineated. In most cases, the CSRC has the final say in regulating markets and listed companies. For instance, although the stock exchanges set out listing requirements, a company's securities may be listed on an exchange only if the CSRC approves of the listing. Additionally, while stock exchanges supervise information disclosure by listed companies, they lack real power to investigate and punish information disclosure malpractice.[132] In contrast, the CSRC enacts information disclosure rules. It supervises the annual and interim reports of listed companies, as well as company announcements for

125. Securities Law, *supra* note 7, art. 103. The CSRC is the major national regulatory authority under the State Council. CSRC, About Us: Introduction of CRSC, http://211.154.210.238/en/homepage/about_en.jsp (last visited Mar. 21, 2007).

126. Securities Law, *supra* note 7, art. 113.

127. *Id*. art. 115.

128. *Id*. art. 114.

129. *Id*. art. 115.

130. *Id*.

131. *Id*. art. 72.

132. *See* Securities Law, *supra* note 7, art. 115 (stating a stock exchange's supervision responsibility on information disclosure of listed companies). In reality, most corporate misconducts of listed companies involve information disclosure, and lack of specified civil liability against wrongdoers and a weak enforcement regime resulted in only a handful of them being punished. *See* Gongmeng Chen et al., *Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions*, 24 J. ACCT. PUB. POL'Y 451, 480 (2005); *see also* In-Mu Haw et al., *Securities Regulation, the Timing of Annual Report Release, and Market Implications: Evidence from China*, 17 J. INT'L FIN. MGMT. ACCT. 110 (2006).

distributing and allocating new shares.[133] In effect, the CSRC's interventionist role in securities regulation overshadows the stock exchanges' ability to practice their self-regulatory role mandated by the Securities Law.

C. Listed Companies in China

Listed companies emerged as a result of the reform and transformation of the state-owned enterprises. Since 1979 the state-owned enterprises have gone through four major strategic economic and legal policy shifts: (1) greater autonomy for managers, (2) management contracting, (3) restructuring, and (4) ownership diversification.[134] The most significant shift was the restructuring of state-owned enterprises as corporations.[135]

The Company Law was promulgated in 1993 by the National People's Congress to facilitate the corporatization of state-owned enterprises. Under the Law, state-owned enterprises may be restructured, or "corporatized," into three types of companies: wholly state-owned companies, limited liability companies, and joint stock limited companies.[136] After meeting listing requirements, restructured state-owned enterprises can be listed on the stock exchanges. The majority of listed companies in China are transformed state-owned enterprises.[137]

Though transformed, the restructured companies inherited the traditional operating and management culture of the old state-owned enterprises because many controlling shareholders are government-owned entities.[138] The governance

133. Securities Law, *supra* note 7, art. 70.

134. For a detailed account governing state enterprises in China, see Shi, *supra* note 8, at 60-94.

135. *See* Fang Liufang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149, 181-85 (1995).

136. Company Law, *supra* note 52, ch. 5, art. 159. In a limited liability company, shareholders assume liability towards the company to the extent of their respective capital contributions, with the company liable for its debts to the extent of all its assets. *Id.* ch. 1, art. 3. A wholly state-owned company is a limited liability company invested in and established solely by a state-authorized investment institution or a department authorized by the state. *Id*. ch. 2, art. 63. A joint stock limited company has its total capital divided into shares of equal value, with shareholders being liable to the proportion of their holdings and the company being liable for its debt to the extent of all its assets. *Id*. ch. 1, art. 3. A joint stock limited company may be organized as a public share offer, with a maximum of sixty-five percent of shares going to the public. *Id.* ch. 3, art. 83. With such public involvement, incorporation is subject to the approval of either a department authorized by the State Council or a government department at the provincial level. *Id*. ch. 3, art. 77.

137. *See* Schipani & Liu, *supra* note 21.

138. Traditionally, state enterprises were not independent economic entities because the government managed and operated them. *See* SHI JIANHUI ET AL., GONG SI ZHI LI: ZHONG GUO DE JING YAN [CORPORATE GOVERNANCE: CHINA'S EXPERIENCE] 103 (*Ren min chu ban she* 2001).

of listed companies still presents complex, and sometimes intractable, problems inherent to the transitioning from a planned socialist economy to a market economy.[139]

The shareholding structure of domestically listed companies is comprised of state shares, legal person shares, and individual shares.[140] Central and local governments generally hold state shares and are represented by corresponding financial institutions.[141] State asset management companies or investment companies may also hold state shares.[142] Legal person shares are held by domestic institutions such as industrial enterprises, securities companies, trust and investment companies, various foundations and funds, banks, construction companies, transportation and power companies, and research institutes.[143] Individual shares are held by individual investors.

State shares cannot be traded on the stock exchanges and legal person shares can only be traded between legal persons. This caused pricing and liquidity problems in China's securities market. Accurate pricing and good liquidity are essential features of an efficient market.[144] Accurate pricing is not only important for initial public offerings and subsequent offerings but also for monitoring corporate control and management performance.[145] Market liquidity reduces transaction costs and risks associated with investments.[146] Markets are liquid when investors can buy or sell shares without too many constraints. No transferability of state shares and legal person shares constrained the fair liquidity of the stock markets.[147]

"By the end of 2004, the[se] non-tradable shares accounted for 64% of the total shares in the Chinese capital market (among which the state owned 74%)."[148] The non-tradability of these shares had such a negative impact on the markets[149] that in October 2005, the CSRC issued measures to reform non-tradable shares.[150] According to the reform measures, the state still owns some

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139. Such as the separation of the state's role as the owner of the state-owned enterprises (SOEs) from its role as the regulator.

140. *See* TEVEV ET AL., *supra* note 28, at 76.

141. *See id.*

142. *Id.*

143. *Id.*

144. *See* Ronald Gilson & Reinier R. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

145. *See* Marcel Kahan, *Securities Regulations and the Social Costs of Inaccurate Stock Prices*, 41 DUKE L.J. 977, 1006 (1992).

146. *See id*. at 1020.

147. Liu Xinhui, King & Wood, *Liquidity on China's Securities Market After the Full Circulation Reform*, *available at* http://www.kingandwood.com/Bulletin/Bulletin%20PDF/en_2006-07-China-liuxinhui.pdf (last visited Mar. 29, 2007).

148. SECURITIES AND FUTURES, *supra* note 29, at 5.

149. *Id.*

150. *See supra* text accompanying note 55.

two-thirds of China's listed companies, but those shares were converted into tradable form during 2006 under a plan which compensated minority shareholders for the dilution in their holdings.[151] Some 97% of listed companies have now completed the reform program.[152] Those companies that fail to undertake the reform have been placed in a new category: "S" shares. They will be penalized by having their daily trading limits halved.[153] The reform program has successfully removed split share structure (tradable versus non-tradable shares), which is the key culprit for China's stagnant stock market.[154] The implementation of the reform has already boosted investor confidence and market performance.[155]

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151. The reform process involves four steps:

> First, a reform proposal must be raised by the holders of at least two-thirds of the non-tradable shares of the company, with the help of professional advisors such as sponsors and lawyers. The sponsor must, on behalf of the board, seek the opinion of the relevant stock exchange on the technical feasibility of the reform proposal. Second, the holders of non-tradable shares and the listed company will hold various meetings with the holders of tradable shares to discuss the reform proposal. Third, the holders of the non-tradable shares entrust the board of directors of the company to convene a shareholders' meeting. The reform proposal must be approved by at least two-thirds of the voting rights of all shareholders present at the meeting and at least two-thirds of the voting rights of the holders of tradable shares who participated in the vote (either by attending the shareholders' meeting or via the Internet voting system). Finally, if the reform proposal is approved at the shareholders' meeting, the board makes a public announcement on its implementation. If the reform proposal is not adopted at the shareholders' meeting, the holders of non-tradable shares may, after three months, entrust the board to convene another shareholders' meeting on the reform proposal.

