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China & the Convergence of Securities Regulation

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China & the Convergence of Securities Regulation

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ABSTRACT:

While an international regime of securities regulation seems to make perfect sense, there is a lack of understanding as to what such a regime would entail. In answering this question, this author will engage firstly in a discussion of the possible approaches to converge securities regulation, before arriving at his prediction of how this international securities regulation will look like.

A related question that the author wishes to explore from this first query is how far China will go in supporting the convergence project. Given the sphere of China's influence over the global economy, its endorsement of such a convergence project would be critical in providing the project legitimacy in an international context.

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CHINA & THE CONVERGENCE OF SECURITIES REGULATION

I. INTRODUCTION

There is a case to be made that a formalized international securities regulatory framework is the key to minimizing risks and preventing future financial crises. Indeed, against the backdrop of the financial downturn in 2008, the Obama Administration had made raising international regulatory standards and improving international cooperation one of its priorities¹. Extrapolating from this, an international regime for securities regulation seems to make perfect sense; the pooling the expertise and experience of different securities regulators can only mean an increase in the efficiency of markets and a decrease in systemic risk².

Unfortunately, there is a lack of what such this international securities regulatory regime entails. Are we talking about a set of common laws? Or better yet, a centralized regulator? Or is the end goal just a loose network of cooperation from autonomous regulatory regimes? To answer this question, this author will endeavour to first engage in a discussion of the different possible approaches the convergence of securities regulation, before arriving at his prediction of how this international securities regulatory regime (if any) will look like.

A related question that arises from this first query is how far the People's Republic of China ("PRC"), the world's second largest economy³, will chime in on this convergence project. Given the sphere of influence China has over the global economy, its endorsement of this convergence project would be critical in providing the project legitimacy in an international context. It is interesting to note however that China has had a track record of going against the flow. This is perhaps best encapsulated by Joshua Cooper Ramo's "Beijing Consensus" – a ruthless willingness of the Chinese to experiment with the settled practices, in opposition to the belief that there are

¹ US Department of the Treasury, *Financial Regulatory Reform: A New Foundation* (Washington, DC: 2009), available online: http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf at Page 80 - 88

² Eric C. Chaffee, "Finishing The Race to the Bottom: An Argument for the Harmonization and Centralization of International Securities Law" (2010) 40 Seton Hall L Rev 1581 at Page 1603

³ World Bank, "China Overview", online: World Bank <http://www.worldbank.org/en/country/china/overview>

uniform solutions to every problem⁴. This author will therefore also assess in the second part of this paper the extent China will go in supporting the convergence project.

II. APPROACHES TO CONVERGENCE IN SECURITIES REGULGATION

The prevailing rhetoric seems to perceive the various approaches to convergence not as watertight and mutually exclusive categories, but rather on a sliding scale. As such, it would be important to note that all approaches to convergence are expected to have some degree of overlap, or may exist as stronger or weaker variations of each other. Briefly, this author will now attempt to determine the merits and shortcomings of employing (1) competition, (2) harmonization and (3) centralization as the approach to convergence in securities regulation.

A. Convergence Via Competition

Competition as the basis of convergence may seem like a misnomer to some since the term in itself seemingly suggests a lack of uniformity or consolidation. Commentators however do not seem to be disturbed by this lack of uniformity or consolidation – they are still able to present the theory coherently and are also able to place a finger on its impact on regulation.

Indeed, competition is quite different from the other approaches because responsibility is divested largely upon national regulators and issuers. The theory is underscored by the belief that issuers should be permitted to choose between different regulatory frameworks and adopt one that best suits its needs⁵. National regulators then adjust their regulations to mimic that of the most successful regimes – eventually leading to some degree of convergence amongst national regulators. Some will attest that this is indeed the state of current securities regulation,

⁴ Joshua Cooper Ramo, *The Beijing Consensus* (London: The Foreign Policy Centre, 2004) at Page 4

⁵ Robert A. Prentice, “The Inevitability of a Strong SEC” (2006) 91 Cornell L Rev 775 at Page 777 – 780

especially in light of today's highly globalized world featuring a myriad of cross and dual listings⁶.

i. Merits of a 'Competitive' Approach

The competitive approach has been noted to have impacted the European capital markets positively by encouraging 'a race to the top'⁷. According to some commentators, since the good governance of an issuer will be reflected by the offering price of its securities, issuers and domestic regulators have much incentive to pursue good corporate governance practices⁸. Where regulatory standards fail to match up against foreign regulators, domestic issuers and regulators will have no choice but to part with investors and their capital. Accordingly, issuers and their regulators will therefore look to increasing their standards in order to out-compete their equivalents – hence the 'race to the top'.

