



Legal Reflections on China's Stock Market

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Abstract

The long-term sluggish stock market of China has got rooted in the current Chinese securities law and regulatory practice which fail to give an appropriate consideration to promoting efficiency, competition, and capital formation while focusing on maintaining the social and economic order and the public interest superficially and protecting investors nominally. Based on the provisions of the current Chinese securities law, the sluggish stock market mainly comes from the failure to integrate such three components of securities law as the public disclosure (especially IPO) system, the fiduciary system and the liability (especially civil liability) system, or rather it is mainly due to the unfair offering system, the inadequate civil liability system and the insufficient fiduciary system. Thus, correspondingly fundamental reforms are required in China.

Key words: IPO system; Civil liability; Fiduciary system

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INTRODUCTION

More than twenty years has passed for China's securities market since the establishment of Shanghai Stock Exchange in December 1992. In terms of contributions, China's securities market has played an undeniable role in maintaining the social and economic order and public interest, especially in promoting the development of the so-called socialist market economy.¹ As a result, a large number of state-owned enterprises (SOEs) have got rid of financial difficulties by initial public offering and listing after restructuring, while the stock market, though troubled with big problems, has taken an increasingly important role in China's financial market.

Anyway, for a long time, especially in the recent period, China's securities market has remained sluggish and nearly everyone seems like a burnt child dreading fire when talking of the stock market. "China's stock market is like a patient with lingering and serious diseases, which seem incurable with either traditional Chinese medicines or western medicines by regulators" (YUAN, 2004, p.2). Some scholars have become so disappointed that, as expressed by themselves, they would no longer do any research on China's securities market. What is the cause of such problems in China's stock market? In a legal view, it is the failure to integrate such three components of securities law as the public disclosure (especially IPO) system, the fiduciary system and the liability (especially civil liability) system, or rather it is mainly due to the unfair offering system, the inadequate civil liability system and the insufficient fiduciary system, which may be traced back in the fundamental economic system.

¹ See the purposes of the securities law as provided for in Article 1 of the Securities Law of the PRC.

1. UNFAIR OFFERING SYSTEM

The fundamental cause of the problem of China's sluggish stock market is the failure in the process of public offering to obey the principles of "publicity, fairness and justice"², the soul of the legal system of the securities market. Specifically, the relevant provisions of the offering system and practices are unfair in themselves. At the very beginning, China's stock market witnessed a rapid development due to the alliance and participation of some local interested institutions and monopoly capital, where the participation of and control by powers had facilitated the progress of reforms. However, it is such a non-market development mode that has foreshadowed the long-term distortion of the fundamental system of China's stock market. (YUAN, 2004, p.14). The stock market has consequently become the best funding source to rescue difficulty stricken SOEs as well as the place for officials to pursue private interests and seek rents. Eventually, among over 2,350 listed companies currently in Shanghai Stock Market and Shenzhen Stock Market the majority are SOEs. How could the stock market stand well where most of the shares sold and purchased were those of bad-performance enterprises?

The philosophy of securities law is publicity or disclosure, as "sunlight is said to be the best of disinfectants; electric light the most efficient policeman (Brandeis, 1932, p.92)". The securities law of almost every nation is designed around such core philosophy for ensuring the truthfulness and reliability of public disclosure. However, different ideas have formed different guiding thoughts in legislation, hence, the merit model and the disclosure model of securities regulation. As commented by Professor Stephen Bainbridge (April 22, 2012), Wendy Gerwick Couture has identified the common complaints lodged against merit review (63 Baylor L. Rev. 1):

[Merit review is] premised on the debatable notion that a security has an ascertainable fair price. In addition, by lowering offering prices below what the market will bear, [it will] divert money away from the issuer to be scooped up by speculators in the secondary market.

Other criticisms are also identified. First, merit review is widely criticized as unduly paternalistic. Second, merit review is often criticized for interposing an ill-equipped middleman (China Securities Regulatory Commission, or CSRC) between issuers and investors. Third, merit review is often maligned for preventing issuers from raising capital by denying them registration, hence unnecessarily constraining the freedom of people to do business as they see fit, discouraging entrepreneurial initiative and impeding the flow of capital to its most efficient use.