Emma Davies, *China's Share Conversion Reform: Impact on Foreign Companies Investing in Chinese Listed Companies*, 12 World Sec. L. Rep. (BNA) (Mar. 2006).

152. *See* Huang Jintao & Wang Lu, *S gu zhang die fu xia zhou yi qi tiao wei 5* [*Share Price of S Shares Companies Cannot Rise or Fall by More Than 5 Per Cent in One Day*], SHANGHAI SEC. DAILY, Jan. 4, 2007, *available at* http://www.cnstock.com/paper_new/html/2007-01/04/content_51681164.htm.

153. The share price of these companies cannot rise or fall by more than 5% in one day from the previous session's close, compared to 10% for other shares. Shenzhen Stock Exch., *Listed Companies Not Implementing the Share Reform To Be Differentiated*, *available at* http://www.szse.cn/main/aboutus/bsyw/200612259669.shtml (last visited Mar. 30, 2007).

154. *See Challenges and Opportunities for Post-WTO China's Securities Market*, *available at* http://business.sohu.com/20060708/n244690661.shtml (last visited Mar. 29, 2007).

155. *See* Colleen Ryan, *Reforms Lift Shanghai Market Skyward*, AUSTRALIAN FIN. REV., Jan. 5, 2007.

The performance of listed companies in the stock market and investors' confidence in listed companies is also reflected in companies' ability to pay dividends. Overall, few companies have offered dividends to minority shareholders since the start of their operations.[156] About 65% of listed companies failed to distribute dividends from 1993 to 2003.[157] Only 244 of 1300 listed companies have provided cash dividends over the past three years, and only 85 of 224 companies offered post-tax dividends at a rate higher than the one-year interest rate for banking deposits.[158]

This inability of shareholders to share in their companies' profits was one of the reasons why the stock market became bearish.[159] To boost the market and restore investors' confidence, the CSRC issued an order compelling listed companies to pay dividends to shareholders.[160] If companies did not provide cash dividends, the CSRC would not approve additional share issues.[161] The government adopted other measures to boost the stock market: it reduced taxes on share trading, allowed insurance companies and social security funds to enter the market, and reformed the pricing mechanism for initial public offerings.[162] While these measures have been helpful, the government needs to do more to revive the stock market. It must strengthen effective regulation of market players, improve corporate governance, enhance the national credit record system, and improve the quality of professional managers. Hence, while stock exchanges and listed companies are on the receiving end of rigorous CSRC regulations, their self-regulatory functions have yet to be fully explored.

D. A Comparison of Chinese and Foreign Regulatory Bodies

Local governments and provincial branches of the People's Bank of China (PBOC) initially regulated the Shanghai and Shenzhen Stock Exchanges. The State Council Securities Commission, the predecessor of the CSRC, later took over the PBOC's regulatory role. In 1998, the State Council restructured the State Council Securities Commission into the CSRC to create a single, uniform regulatory agency.[163] The CSRC reports directly to the State Council and is the sole regulatory body of the securities markets, effectively limiting the PBOC's

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156. *Poor Governance Blamed for Securities Market*, CHINA DAILY, Apr. 3, 2005, *available at* http://www.chinadaily.com.cn/english/doc/2005-04/03/content_430562.htm (last visited Feb. 24, 2007).

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *Poor Governance Blamed for Securities Market, supra* note 156; *see also* SECURITIES AND FUTURES, *supra* note 29, at 7, 14, 31.

163. WALTER & HOWIE, *supra* note 1, at 9.

powers over securities.[164] The CSRC drafts and enforces securities rules and approves all public share issues through domestic or foreign stock exchanges.[165]

According to Article 179 of the Securities Law, the CSRC:

1. Formulates securities market rules and regulations, and examines, approves, and verifies securities;
2. Regulates the offering, trading, registering, custody, and clearing of securities;
3. Regulates business activities of securities issuers, listed companies, stock exchanges, securities companies, securities registration and clearing institutions, securities investment fund management institutions, securities investment consulting organizations, credit-rating institutions, law firms, public accounting firms, and asset appraisal organizations engaged in the securities business;
4. Formulates qualification criteria and the code of conduct for persons engaged in the securities business, and ensures the criteria and code are observed;
5. Supervises and inspects information disclosure for the offering and trading of securities;
6. Guides and supervises the Securities Industry Association; and
7. Investigates violations of securities market laws and administrative regulations.[166]

Under the State Council's supervision, the CSRC has cemented its regulatory role. In June 1993, before the Company Law was promulgated, the CSRC released preliminary rules on the content and form required for information disclosure by listed companies.[167] The rules cover share issues, the prospectus,

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164. *See* Securities Law, *supra* note 7, art. 7. For example, prior to the Securities Law, the People's Bank of China (PBOC) could issue business licenses to securities firms, but now only the CSRC may issue business licenses. "The establishment of a securities company shall be subject to examination and approval by the securities regulatory authority under the State Council. No one may engage in securities business without approval of the said authority." *Id*. art. 122. The PBOC tried to retain its power by delaying its relinquishing of supervisory control to the CSRC. This is because regulatory bodies retain their vested interests by protecting and consolidating their interests in the face of economic liberalization. *See* BERNARD M. HOEKMAN & MICHEL M. KOSTECKI, THE POLITICAL ECONOMY OF THE WORLD TRADING SYSTEM: FROM GATT TO WTO 140 (Oxford Univ. Press 1995).

165. TOKLEY & RAVN, *supra* note 74, at 69.

166. Securities Law, *supra* note 7, art. 179.

167. CSRC, IMPLEMENTATION RULES ON INFORMATION DISCLOSURE BY LISTED COMPANIES, *available at* http://www.oecd.org/dataoecd/6/60/1931117.pdf (last visited Mar.

the annual report, changes in shareholding, and listing shares.[168] The Securities Law reinforced the CSRC's position, requiring stock exchanges to timely report any abnormal trading to the CSRC and to seek CSRC approval to form rules for listing, trading, and membership.[169]

In comparison, the securities markets' regulatory bodies in the United States, the United Kingdom, and Australia intervene less when regulating stock exchanges and listed companies. Although the U.S. securities regulation regime is considered strict, the U.S. Securities and Exchange Commission (SEC)—the central regulatory authority with broad supervisory and investigative powers—actually has a limited role in regulating company listing and internal stock exchange operation.[170] Its authority in this area is limited to trading rules, and it does not interfere with issuer-related matters.[171] In contrast, the CSRC has final approval of the listing and trading rules of Chinese stock exchanges.[172]

Moreover, while the SEC ensures "fair competition . . . among exchange markets,"[173] the CSRC has never played an advocacy role. For instance, before the Securities Law was amended, the CSRC allocated a company listing to either of the two stock exchanges in China.[174] As such, Chinese exchanges had no incentive to create a better regulatory environment for investors through self-regulation.

In some western countries, self-regulation has proven to effectively regulate securities markets and stock exchanges. For example, both the New York Stock Exchange and the American Stock Exchange are self-regulated.[175] The London Stock Exchange has substantial regulatory power and follows a set of

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27, 2007). The rules require directors of listed companies to ensure there are no false or misleading statements or material omissions in the disclosure documents of their companies. Directors will be jointly liable if they fail to do so. *See id.* § 5.

168. CSRC, Abolished Rules, *available at* http://www.csrc.gov.cn/n575458/n575727/n575802/index_4.html (last visited Mar. 29, 2007).

169. Securities Law, *supra* note 7, arts. 115, 118. Additionally, information disclosed by listed companies must be authentic, accurate, and complete, and must contain no false or misleading statements or major omissions. *Id.* art. 63.