Issuers are also likely to prefer such a regime since they could benefit from a competitive environment. For one, companies based in countries with weaker corporate governance would be able list on foreign exchanges and therefore outsource enforcement by 'bonding' themselves to stronger regimes and stricter governance standards abroad⁹. Also, by 'bonding' to stronger regimes, issuers are able to inflate prices by signalling stronger regulatory standards to potential investors. The prospect of such 'reputational bonding' is especially tempting for prospective issuers based in emerging economies, given the relatively underdeveloped regulatory regimes they come from¹⁰.

⁶ Christopher M. Zoeller, "Corporate Scandals: Global Recognition of Securities Regulation – How is China Faring?" (2009) 41 U Tol L Rev 213 at Page 231

⁷ Howell E. Jackson & Eric J. Pan, "Regulatory Competition in International Securities Market: Evidence from Europe in 1999 – Part 1" (2001) 56 Bus Law 653

⁸ Amir N. Licht, "Regulatory Arbitrage for Real: International Securities in a World of Interacting Securities Markets" (1998) 38 Vir J Int'l Law 563 at Page 563, 565 & 609

⁹ Curtis J. Milhaupt & Katharina Pistor, *Law & Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development Around the World* (Chicago: Chicago University Press, 2008) at Page 134. See also John C. Jr. Coffee, "The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications" (1999) Columbia Law School Centre for Law and Economic Studies Working Paper No. 144 at Page 23.

¹⁰ Jordan I. Siegel, "Can foreign firms bond themselves effectively by renting US Securities laws?" (2005) 75 Journal of Financial Economics 319 at Page 321

ii. *Shortcomings of a 'Competitive' Approach*

Unfortunately, neither 'bonding' nor 'race to the top' figures in reality. Under a competitive regulatory regime, issuers have observably migrated to jurisdictions of looser standards¹¹. Issuers are also known to engage in 'regulatory arbitrage' by capitalizing on loopholes in regulatory systems in order to circumvent unfavourable regulations¹². Such a practice is undoubtedly detrimental to investors and also injurious to the capital markets.

In fact, national regulators have also been seen to engage in what some commentators have termed a 'race to the bottom'. It is easy to imagine how some regulators will become free-riders¹³ or bystanders¹⁴, withholding from investing in regulation and enforcement in the hope that others will tend to the problems that arise.

Finally, the benefits of competition cannot be felt without the establishment of a fully coordinated international enforcement regime buttressed by multilateral government initiative¹⁵. There will only be an incentive to improve standards where there is active policing and coordination between national regulators in enforcement operations. Commentators note that the mere presence of Memorandums of Understanding ("MOUs") and cooperative agreements is insufficient¹⁶ – there must be mutual recognition of statutory securities domicile through the signing of a treaty or an executive agreement involving higher governmental levels¹⁷.

¹¹ *Supra* Note 1 at Page 80

¹² *Supra* Note 2 at Page 1595

¹³ Donald C. Langevoort, "U.S. Securities Regulation and Global Competition" (2008) 3 Va L & Bus Rev 191 at Page 204

¹⁴ Damien Schiff, "Samaritans: Good, Bad and Ugly: A Comparative Law Analysis" (2005) 11 Roger Williams U L Rev 77 at Page 122

¹⁵ Roberta Romano, "The Need for Competition in International Securities Regulation" (2001) John M Olin Center for Studies in Law, Economics, and Public Policy Working Papers Paper 258 at Page 9

¹⁶ *Ibid*

¹⁷ *Ibid*

B. Convergence Via Harmonization

The harmonization approach requires the securities law of all nations to be identical, without providing individual nations the ability to experiment with how to achieve the norms underlying the regulatory system¹⁸. The objective of this approach can be more simply understood as an endeavour to create a common legal vocabulary and standard operating procedures with regards to securities regulation. More specifically, harmonization will require vocabulary that can survive statutory and treaty interpretation, as well as apply under different regulatory cultures and time periods¹⁹. In other words, a truly harmonized international regulatory regime must preserve at least some form of principled legal coherence.

i. *Merits of a 'Harmonization' Approach*

At the outset, it should be noted that there is already a substantial degree of similarity amongst the securities laws of many countries. Most of these laws are partially copied or taken in *verbatim*²⁰. A good example would be the sections within the Malaysian and Singaporean Securities Laws dealing with disclosure requirements. Both were borrowed from the Australian Uniform Companies Act²¹ (which is again in itself similar in aspects to the UK Companies Act 1948)²². Notably, all the abovementioned pieces of legislation require mandatory disclosure and the issuance of a prospectus prior to the distribution of securities to the public. It is also a common requirement for all issuers to provide disclosures on an on-going basis pursuant to listing.