Merit review has also been blamed for impeding capital formation. "Small issuers in particular complained bitterly that the cost of complying with California's merit review standard in order to register their securities offerings for sale in this state substantially raised their capital formation costs." (30 Loy. L.A. L. Rev. 1573, 1586)

In assessment of merit review in Chinese securities law, Robin Hui Huang suggested another problem with the merit review system that merit regulation had also provided a fertile breeding ground for rent seeking and corruption by regulators. This was because the approval requirement made the right to do an IPO a scarce commodity and thus led to many rent-seeking activities in the process. (41 Hong Kong L. J. 261, 270) Merit review had also been vehemently attacked in recent times for such problems in China as associated costs, indefiniteness, inconsistency and the potential for corruption. Finally, public regulators are unable to outperform the market in evaluating financial products. Furthermore, as commented by Professor Zhu Jinjing, "In practice, there are so many formalities in the offering process in China, and it may be said that China's merit review is more than merit review." (ZHU, 2009, p.95) As a result of such review, there are only a few non-state-owned enterprises listed in Shanghai Stock Exchange and Shenzhen Stock Exchange since it is too hard for them to pass the mandatory review due to their lack of access to governmental relationship; and many high quality non-state-owned enterprises can only go listing in overseas markets, including New Oriental, Baidu, Sina, Sohu and Mengniu.

Even with such excessive merit review, rent-seeking and corruption are so popular that fraud and false listings have never stopped, including the notorious scandals of Hongguang Industrial in 1997 to Green Land in 2011. Why fraud in offering is so popular with merit review? May a stock market become prosperous without quality enterprises? It is not a surprise that the Chairman of CSRC has recently doubted whether merit review could be discarded in IPOs or not.

Such doubt is also hidden in the self-contradictory provisions of the Chinese securities law. The disclosure philosophy is reflected in Article 27 of the Securities Law of the PRC, i.e., caveat emptor, which is contradictory to the provision of Article 10 of the same law, a merit review standard practiced in China.

We should say no to such merit review of Chinese characteristics. The disclosure philosophy should be realized consistently, or the registration system should be adopted, provided a complete civil liability system should be established and practiced, especially the system of civil liquidated damages.

² See Article 3 of the Securities Law of the PRC.

2. INADEQUATE CIVIL LIABILITY SYSTEM

Protection of investors is one of the purposes of securities law. How to protect investors without a complete responsibility system for violation in securities? Investors may lose their confidence in the stock market without proper protection. The public offering system of securities may not well operate without a complete responsibility system for violation in securities, and hence, the stock market may become a casino full of frauds.

Especially, a complete civil liability system should be established and practiced. Only when investors may claim for liquidated damages conveniently through litigation can they become a positive market force to check violations including misrepresentation, misleading statements and material omissions. Under such civil liability system, responsible persons shall be liable and even go bankrupt once public disclosure is untruthful with loss to investors. In short, the cost for a lie in information disclosure shall be high enough.

There are four types of responsibilities for securities violations, i.e., civil liabilities, administrative liabilities, criminal liabilities and self-disciplinary liabilities. Though the Chinese law has corresponding provisions, there is insufficiency to varying degrees. Among the four types of responsibilities for securities violations, civil liabilities should be in a dominant position, supplemented by administrative liabilities, criminal liabilities and self-disciplinary liabilities, or in other word, damages shall be supplemented by punishment. Upon looking into the responsibility system of China's Securities Law, it can be found that administrative punishment is in a dominant position. Among the total forty-eight articles of Chapter 11 of China's Securities Law nearly all provisions cover administrative punishment, and only four articles touch civil liquidated damages as ancillary.

In terms of civil liabilities, there are twelve provisions in China's Securities Law, with a wide coverage over untruth publicity by issuers, insider trading, market manipulation, fraud by securities firms, illegal operation of consulting agencies and illegal takeovers as well as disgorgement of unauthorized offerings. Such broad provisions on civil liabilities are forward looking to some extent. Since the truthfulness of disclosure in offering by issuers is at the core position in the operation of the entire securities market, the civil liabilities thereof are the core for securities violations.

In reality, violations have become rampant in the stock market of China. With respect to civil liquidated damages in fraud cases of securities, the Supreme People's Court issued two circulars in 2001 and 2002 and one judicial interpretation in 2003, which, though opened the doors to civil liquidated damages for securities violations step by step, still left various pre-conditions as obstacle to acceptance by courts of such cases.