170. *See* U.S. Securities and Exchange Commission, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Feb. 15, 2007).

171. *Id.*

172. Securities Law, *supra* note 7, art. 118.

173. Securities Exchange Act of 1934 § 11A, 15 U.S.C.A. § 78k-l(a)(1)(C)(ii) (2000).

174. *See* Shanghai Stock Exch., Listing Procedures, http://www.sse.com.cn/sseportal/en_us/ps/lc/lst_proc.shtml (last visited Feb. 15, 2007).

175. Self-regulation is the process of allowing industry to correct systemic problems within that industry without government intervention. *Cf.* BLACK'S LAW DICTIONARY (8th ed. 2004), *available at* Westlaw, self-regulation. Some examples of self-regulated organizations include stock exchanges and the National Association of Securities Dealers (NASD) in the United States. *See* Securities Exchange Act of 1934 § 6.

rules for self-regulation.[176] Under the supervision of the Australian Securities and Investments Commission, the Australian Stock Exchange may formulate its own listing rules and other business rules.[177]

The CSRC's dominant regulatory role restricts the self-regulatory powers of the Shanghai and Shenzhen Stock Exchanges. The CSRC consolidated the listing rules of the Shanghai and Shenzhen Stock Exchanges, and those rules are largely similar to the Securities Law's general requirements, except that the listing requirements provide more detailed guidance on information disclosure.[178] The CSRC also coordinated the roles of the two exchanges. For example, the Shanghai Stock Exchange took over the Shenzhen Stock Exchange's main board, and the Shenzhen Stock Exchange set up a Growth Enterprise Market to bridge the gap for "high risk/high return" enterprises that do not fulfill the profitability and track record requirements of the main board of the exchange.[179]

E. Regulatory Problems with Chinese Stock Exchanges

1. Excessive Control by the CSRC

As indicated above, Chinese stock exchanges function under the mandate of the CSRC.[180] They must adopt articles of association as internal governance rules, subject to the approval of the CSRC,[181] which then appoints their general managers.[182] Stock exchanges must issue trading rules and administrative regulations, which the CSRC must approve.[183] The exchanges can suspend, terminate, and resume bond and share trading, as CSRC-established procedures allow.[184] Moreover, an application for listing shares on the stock exchange must

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176. *See* LONDON STOCK EXCH., RULES OF THE LONDON STOCK EXCHANGE (2007), *available at* http://www.londonstockexchange.com/NR/rdonlyres/F5728B81-62A7-47FA-92B7-A59A46B7E950/0/Rulebook200107.pdf.

177. Australian Stock Exch., ASX Listing Rules as at 24 October 2005, *available at* http://www.asx.com.au/supervision/rules_guidance/listing_rules1.htm (last visited Feb. 14, 2007).

178. CSRC, LISTING RULES OF THE SHANGHAI AND SHENZHEN STOCK EXCHANGES, chs. 4-7 (2001). The Listing Rules were recently revised in 2006. *See* Shenzhen Stock Exch., Shenzhen Stock Exchange Listing Rules, *available at* http://www.cs.com.cn/zcfg/02/200605/t20060519_924285.htm (last visited Mar. 29, 2007); Shanghai Stock Exch., Shanghai Stock Exchange Listing Rules, *available at* http://www.cs.com.cn/zcfg/02/200605/t20060519_924259.htm (last visited Mar. 29, 2007).

179. *See* STEPHEN GREEN, CHINA'S STOCK MARKET 24-30 (Profile Books Ltd. 2003).

180. *See supra* Part III.B.

181. Securities Law, *supra* note 7, art. 103.

182. *Id*. art. 107.

183. *Id*. art. 118.

184. *See, e.g.*, *id.* arts. 55, 56, 60, 61.

first be submitted to the CSRC.[185] Stock exchanges must also report abnormal trading to the CSRC.[186] Clearly, the CSRC plays a central role in the operation of China's stock exchanges.

Exchanges must also meet the CSRC's three general reporting requirements.[187] The first requires stock exchanges to request CSRC *approval* for matters regarding personnel, financial accounts, fees, new listings, and other logistical areas.[188] Under the second reporting requirement, exchanges must report *record-keeping* matters to the CSRC. These matters include personnel appointments and dismissals that do not require approval; documents that do not require approval; changes in major facilities for trading, settlement, or communication; performance assessments of department managers; and expenditures over-budget.[189]

The third reporting requirement involves *operational* decisions—decisions other than those already reported for approval or record-keeping purposes.[190] The CSRC may also require the exchanges to report on any matter that it deems necessary and has broad power to intervene in exchange operation.[191]

The CSRC's tight control over the two stock exchanges has limited their capacity for self-regulation and has thus constrained their independent operation. A cautious and gradual liberalization has begun, but it is still a work in progress. Since 2002, for example, the CSRC has taken steps to grant more autonomy to the exchanges by abolishing some administrative rules and approval systems.[192]

185. *Id*. art. 50(1).

186. *Id*. art. 115.

187. Circular Concerning the Interim Regulation on Reporting System of the Stock Exchanges (China Sec. Regulatory Comm'n, Nov. 19, 1997), *available at* http://www.csrc.gov.cn (last visited Mar. 29, 2007) (P.R.C.).

188. The stock exchanges must report to the CSRC for approval in relation to the appointment and dismissal of assistant managers, chief inspectors and deputy inspectors, managers of the human resources and finance departments, and managers of securities registration and settlement bodies. Exchanges must also report to the CSRC for approval in relation to their budget and financial accounts (and those of the securities registration and settlement bodies), before presenting the budget and accounts at the members' meeting for consideration. All fees charged by the stock exchanges and all new listings of securities must also be reported to the CSRC for approval. *Id.*

189. *Id.*

190. *Id.*

191. Securities Law, supra note 7, art 115.

192. The CSRC reduced its administrative control over the activities of intermediaries. *See* Circular on the First Bundle of Abolishment of Administrative Approval (China Sec. Regulatory Comm'n, Dec. 21, 2002) ISINOLAW (P.R.C.). It also eliminated certain administrative approvals required by the Measures on the Administration of Stock Exchanges. *See* Circular on the Second Bundle of Abolishment of Administrative Approval (China Sec. Regulatory Comm'n, Apr. 1, 2003) ISINOLAW (P.R.C.).

Today, however, the two exchanges are still considered part of the CSRC bureaucracy.

2. Constraints on Self-Regulation and Limits on the Regulation of Listed Companies

Unlike Western stock exchanges, which administer the listing of companies according to listing requirements, Chinese stock exchanges had limited power over company listing due to the control of the CSRC in this area. The 2005 Securities Law shifts the balance of the power conditionally. The Law prescribes listing requirements for listed companies but also grants stock exchanges capacity to specify their own listing requirements, which must be more stringent than statutory requirements and subject to approval by the CSRC.[193] Hence the CSRC still plays a role in listing.

After the listing, the stock exchanges then supervise the mandatory, timely disclosure of information by these companies.[194] Globalization has increased the value of reliable information in capital markets. The enhanced disclosure of information will improve the efficient functioning of capital markets.[195] The Shenzhen and Shanghai Stock Exchanges' listing rules require issuers and companies to ensure that all documents sent to the relevant stock exchange contain no false information, misleading statements, or material omissions.[196] Nor may the issuer disclose relevant information during the application period without prior approval by the exchange.[197] A listed company is also required to timely disclose any information that may materially affect the company's share price.[198] Most significantly, the Securities Law has introduced continuous disclosure requirements.[199]

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193. *See* Securities Law, *supra* note 7, art. 50.

194. *Id.* art. 115.

195. *See* Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405, 406-07 (2001).