The main benefit of a harmonization approach lies in the fact that there is little political baggage. As with most other fields of public law, primary principles of securities law are fleshed out by a regulatory agency, which is fairly independent of the national

¹⁸ Edward F. Greene, "Beyond Borders Part II: A New Approach to the Regulation of Global Securities Offerings" in Nicholas Grabar & Michael Mann, eds, *Foreign Issuers & The U.S. Securities Laws 2008: Strategies for the Changing Regulatory Environment* (Practising Law Inst. ed., 2008) at Page 607 & 612

¹⁹ Mark Humphery-Jenner, "The Desirability of 'Weak' Form Legal Harmonization: Perspectives from Statutory Interpretation and Legal Coherence" (2012) 13 German L J 807 at Section D

²⁰ Mark Gillen & Pittman Potter, "The Convergence of Securities Laws and Implications for Developing Securities Markets" (1998) 24 N C J Int'l L & Com Reg 83 at Page 86

²¹ H.A.J. Ford, *Principles of Company Law* 4th ed (Australia: Butterworths, 1986) at Page 15

²² *Companies Act 1948 (UK)*, 11 & 12 Geo 6, c 38

legislature. As such, the process of harmonizing is neutral and technocratic. The process also does not challenge long established social policies²³. Unlike parliaments, regulators therefore are able to more freely and openly negotiate over regulatory policies.

Moreover, the harmonization approach does not require an overhaul of the present framework in most jurisdictions. There is already a sufficient degree of harmonization actually taking place between financial institutions around the world – key examples being accounting and auditing standards²⁴. While securities regulators are in theory supposed to promulgate rules on disclosure, they usually defer to guidelines laid down by international accounting standards such as the Generally Accepted Accounting Principles (“GAAP”) as well as the International Financial Reporting Standards (“IFRS”). In essence, the uniformity in accounting standards across jurisdictions provides a good basis for the harmonization endeavour.

ii. *Shortcomings of a ‘Harmonization’ Approach*

There are however some considerations that will militate against the effecting of this approach. For one, while there is no political baggage that comes with promulgating the set of common laws, there would be political obstacles to finding ‘hard law’ solutions that are necessary to effect common standard-setting and cross-border dispute resolution²⁵. There are also practical difficulties in trying to fairly enforce similar regulations across international boundaries. Commentators have noted that where there is disparity between the economic power of the home and recipient country, and where there are “buoyant” relations

²³ *Supra* Note 9 (Coffee) at Page 63

²⁴ Deloitte, *Corporate Reporting: Trends and Tensions in Convergence* (2008), online: <http://www.iasplus.com/en/binary/resource/0806willemain.pdf>

²⁵ Donald C. Langevoort, “Global Securities Regulation After the Financial Crisis” (2010) 13:3 *Journal of International Economic Law* 799 at Page 800

between the recipient and home country, public enforcement is disincentivized for the recipient country²⁶.

Secondly, despite the wave of exchange consolidation²⁷, many exchanges today are still very much concerned about a regulatory spill-over that could result from harmonization of rules. From an exchange's point of view, the aim of consolidation is purely commercial – to increase market power. It is not to introduce new regulatory standards to disrupt the settled expectations of their customers. This is best evidenced by how some exchanges have negotiated specific provisions so that when they are involved in a merger or alliance, they would be able to preserve their status as a distinct corporate entity. Provisions like these were clearly put in place so that issuers listed on their platform are not subject to another country's securities regulation²⁸.

Further, because international lawmakers are not subject to political and electoral discipline, the legitimacy of such rules, like many international documents, may be disputed²⁹.

On a more fundamental level, true harmonization is difficult because of the disparity between economic systems. Smaller capital markets need to play catch-up and are likely to demand concessions, exceptions or even act to bargain down certain requirements. Yet, if we were to allow for flexibility in within this harmonized set of laws to

²⁶ Paul Michael Jindra, "Securities Fraud in Singapore: China and the Challenge of Deterrence" (2012) 51 Colum J Transnat'l L 120 at Page 139. See also Note 9 at Page 145 – 146. The given example was the case of the China Aviation Oil ("CAO") scandal, where it was noted that "with the exception of the important criminal prosecution of the executives involved, resolution of the financial crisis at CAO rested on a negotiated solution among governmental entities and affiliates from China and Singapore. Implicit in this was that the Singaporean authorities were more concerned about their large state investment in the CAO and Singapore's strong national interest in maintaining amicable ties with China.

²⁷ Ernst & Young, *IPO Insights: Comparing Global Stock Exchanges* (2009), online: Ernst & Young http://www.ey.com/GL/en/Services/Strategic-Growth-Markets/Strategic-Growth-Markets_IPO_Comparing-Stock-Exchanges at Page 5

²⁸ Reena Aggarwal, Allen Ferrell & Jonathan Katz, "U.S. Securities Regulation in a World of Global Exchanges" (2007) John M. Olin Center For Law, Economics, and Business Discussion Paper No. 569. Examples of such provisions can be found in the corporate documents of entities such as NASDAQ/OMX, NYSE/Euronext.