Market economy relies on its own adjustment mechanism and the play of the role of market force, where the supervision and punishment by government agencies may only play a residual function. Investors are the main market force to check falsification, promote due investigations by various types of persons responsible for publicity and guarantee the truthfulness in public disclosure by issuers by prosecuting wrongdoers in false statements for protecting their own legitimate rights and interests. However, the current Chinese system is like putting the cart before the horse. On one hand, governmental supervision is enhanced, and on the other hand, pre-conditions are set to prevent prosecution by investors, suppressing the underlying force of the market to check falsification and misrepresentation. That is the main cause for the problems of the stock market and the incomplete rule of law in securities, which is also the remaining obstacle to the civil litigation system. Some scholars even pointed out that the only backlog rested on courts, or rather the Supreme People's Court (ZHU, 2009, p.174.). But, are courts authorized to allow investors to sue listed SOEs to die or would courts be willing to do so in China?

Take for example, in the notorious Green Land, the court granted probation to all the five defendants and a fine of only RMB 4 million was imposed on the company. As commented by many people, the responsibility thereof is too light and the cost for breach is too low. In that case, even the People's Procuratorate could not tolerate it, and a formal protest has been lodged.

Similarly, all those enterprises could not be tolerated that go listed for the sole purpose of fund-raising by use of various privileges including status and relations. A breakthrough may be made in reforms on the offering system only with the coordination by a complete system of civil liquidated liabilities. Certainly, the system of civil liquidated liabilities is only a necessary but not a sufficient condition for the prosperity of a stock market. For a stock market to be prosperous, all the qualified enterprises, stated owned or privately run, shall have the opportunity to offer their shares in stock exchanges, that is, there shall be a fair offering system as mentioned above.

3. INSUFFICIENT FIDUCIARY SYSTEM

Also among the fundamental principles of the securities law is the fiduciary principle, or in essence, the fiduciary principle of professionals. Some scholar once commented that the fiduciary principle should be deleted from the Securities Law of the PRC because there were related provisions concerning to the good faith principle in the General Provisions on Civil Law of the PRC and the Contract Law of the PRC. That was clearly a misunderstanding. The fiduciary principle set forth in Article 4 of the Securities Law of the PRC has a special

meaning, which is in essence the fiduciary principle of professionals, totally different from the good faith principle. The fiduciary principle is one of the three pillars constituting the securities law, the other two pillars of which are publicity (including disclosure in IPOs and continuous disclosure) and liabilities (including civil liquidated damages).

The fiduciary principle is different from the good faith principle in that as required by the latter, one should respect and promote (without harm at least) others' interests and public interests while pursuing one's own interests, and the former covers a separate legal category, including special relationships with and of agents, trust, partnerships, corporate officers, lawyers, accountants, securities service agencies (Tamar, 2011, p.42-62). As one of the three pillars of the securities law, the fiduciary principle and related rules and systems are mainly designated to supervise financial intermediaries or gate keepers including securities service agencies, directors, officers, controlling shareholders and actual controllers, which are also applicable to regulators and their staff members. The provisions on presumptive fault liabilities for securities service agencies and officers and senior management of issuers set forth in Article 69 of the Securities Law of the PRC aim at enhancing the prosecution of liabilities, which reflects the requirements of the fiduciary principle.

A sole principle is of no use without specific rules, systems and measures in its implementation and law enforcement. The problems of China's stock market come from the unfair offering system and almost each case concerning securities offering is related to the frauds by intermediaries including securities firms, accountants and lawyers besides those by issuers and listed companies. The inadequate punishment against fiduciaries including intermediaries, directors and officers in the fraud listing cases of Hongguang Industrial and Green Land has indicated the shortage of legislation and enforcement in the fiduciary field of securities market. Furthermore, in Wang Xiaoshi, the hidden lover of Wang Xiaoshi, a staff member of CSRC sold the name list of reviewers involved in offering of securities for her private profits. That case indicated the rent-seeking phenomenon in the merit review system of China's securities market, which was also the embodiment of the weakness in the current fiduciary system. The normal development and prosperity of the stock market of China is in urgent need of a complete fiduciary system. In such system, government teaches the whole people by its example. If the government becomes the lawbreaker, it breeds contempt for law; it invites every man to become a law unto himself; it invites anarchy. As emphasized by the Chairman of CSRC, CSRC should take a lead in the construction of the fiduciary system.