196. *See* Shanghai Stock Exch., Shanghai Stock Exchange Listing Rules, *available at* http://www.sse.com.cn/sseportal/ps/zhs/fwzc/jbywgz.shtml (last visited Jan. 9, 2007); *see also* Shenzhen Stock Exch., Shenzhen Stock Exchange Listing Rules, *available at* http://www.szse.cn/UpFiles/Attach/1412/2006/05/18/1831327522.doc (last visited Jan. 9, 2007).

197. Shanghai Stock Exch., *supra* note 196; Shenzhen Stock Exch., *supra* note 196.

198. Shanghai Stock Exch., *supra* note 196; Shenzhen Stock Exch., *supra* note 196.

199. Continuous disclosure means that listed companies are required to not only provide annual and periodical financial and operational information to their shareholders and to the regulators but also report information arising when certain material events occur in relation to the company's operations or financial position. *See generally* Securities Law, *supra* note 7, ch. 3.

The exchanges' authority to monitor information disclosure overlaps with CSRC authority, which is one of the CSRC's major regulatory domains. In recent years, the CSRC has formulated numerous rules governing information disclosure in response to widespread misconduct involving information disclosure in the early 1990s.[200] At that time, a large number of companies were publicly de-listed, suspended, or otherwise punished for engaging in false or fraudulent information disclosure practices.[201]

F. A Survey of the Regulatory Issues That Listed Companies Face

1. State Ownership of Listed Companies

In the 1930s, Adolf Berle and Gardiner Means laid the foundation for modern corporate governance by identifying as essential the "separation of ownership from control."[202] In Chinese-listed companies, two critical "separation" issues remain unresolved: separating ownership from state control, and separating the state's administrative role from its shareholder role.[203] Unfortunately, the nagging problem of state administration overlaps with enterprise management and prevents listing on the stock exchange from improving the corporate governance of transformed state-owned enterprises.

As previously mentioned, state and legal person shares cannot be traded on stock exchanges, which effectively hampers market functioning and external monitoring mechanisms. When the state is a controlling shareholder, it can still dominate shareholders' meetings, the board, and management.[204] Thus, the separation of state power from enterprise management is largely illusory. Moreover, because the state is an abstract entity, agents carry out its role as a controlling shareholder.[205] Directors and managers of listed companies largely are

200. *See* Gongmeng Chen et al., *supra* note 132, at 480.

201. *Id.*

202. Traditional economic theory defined ownership as a set of rights including residual claimant right, the right to dispose, the right of control, and the right to interest. An owner had absolute right over his property. But this is not applicable to modern companies with dispersed share ownership. Shareholders, as the owner of the companies, are the residual claimants of company property. The right of control has shifted to professional managers for efficient operation of companies. Hence ownership is separated from control. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 69-118 (1932).

203. *See* Schipani & Junhai Liu, *supra* note 21, at 28-32. The state is the controlling shareholder of most listed companies. *Id.* at 56.

204. *Id.* at 56.

205. *See* Donald Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494, 499 (2003).

political appointees whose job is to safeguard state assets;[206] without adequate supervision, they may pursue personal interests. Thus, information asymmetry has become an issue, resulting in adverse selection and moral hazard.[207]

Many scholars have suggested that state ownership should be reduced to improve both the quality of governance of listed companies and the liquidity of the share market.[208] Reducing state ownership also means reducing the state's heavy-handed role in governing listed companies. Liquidity depends on stock exchanges efficiently operating and transferability of shares. Tellingly, the government has moved cautiously toward reform largely because it fears losing its status as controlling shareholder if state shares are freely traded.[209] Proponents argue that reducing state ownership and selling state shares would not only balance listed companies' ownership structure,[210] but would also fund the social security system. There were attempts made to reduce non-tradable state shares, but political concern for social stability and the socially engrained risk-adverse approach have halted the share-reduction strategy.[211] In a recent attempt, the CSRC conducted a share reform program to change the circulation capacity of non-tradable A shares through a process whereby holders of non-tradable shares pay a goodwill price to the holders of tradable shares in return for the right to

206. *See* Schipani & Liu, *supra* note 21, at 42-53.

207. Information asymmetry usually occurs in two situations. In adverse selection, management holds some private information unknown to the board (including their ability to run the company), resulting in unqualified management being chosen by the board. The other is moral hazard, where management acts opportunistically by overtly agreeing to, but covertly opposing, the board's decisions, where the board is unable to monitor management "on the spot." *See* Paul M. Healy & Krishna Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405 (2001). *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

208. *See* TEVEV ET AL., *supra* note 28, at 76; *see also* Yi-min Lin & Tian Zhu, *Ownership Restructuring in Chinese State Industry: An Analysis of Evidence on Initial Organizational Changes*, 166 CHINA Q. 305, 309-11 (2001).

209. *See generally* Clarke, *supra* note 205.

210. *See generally* Martin T. Hovey, *Corporate Governance in China: An Analysis of Ownership Changes After the 1997 Announcement* (Aug. 2005) (working paper on file with the Social Science Research Network), *available at* http://ssrn.com/abstract=811105.

211. In late June 2002, more than a year after authorities unveiled a plan to raise much-needed money for the country's social-security fund by selling some state shares, the State Council admitted failure and scrapped the sales. Only a tiny portion of the sales had actually happened, but the threat that more might come had sent Shanghai's "A"-share market, which consists of renminbi-denominated shares restricted to domestic investors, into a 35% tailspin between May and October in 2001. *Comment: Time to Move State Shares*, PEOPLE'S DAILY (P.R.C.), Dec. 1, 2003, *available at* http://english.peopledaily.com.cn/200312/01/eng20031201_129400.shtml (last visited Jan. 9, 2007).

trade.[212] The reform has been long overdue, and it is too early to evaluate the impact of the reform on the markets.

2. The Government's Role in Corporate Governance of Listed Companies

The state's multiple roles further complicates the problems associated with excessive state ownership of listed companies. The state is a key figure in corporate governance, drafting and enforcing regulations and controlling a majority of the shares in many listed companies.[213] The state degrades corporate governance by occupying the roles of both referee and player, while pursuing political objectives instead of acting as a responsible shareholder.[214] The state must minimize this influence and improve the efficiency of state-owned enterprises. Indeed, China must explore new paths to manage its state assets.[215]

Separating the state's administrative role from its role as shareholder is daunting; it hinges on broad political, cultural, and market conditions as well as on deeper structural reform of state-owned enterprises. While the government addressed this in some measure, path dependency may influence the extent to which the state can delineate its roles.[216] Government intervention in markets and business operations is deeply rooted in Chinese history.[217] Indeed, the government may never be completely separated from market and business operations. Because of institutional and systemic constraints on the two "separations," there is a pessimistic view that separating ownership and control (a result of corporatization of state-owned enterprises) has not produced greater efficiency and is not necessarily appropriate for Chinese companies.[218] Also, achieving transparency has been a challenge, and mandatory and continuous disclosure of information is still a "work in progress" today.[219]

212. *See* SECURITIES AND FUTURES, *supra* note 29, at 5-6.

213. *See generally* SHANGHAI STOCK EXCH., *supra* note 35, at 3-5.

214. *Id.*

215. *Id.*

216. Path dependency means that a country's pattern of corporate governance at any point in time depends partly on its earlier patterns. Consequently, different systems of countries "might persist at later points in time even if their economies have otherwise become quite similar." Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 129 (1999).

217. For a historical account of government and business relations, see Chenxia Shi, *Commercial Development and Regulation in Late Imperial China: An Historical Review*, 35 HONG KONG L. J. 481 (2005).

218. *See* Fang Liufang, *supra* note 135, 181-85.

219. The previous and amended Securities Law set down continuous disclosure requirements for listed companies, but in practice, misleading or deceptive information disclosure by listed companies has always been a great concern for investors and the

3. Protecting Investors

The interests of minority shareholders are not adequately protected because the state is the controlling shareholder in most listed companies. A controlling shareholder can exploit minority shareholders in various ways, such as by manipulating prices in transactions with other entities it controls.[220] Before the Company Law and the Securities Law were amended in 2005, minority shareholders had no remedies. The government and the courts were reluctant to allow shareholder lawsuits—particularly class actions—because they feared it would invite social trouble.[221]

The newly amended Securities Law better protects investors, for example, by requiring listed companies to disclose more information. Authenticity, accuracy, and completeness are the three benchmarks of proper information disclosure.[222] Listed companies are prohibited from using false or misleading information or omitting material information from disclosure documents.[223] The Law also requires disclosed information to be circulated in the media as designated by the securities regulatory authorities under the State Council and to be kept at the company's registered office and at a stock exchange for public inspection.[224] The Law also has improved provisions for continuous disclosure, combating fraud, reporting and auditing, preventing market

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securities watchdog, the CSRC. The CSRC implemented a series of rules and measures to enhance the compliance level of information disclosure by listed companies. It also used its enforcement and investigative power to crack down and punish companies engaged in malpractice. For example, one of the biggest fraudulent disclosure cases in corporate China, the Yinguangxia case, was exposed in 2001. The Yinguangxia company inflated its export income to Germany for the year 2000 in its annual report to as high as Deutschmark 180 million, whereas the actual figure was less than U.S. $30,000. The serious and widespread practice of false disclosure or major omissions in the disclosure documents of listed companies prompted the CSRC to conduct a vigorous campaign in 2001, naming that year as a year of Regulation Storm. Statistics indicate that about fifty listed companies received an inspection, warning, criticism, or fine from the CSRC, SETC, or other regulatory bodies. *See Gong si zhi li zhong chuang wei gui gong si, gu shi jian guan jin ru shou gong jie duan* [*Corporate Governance Measures on Noncompliance Issues of Companies as the Discipline of Securities Market Enters the Final Stage*] CAN JIN SHI BAO [CHINA BUS. POST], Oct. 25, 2002, *available at* http://www.chinabusinesspost.net.

220. Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 148 (2006).

221. Only recently did the Supreme People's Court rule that investors could sue a company or its directors if investigation by the CSRC revealed that there was fraudulent conduct by the company or its directors. *See* Susan V. Lawrence, *Ally of the People*, 165 FAR E. ECON. REV, 26-29 (2002).

222. Securities Law, *supra* note 7, art. 63.

223. *Id.*

224. *Id*. art. 70.

manipulation, and insider trading.[225] Because most investors can only rely on information to make their investment decisions, the importance of information disclosure cannot be understated.

The Law also requires the state to establish a Securities Investor Protection Fund.[226] The Securities Investor Protection Fund was launched with a paid-in capital of RMB 6.3 billion yuan in late 2005 to protect investors against losses suffered from failing securities companies.[227]

To better protect investors' interests, the new Securities Law increases the liability of directors, senior management, and supervisors of listed companies.[228] For instance, directors and senior management are required to write their opinions into the company's periodic reports.[229] Most importantly, the amended Company Law gives company shareholders the right to bring actions against company directors, senior management, and supervisors for violating the Company Law or other regulations, or for breaching the company's articles of association.[230] Shareholders who hold 10% or more of a company's shares are entitled to petition the People's Court to liquidate the company when managerial failures threaten to harm the interests of its shareholders.[231] Shareholders who

225. *Id*. ch. 3, § III.

226. Securities Law, *supra* note 7, art. 134, states:

> The state will establish a securities investor protection fund. The securities investor protection fund shall be composed of funds paid in by securities companies and other funds raised in accordance with the law. The specific measures for raising, management and use of such fund shall be specified by the State Council.

227. *See* Measures for the Administration of the Securities Investor Protection Fund (promulgated by the Ministry of Finance, the China Sec. Regulatory Comm'n & the People's Bank of China, June 30, 2005, effective July 1, 2005), art. 2, *available at* http://www.tdctrade.com/report/reg/reg_051005.htm (last visited Jan. 27, 2007) (P.R.C.); SECURITIES AND FUTURES, *supra* note 29, at 31.

228. Securities Law, *supra* note 7, arts. 68-69. Company Law, *supra* note 52, ch. 2, art. 46, also increased the duties of directors.

229. Securities Law, *supra* note 7, art. 68, states:

> The directors and senior management of a listed company must subscribe their opinions in the periodic report of their company. The board of supervisors of a listed company must inspect the periodic report that is prepared by the board of directors and must produce written examination opinions. The directors, supervisors, and senior management of a listed company must guarantee the authenticity, accuracy, and integrity of the information that is disclosed by the company.

230. Company Law, *supra* note 52, ch. 2, art. 63.

231. *Id*. ch. 3, art. 111.

hold 3% or more of a company's shares may present proposals to the company's board of directors.[232] Shareholders who oppose decisions about the acquisitions of, or mergers by, the company may also require the company to buy back their shares.[233] But the lack of detailed procedures for shareholder actions and civil remedies may lead to enforcement difficulties. Clearly, poor legal enforcement has been a problem for China.

IV. REGULATORY ENFORCEMENT

The extent investors are protected determines how well securities markets develop.[234] Effectiveness of enforcement of laws and regulations protects investors' rights and interests, such as the right to vote, the right to access company information, and the right to receive dividends. Accordingly, regulators and the courts must effectively enforce the laws to protect investors, regulate market players, improve corporate governance, and boost investor confidence in the markets.[235]

The regulatory framework for the securities markets in China is still a work in progress; regulations for listed companies and the markets clearly must be better enforced. Legislatively, the Securities Law, Company Law, Securities Investment Fund Law, and Criminal Law impose civil, administrative, and criminal penalties on any person who has violated the relevant law. Typical violations include engaging in fraudulent information disclosure, insider trading, or market manipulation. As a regulator and enforcer, the CSRC supervises listed companies, conducting regular reviews and random investigations.[236]

232. *See id*. ch. 3, art. 104.

233. *See id*. ch. 3, art. 111.

234. *See generally* Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 1, 3-28 (2000), *available at* http://post.economics.harvard.edu/faculty/shleifer/papers/ip_corpgov_paper.pdf; Rafael La Porta et al., *Investor Protection and Corporate Governance*, 57 J. FIN. 1147, 1147-70 (June 2002), *available at* http://post.economics.harvard.edu/faculty/shleifer/papers/Valuation_JOFJune2002.pdf; Andrei Shleifer & Daniel Wolfenzon, *Investor Protection and Equity Markets*, 66 J. FIN. ECON. 1, 3-27 (Apr. 2002), *available at* http://post.economics.harvard.edu/faculty/shleifer/papers/InvestorProtectionandEquityMarkets_April2002.pdf.

235. *See* Mark L. DeFond & Mingyi Hung, *Investor Protection and Corporate Governance: Evidence from Worldwide CEO Turnover*, 42 J. ACCT. RES. 269-312 (2004).

236. CSRC, *Rules on Listed Companies Inspection System* (issued on Mar. 19, 2001), *available at* http://www.csrc.gov.cn (last visited Mar. 29, 2007) (P.R.C.). Under these rules, the CSRC empowers local agencies to inspect listed companies in relevant local areas. The CSRC will publish the inspection results if misconduct is detected, but the CSRC will warn the company if the infringements are only minor. The CSRC usually issues public criticism, public condemnation, official warnings, and monetary fines. *Id.*

Some argue that the CSRC does not very effectively enforce the regulations.[237] It lacks expertise, resources, and independence from the government and is susceptible to political pressure.[238] Even with these enforcement problems inherent in China's broader political, economic, and cultural infrastructure, the CSRC's enforcement campaigns reflect its effort to rein in listed companies.