The fiduciary principle is of three attributes, namely being subject to specific subjects, specific fields and specific rules. As required by the fiduciary principle, the act of the trustee shall be in the best interest of the beneficiaries, and the act of the trustee shall not be affected by its own interests or the interests in conflicts with those of the beneficiaries. Such requirement is higher than that of the good faith principle in civil law and contract law. The fiduciary duties are divided into the duty of loyalty and the duty of care, among which the duty of loyalty is related to the property and power entrusted and the duty of care is related to the quality and care of fiduciaries' performance of their service. Based on the duty of loyalty are the duty to follow and abide by the directives of entrustment with respect to the entrusted power or property, the duty to act in good faith in performing fiduciary services, the duty not to delegate the fiduciary services to others, the duty to account and disclose relevant information to the entrustors, and the duty to treat entrustors fairly. The duty of care requires fiduciaries to execute their services and execute them well, and when executing services, fiduciaries shall stick to the following principles: fiduciaries should possess and use the expert skills they purports to possess, fiduciaries' performance is evaluated by the process that the fiduciaries have adopted in performing their services, care may depend on the kind of "red flags" that the fiduciaries should failed to, notice, the duty if care may be affected by the legal risk imposed on the fiduciaries, the evaluation of the fiduciaries' performance is affected by the reasonable expectations of the parties and the constraints on the fiduciaries' discretion, the duty of care may vary depending on different applicable laws, and courts evaluate the performance of highly expert fiduciaries with the aid of other experts in the fiduciaries' area. (Tamar, 2011, p.101-174.) In such regard, we need to revise China's Securities Law and Securities Investment Fund Law so as to incorporate such requirements of the fiduciary principle.

CONCLUSIONS

To regulate the stock market and make it prosperous, the three pillars, or the three systems of offering, fiduciaries and civil liquidated damages must be combined organically for adopting an integral philosophy and systematical measures, and no isolated practice may reach the expected result of governance of the stock market.

Recently, no measure is thoroughly complete in any of the above-mentioned three aspects though a series of highly technical measures have been adopted, including cracking down on insider trading, piecemeal reforms on the offering system, and emphasized opinions on fiduciary behaviors on the part of CSRC.

The securities market is a market ruled by law, and the securities market is an important national asset which must be preserved and strengthened³. If one of the historical purposes of China's Securities Law were to rescue a number of difficulty-stricken SOEs and promote the institutional reforms of economy at the inception of the securities market, which has foreshadowed the long-term twisted and sluggish development of the securities market, at present, we need to revise those purposes. In the coming revision to China's Securities Law, the purposes of the securities law should be modified to include protection of the public interest and investors, and promotion of efficiency, competition and capital formation⁴.

It is comforting to note that, on July 31, 2012, CSRC released the Interim Measures for Supervision and Administration of Fiduciary Conducts of Securities and Future Markets, indicating China is thinking over how to promote construction of the fiduciary system in the securities and futures markets in an integral measure, which may be of a far-reaching significance. However, in view of the content of the Interim Measures, it can be found that there is inadequate punishment against the violation of fiduciary standards, and that a set of complete ideas have not been formed on construction of the legal liability system for the fiduciary conducts of financial intermediaries (ZHANG Lu, 2012, p.A3).

It's is easy to pretend that the sluggish securities market in China was caused by nothing more than regulation. But it wasn't; it was, in large part, the result

of a corruptly strong system of government power. And the securities market was a big part of that corruption of government power. Succinctly, the only way out for China to have a prosperous stock market is to integrate the fundamental reforms on the three systems of offering, fiduciaries and civil liquidated damages in the securities market. If such three systems are not complete, there would be no institutional safeguards for the further development of Chinese securities market, not to mention a healthy and prosperous securities market, and the expansion of the stock market and the launch of an international board would only be a mirage.

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³See Subsection (a)(1) of Section 11A of the US Securities Exchange Act of 1934.

⁴See Subsection (b) of Section 2 of the US Securities Act of 1933.