Between 1999 and 2003, in the midst of widespread misconduct by listed companies, the CSRC investigated nearly 12% of listed companies and brought enforcement actions against those companies.[239] CSRC enforcement actions have share market consequences.[240] According to an empirical study, the publicity of these enforcement actions caused the share prices of the investigated companies to drop significantly.[241] Below is a synopsis of three of the major market scandals investigated by the CSRC:

1. Yinguangxia, a company listed on the Shenzhen Stock Exchange, reported an increase of 136% in its annual turnover and an increase of 226% in net profit in its financial report for the year 2000. The company's share price increased by 440% in the same financial year. The financial press alleged fraudulent information disclosure by the company in August 2001, casting doubt on the accuracy and truthfulness of the company's financial statements. The CSRC investigated and released its results a month later. It found that Yinguangxia fabricated RMB 745 million yuan in profits in 1999 and 2000 by forging documents and accounting records. The CSRC referred the case to prosecutors, and the company's auditing firm was stripped of its CPA license by the Ministry of Finance. In the meantime, minority shareholders took civil action against the company.[242]

2. Zheng Baiwen, a corporatized state-owned enterprise, reported a net profit of RMB 812.9 million yuan and a return on capital of 20.7% in 1997. The company was among the biggest 100 listed companies in China. Just a year later, the company's profits turned into huge losses, which brought about a sharp decline in the company's share

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237. Anderson, *supra* note 3, at 1935.
238. *Id.* at 1951.
239. Chen et al., *supra* note 132, at 480.
240. *Id.* at 451.
241. *Id.*
242. *See id*. at 483.

price. The company's collapse raised questions. The CSRC found the company had falsified its annual return and profits since 1995, and had disclosed fraudulent information in the company's initial public offering prospectus. The company was liquidated on the ground of bankruptcy in March 2000.[243]

3. In 1998, the CSRC announced that the 1996 annual report of Qiong Minyuan contained false information. The company made up profits of RMB 570 million yuan and non-existent capital reserves of RMB 600 million yuan. The senior executives of the company, Mr. Ma Yu (Chairman) and Mr. Barn Minchiu (Chief Financial Officer), were charged with criminal offenses. As a result of the losses incurred, Qiong Minyuan was taken over by Beijing Zhonguancun in December 1998.[244]

To enhance its enforcement powers, in December 2005 the CSRC issued its Implementation Measures on Freezing and Sealing of illegal funds, assets, and important evidence.[245] The CSRC's regulatory power limits not only stock exchanges' self-regulation, but also the exchanges' enforcement functions. Nevertheless the stock exchanges are gradually getting more enforcement functions. In January 2006, an amendment to the Securities Law granted Chinese stock exchanges the power to de-list a company.[246] Private enforcement actions have been available under the amended Company Law and Securities Law; it remains to be seen whether the right to commence a derivative action will actually bring about real protection of investors.[247]

V. RECOMMENDATIONS FOR IMPROVING REGULATION AND STRENGTHENING ENFORCEMENT

As the experience of other countries such as the United States and Australia has indicated, a fair and competitive market develops from a well-structured and functioning regulatory framework. The international competition fueled by globalization and China's entry into the WTO has compelled more effective regulation and measured liberalization of China's securities markets. In

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243. *See id*.
244. *Id*. at 483-84.
245. SECURITIES AND FUTURES, *supra* note 29, at 48.
246. Securities Law, *supra* note 7, art. 118.
247. *See* Company Law, *supra* note 52, ch. 3, art. 111; Securities Law, *supra* note 7, arts. 10, 39, 102, 104, 169, 188, 197.

this regard, improving regulatory arrangements and increased enforcement activity are essential to develop these markets.

A. Suggestions for Reducing Direct Control by the CSRC over Stock Exchanges and Listed Companies

As discussed in Part III, the CSRC's regulatory role effectively limits the scope for self-regulation by stock exchanges in China. Greater self-regulation would enable stock exchanges to foster fair, well-informed, and competitive markets, as demonstrated in the United States and the United Kingdom. Although a wholesale embrace of Western-style self-regulation would not suit China's current institutional setting well, certain mechanisms such as self-regulatory stock exchanges would still be useful. Stock exchanges should be given more independence in managing their business affairs.

For example, members of the council and of the board of directors of a stock exchange should be elected or nominated by the exchange itself and not by the CSRC. Also, the exchange's board of directors should have power to appoint and dismiss the general manager.

Moreover, CSRC approval should not be required for business matters of an exchange (such as trading products). Excessive pre-approval impedes innovation and competition between the exchanges in China. Importantly, the autonomy of these exchanges as self-regulating organizations should be strengthened. Certain grants of autonomy have served the exchanges well. The amended Securities Law allows exchanges to adopt listing standards more onerous than those prescribed under the Securities Law.[248] This autonomy should be expanded to allow the exchanges to make their own listing requirements, which would be driven by business conditions and not constrained by the Law's uniform requirements. Greater self-regulation by the exchanges and gradual reduction of the CSRC's direct regulatory role will foster a healthy competitive environment.

B. Promoting Self-Regulation of Stock Exchanges and Listed Companies

Chinese stock exchanges were established by the imperatives of reform and not by market forces that naturally nurture the formation of stock exchanges as self-regulating organizations. Accordingly, self-regulation as a regulatory alternative that may have better outcomes and lower regulatory costs has not been sufficiently appreciated and promoted by market participants in China. Lessons from countries with successful experience in introducing self-regulatory mechanisms, such as the United States, will help inform China's process of strengthening its regulatory framework.

248. Securities Law, *supra* note 7, art. 50.

As self-regulating organizations, stock exchanges would be responsible for regulating their own markets and enforcing member compliance of relevant securities laws and rules.[249] The SEC has stated that self-regulating organizations are "charged with an important public trust to carry out their self-regulatory responsibilities effectively and fairly, while fostering free and open markets, protecting investors, and promoting the public trust."[250] Under the Securities Exchange Act, no exchange can enjoy the benefits of a licensed exchange unless the exchange fulfills its obligations as a self-regulating organization. Self-regulation, therefore, is not a right that is granted to stock exchanges, but rather is a duty imposed by statute.[251] The New York Stock Exchange (NYSE), as a self-regulating organization, is an important part of securities regulation and enforcement in the United States. It employs more than 700 people in the area of regulation alone.[252]

Self-regulation by the NYSE primarily concerns the members of the exchange, listed companies, and market surveillance. While rule-making powers of the NYSE are limited to those matters that fall within its administration and the Securities Exchange Act, surveillance and enforcement powers are more expansive.[253] For example, when members sell certain securities, the NYSE enforces prospectus delivery duties imposed by the law.[254] The stock exchange has the power and obligation to ensure that its members are reliable market players, with an eye toward their financial status and conduct.[255] The exchange regulates members' financial and operating compliance,[256] and issues rules on "training, experience, and competence" of brokers and dealers.[257]

The NYSE regulates listed companies by making rules on corporate governance standards and rules regarding securities trading issued by these

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249. *See* Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. 71,126, 71,128, 71,129 nn.30-31 (proposed Dec. 8, 2004) (to be codified at 17 C.F.R. pts. 240, 242, 249).

250. For recent discussion on self-regulation in the United States, see Concept Release Concerning Self-Regulation, 69 Fed. Reg. 71256 (Dec. 8, 2004) (codified in 17 C.F.R. pt. 240); 69 Fed. Reg. 71,129 (referring to Securities Exchange Act of 1934 § 6(b)(5), 15 U.S.C. § 78f(b)(5) (national stock exchanges)).

251. *See* Securities Exchange Act of 1934 § 6(b), 15 U.S.C. § 78f(b)(5) (2000) (cataloging the obligations); Silver v. N.Y. Stock Exch., 373 U.S. 341, 346 (1963) ("[The Exchange has] duties of self-regulation under the Securities Exchange Act.").

252. *See generally* NYSE Regulation, http://www.nyse.com/regulation/108923562 1148.html (last visited Jan. 23, 2007).

253. 15 U.S.C. § 78f(b)(5).

254. *See* Ann Davis, *No Prospectus? NYSE Blames Brokerage Firms*, WALL ST. J., Nov. 16, 2004, at C1.

255. Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2547-48 (2006).

256. 15 U.S.C. § 78f(c)(3)(A).

257. *Id*. § 78f(c)(3)(B).

companies.[258] The corporate governance of listed companies is an important aspect of regulation. The listing agreement also regulates listed companies.[259] If a listed company fails to comply with listing rules, the NYSE may admonish the company and even de-list it.[260]

The NYSE also conducts market surveillance as part of its self-regulation. By focusing on insider trading, market manipulation, and other forms of misconduct, the exchange keeps a close eye on the operation of the market.[261]

In comparison, regulation by Chinese stock exchanges over members, listed companies, and the markets themselves, is limited by the CSRC's "top-down" regulatory structure and by the lack of detailed rules on self-regulation. The Shanghai and Shenzhen Stock Exchanges would benefit from more rules on self-regulation and from the experience of the NYSE. In the meantime, listed companies should more actively self-regulate by adopting best-practice codes of conduct and best-practice internal governance rules. The quality of corporate governance can be improved by external and internal regulation of listed companies. The rigor and effectiveness of enforcement ultimately determines the strength of regulation.

C. Developing a Multi-Level Enforcement Regime

An effective enforcement regime enables investors to rely on public and private enforcement actions to protect their rights and interests. The public enforcement power can be exercised by the CSRC and by stock exchanges, while investors can initiate private enforcement either individually or collectively, through class actions. In essence, a multi-level enforcement regime operates with different elements of enforcement that complement each other.

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258. For more details, see NYSE Regulation, Listing Company Manual 303A.00-.13 (2006), *available at* http://www.nyse.com/RegulationFrameset.html?nyseref=&displayPage=/listed/1022221393251.html (last visited Feb. 14, 2007); Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 328-30 (2001). *But see* Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461 (1992) (arguing that markets setting their own listing standards is "unworkable" and conflicts with the Exchange Act).

259. *See* NYSE Regulation, *supra* note 258, at 303A.00-.13.

260. *See* Fleckner, *supra* note 255, at 2547-49.

261. *See* 15 U.S.C. § 78k(1). For an example of an investigation into violations of exchange and federal securities laws, see Jed Horowitz, *NYSE Bars a Former Specialist for Failure to Cooperate in Probe*, WALL ST. J., Dec. 9, 2004, at C6.

1. Enforcement by the CSRC

As discussed in Part IV, regulatory enforcement in China has been weak despite the CSRC's enforcement efforts. The SEC, the CSRC's counterpart in the United States, adopted a wide range of enforcement mechanisms and remedies for protecting investors, and these mechanisms and remedies are worth noting when discussing how to improve enforcement in China. For instance, the SEC established a Department of Enforcement, which reports directly to the Chairman of the SEC.[262] Department investigators have broad powers to investigate.[263] Further, the SEC can seek administrative sanctions against a person who violates securities law and can impose sanctions after a hearing before an administrative law judge.[264]

By comparison, the CSRC's enforcement department has very expansive powers. It drafts regulations to implement rules to prevent market manipulation and insider trading, investigates cases that involve market manipulation and insider trading, and puts forward proposals for disposal of cases.[265] Furthermore, no rules detail the limits of investigators' powers, investigation procedures, or sanctions against violators of securities law. Effective sanctions by regulators are vital to the enforcement of regulations. The following are specific sanctions that SEC may invoke and which the CSRC should consider:

- *Cease and Desist Authority*. The SEC can decide to file a complaint against a respondent alleging a violation with an administrative law judge. The SEC will usually seek a "cease and desist order" for the respondent to stop the violating conduct, or for the respondent to take certain steps to ensure that his or her conduct does not violate securities

262. JAMES D. COX, ORG. FOR ECON. CO-OPERATION & DEV., PROTECTING INVESTORS IN THE UNITED STATES THROUGH MULTIPLE ENFORCEMENT MECHANISMS 2 (2002), *available at* http://www.oecd.org/dataoecd/21/61/2756029.pdf.

263. For example, investigators have the power to subpoena testimony and records from an object of the investigation, and this power is enforceable in the federal courts if the object of the investigation fails to respond to a subpoena request. *Id.*

264. An administrative law judge is not a federal court judge, "but is an agency employee that presides at a hearing between the SEC and the respondent." *Id*. The administrative law judge presides over a hearing at which the SEC and the respondent present evidence and testimony, and the judge makes findings of fact and conclusions of law. *Id*. at 2-3. Administrative penalties begin at $5,000 per violation for the minor offenses and $100,000 for natural persons in relation to fraudulent or deceitful conduct that causes substantial loss to others (this penalty begins at $500,000 for other violators). *Id.* at 4.

265. CSRC, Enforcement Bureau II, http://www.csrc.gov.cn (follow "English" hyperlink; then follow "Enforcement Bureau II" hyperlink) (last visited Jan. 28, 2007) (P.R.C.).

laws in the future.[266] In addition, the SEC has the power to issue "temporary" cease and desist orders against certain market professionals.[267]

- *Disgorgement Sanction*. The SEC may also obtain an order from an administrative law judge to force the respondent to disgorge any profits and gains that he or she has made from the violation.[268] The SEC then distributes the disgorged funds to investors harmed by the violation. The CSRC should adopt such a measure to strengthen investor protection, which was the focus of the amendments to the Securities Law.

- *Trading Suspensions*. If it believes suspending trading to be in the public interest and necessary to protect investors, the SEC can summarily suspend the trading of a company's securities for ten days,[269] and can permanently suspend trading of a security after a hearing.[270] The CSRC may restrict trading of securities in certain circumstances,[271] but has no power to suspend trading permanently, which could

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266. Such an order may sometimes involve the circulation of notices among past and future clients of the respondent in relation to the violation that has occurred. 15 U.S.C. § 78u-3.

267. For example, stockbrokers, dealers, investment advisers, and investment companies. The temporary cease and desist order can be issued without a hearing when the SEC believes that the respondent is engaging in, or is about to engage in, a violation that is likely to result in significant dissipation of assets, conversion of property, or significant harm to investors or the public interest. *See* Bruce A. Hiler & Neil K.Gilman, *The SEC's Use of Its Cease-and-Desist Authority: A Survey*, 23 SEC. REG. L.J. 235 (1995).

268. COX, *supra* note 262, at 4.

269. *Id.*

270. In practice, the SEC seldom uses this sanction as the interests of the investors that own the affected security will be harmed as well. *Id*.

271. Securities Law, *supra* note 7, art. 180(7), states:

> [W]hen investigating major violations of securities laws, such as securities market manipulation, insider trading, etc., it may, with the approval of the main person in charge of the State Council's securities regulatory authority, place restrictions on the purchase and sale of securities by the parties involved in the event under investigation, provided that the period of the restrictions may not exceed 15 trading days; in the event of a complex case, the period may be extended by 15 trading days.

be a deterrent to continuous and serious market misconduct of issuers of the securities.

- *Injunction Order*. The SEC can obtain a preliminary injunction from a court before the final disposition of a case. For example, a preliminary injunction can be sought to stop evidence or funds from being removed or transferred. The court will grant such an order if the SEC can show that there is a high probability of its winning the case.[272] Although the Securities Law gives CSRC similar power,[273] there are no detailed measures on how to exercise that power effectively.

- *Officer and Director Disqualification*. The SEC can request the court to bar a person from serving as an officer or director of a public company. The SEC must prove that the person acted fraudulently in a securities transaction.[274] Because listed companies in China have yet to improve corporate governance and accountability systems, a disqualification order could effectively prevent directors and officers from insider trading and other wrongdoings.

The CSRC should develop similar specific sanctions in cooperation with the people's courts. As mentioned above, people's courts only began to hear securities cases, which involved false disclosure, in 2003, so judicial enforcement of securities law in China has only just begun. Hence, it is crucial that the courts and the CSRC coordinate enforcement actions to develop a strong enforcement regime in China.

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272. Non-compliance with such a court order is itself a separate offense of contempt of court. COX, *supra* note 262, at 4-5.

273. Securities Law, *supra* note 7, art. 180(6), states:

> [The CSRC shall have the authority] to make inquiries concerning the fund accounts, securities accounts and bank accounts of the parties concerned and of the work units and individuals connected with the event under investigation; with the approval of the main person in charge of the State Council's securities regulatory authority, to freeze or place under seal property involved in the case, such as funds, securities, etc., for which there is evidence establishing that it has been or could be removed or concealed, or important evidence for which there is evidence establishing that it has been or could be concealed, forged or destroyed.

274. COX, *supra* note 262.

2. Enforcement by the Stock Exchanges

At present, stock exchanges in China can only de-list a noncompliant listed company. Stock exchanges' enforcement powers rely on their ability to regulate their members. Enforcement measures adopted by stock exchanges in the United States may be instructive to help develop self-regulation and enforcement by stock exchanges in China. For example, the Securities Exchange Act requires that each self-regulated organization be prepared to bring disciplinary proceedings for a violation of its rules and for any violation of securities laws that are committed by its members.[275] The Act also requires the self-regulated organization to allocate the financial resources and the personnel to fulfill its undertakings.[276] The self-regulated organization's disciplinary actions must be fair and the organization must apply appropriate sanctions, including the suspension or expulsion of a member, payment of restitution to customers for any losses caused by the sanctioned member's violation, or payment of fines.[277] Violators are disciplined by full-time personnel of an informal administrative tribunal within the self-regulated organization.[278] A person sanctioned by a self-regulated organization may appeal the sanction to the SEC.[279] The SEC and self-regulated organizations share investigative information, so an enforcement action of the SEC may be accompanied by a disciplinary action of a self-regulated organization against the same person.[280] There is no such mechanism in China, and the Securities Law only stresses information-sharing between the CSRC and other financial regulators.[281]

3. Private Enforcement Actions in China

The private enforcement actions are possible through the PRC General Principles of Civil Law, the Civil Procedure Law, the Securities Law, the

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275. *Id.*
276. *Id.*
277. *Id.*
278. *Id.*
279. *Id.*
280. COX, *supra* note 262, at 6.
281. Securities Law, *supra* note 7, art. 185, states:

> [T]he State Council's securities regulatory authority shall, together with the other finance regulatory authorities of the State Council, establish a mechanism for sharing regulatory information. When the State Council's securities regulatory authority conducts a supervisory inspection or investigation while performing its functions according to law, the relevant authorities shall cooperate with it.

Criminal Law, and CSRC regulations. The Civil Procedure Law provides that in order to initiate a legal action, the plaintiff must have a "direct interest" (*zhijie lihai guanxi*) in the case.[282] However, despite legal provisions regarding private remedies, courts in the past dismissed private securities actions partly because they did not have qualified judges and resources to deal with such actions, and partly because of the belief that private litigation involving the securities markets, traditionally the domain of the CSRC, should not be encouraged.[283] In 2002, the courts finally accepted private securities litigation involving false disclosure,[284] but the judgment on private securities cases has been very slow as the lower courts await further instructions from the Supreme People's Court regarding calculating damages and other particulars.

The amended Company Law provides a right for shareholders to commence a derivative action, which is a significant step in the development of shareholder remedies in China.[285] However, the Law does not spell out the procedures for taking such an action, nor does it elaborate on the types of remedies available to shareholders apart from compensation. This may give rise to enforcement problems.

Moreover, the Law does not provide for class actions lawsuits. Class actions and contingency fees play an important role in the enforcement of securities law in the United States. Class actions allow numerous individual investors "who have been harmed by the same securities violation to pool their claims together into a single action."[286] The combined recovery of losses is sufficient to make the action financially viable. Also, contingency fees allow lawyers to be paid only if the action is successful, which enables investors to attract lawyers to represent them without the investors incurring a financial burden if they lose their case.[287] Thus, class actions and contingency fee arrangements deter violations of securities law. The law should be reformed in order to give investors a right to commence class actions in China.

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282. Minshi susong fa [Law of Civil Procedures] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 8, 1982, effective Oct. 1, 1982), art. 108, *available at* http://www.novexcn.com/civil_procedure_law.html (P.R.C.).

283. *See* Jiong Deng, Note, *Building an Investor-Friendly Shareholder Derivative Lawsuit System in China*, 46 HARV. INT'L L.J. 347, 353 (2005).

284. *See* Supreme People's Court, *Guanyu shenli zhengquan shichang yin xujia chenshu yinfade minshi peichang anjian de ruogan guiding* [*Several Regulations Concerning the Adjudication of Civil Compensation Securities Cases Based upon Misrepresentation*], 17 CHINA L. & PRAC. 53, 53-62 (2003).

285. *See* Company Law, *supra* note 52, ch. 3, art. 111.

286. COX, *supra* note 262, at 7.

287. *Id.* at 7-8.

VI. CONCLUSION

Since China's securities markets developed and the Shanghai and Shenzhen Stock Exchanges were established, the government has taken direct administrative control of the markets and exchanges. Because of the government's expansive role, investor protection has been problematic since the establishment of the markets. While direct government control over the markets forcefully quickened the formation of the securities markets and stock exchanges, it effectively limited the scope for self-regulation by listed companies and stock exchanges, and gave rise to regulation avoidance schemes. Inevitably, significant regulatory issues faced by the stock exchanges and listed companies stem from excessive government control.

While the CSRC, as a strong regulatory authority, is a key component of securities regulation, developing functioning markets also requires that stock exchanges, listed companies, securities firms, and investors play an important role. Therefore, a multi-layer regulatory framework centered on investor protection, where government regulation and self-regulation both participate in regulating the markets, should be nurtured and developed. Stock exchanges are mandated by the Securities Law to practice self-regulation, which has been in reality restricted by the dominant regulatory role of the CSRC. The stock exchanges and listed companies can enhance efficiency, transparency, and liquidity only if the government loosens its tight control of the markets. Hence self-regulation of market players should be promoted and government regulation should be reduced.

Moreover, only effective enforcement of securities market regulations can ultimately protect investors. It is crucial that the courts and the CSRC coordinate and cooperate closely in developing a strong public enforcement regime and private enforcement actions in China. The courts should develop detailed civil remedies, the CSRC should consider effective administrative enforcement orders. And stock exchanges should focus on independent enforcement measures and disciplinary actions. A multi-level enforcement regime will strengthen the regulation of China's securities markets.

China's fulfillment of its WTO commitments since 2001 has gradually opened up China's securities markets and brought about changes in market regulation. However, China's rapid market expansion and its interaction with the world market will generate more regulatory challenges on top of old persistent regulatory problems resulting from excessive state control. A systemic, transparent, and foreign-investor-friendly regulatory regime must be developed, and securities regulation must provide protection to both domestic and foreign investors. It shall be noted that continuous liberalization of the securities markets for foreign investors and enhanced cooperation with regulatory authorities of other countries will be instrumental in building up regulatory experience of the CSRC with increasingly internationalized markets.

In short, effective regulation of China’s securities markets requires a multi-layer regulatory framework, a multi-level enforcement regime, reduction of government control, and continuous opening up of the markets to foreign investors. The vigor and effectiveness of the regulation defines the extent and strength of investor protection.