²⁹ Paul B. Stephan, "Regulatory Cooperation and Competition: The Search for Virtue" (1999) University of Va. Sch. of Law Working Paper No. 99-12

accommodate these countries, we would have to give up on the specificity and certainty of what is being promulgated³⁰.

C. Convergence Via Centralization

The plain meaning of ‘convergence’ suggests an act of moving towards uniformity³¹. Convergence, taken to its logical extremes, would therefore imply the creation of an international organization that would have monitoring, regulatory and enforcement responsibilities in the capital markets across the globe³². The benefits of such a regime are obvious – aside from reducing both costs and the duplication of effort, centralization also facilitates better coordination among various jurisdictions.

While it would be ideal to have a centralized securities regulatory regime, there are doubts with regards to the feasibility of such an approach. Firstly, it is doubtful how a central body will exist where there is much disparity in the second-order institutions in each jurisdiction³³. Lawyers, bankers and accountants in different jurisdictions can vary quite perceptibly in terms of professional standards. Also, emerging markets and developing countries are likely to have untested legal systems, as well as inexperienced enforcement agents.

Even if this prerequisite for centralization is in place, there would be much inertia for countries to subject themselves to the authority of a central regulator. The European Union has been trying for years to work out a mechanism to centralize securities regulation without much success. While they have managed to procure treaty-based commitment to full economic

³⁰ ³⁰ B. van Rooij, “Bargaining about the land bill: Making effective legislation to protect arable land in China” in J. Arnscheidt, B. Van Rooij, J. M. Otto, eds. *Lawmaking For Development: Explorations into the Theory and Practice of International Legislative Projects* (Leiden University Press, 2008)

³¹ *Merriam-Webster*, online, *noun*, “convergence”, available online: <<http://www.merriam-webster.com/dictionary/convergence>>

³² Howell E. Jackson, “Centralization, Competition, and Privatization in Financial Regulation”, (2001) 2 *Theoretical Inquiries L.* 649 at Page 656 – 657

³³ Troy A. Paredes, “A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer”, (2004) 45 *Wm & Mary L Rev* 1055 at Page 1077

integration, the responsibility of capital markets regulation still largely resides with that of individual member countries³⁴.

If anything, our experience with the BASEL framework should be evidence enough of the inherent limitations to adopting such an approach to regulatory convergence. The BASEL framework is described as “a global regulatory framework for more resilient banks and the banking system”³⁵ and has also been hailed as an exemplar of international regulation and law making³⁶. In fact the most recent formulation of this framework (BASEL III) involves a comprehensive set of reforms aimed at improving the banking sector’s ability to absorb shocks from financial stress, improve risks management as well as strengthening bank disclosures and transparency³⁷. Unfortunately the framework was met with resistance by banks as it was alleged to hamper growth and recovery³⁸. This therefore led to the eventual easing of rules and expectations as part of a compromise³⁹. For instance, the BASEL’s implementation schedule was extended from 2015 to 2019⁴⁰. Also, the definition of ‘liquid assets’ was considerably broadened⁴¹. Perhaps most discouraging is that as of 1 January 2013, only 11 out of 27 member countries have adopted and implemented the BASEL framework. This however does not include major economic powers such as the EU and the U.S.⁴². Given our experience with the BASEL framework, it is therefore patently clear that a centralized international regime capable of conducting prudential cross-border supervision is unlikely to eventuate in the near future⁴³.

³⁴ Elis Ferra, *Building an E.U. Securities Market* (Cambridge: Cambridge University Press, 2004)

³⁵ Bank for International Settlements, “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems” *BIS* (2011), available online: BIS <http://www.bis.org/publ/bcbs189.htm>

³⁶ Narissa Lyngen, “Recent Development, Basel III: Dynamics of State Implementation”, (2012) 53 *Harv Int’l L J* 519

³⁷ Bank for International Settlements, “International Regulatory Framework for Banks (BASEL III)”, available online: BIS <http://www.bis.org/bcbs/basel3.htm>

³⁸ Patrick Slovik & Boris Cournède, *Macroeconomic Impact of Basel III* (2011) OECD Economics Department Working Papers, No. 844, OECD Publishing at Page 2

³⁹ Andrew Ross Sorkin, “Easing of Rules for Banks Acknowledges Reality” *Dealbook* (7 January 2013), online: Dealbook <<http://dealbook.nytimes.com/2013/01/07/easing-of-rules-for-banks-acknowledges-reality/>>

⁴⁰ Admati, Anat, and Martin Hellwig, “Must Financial Reform Await Another Crisis?” *Bloomberg* (6 February 2013), online: Bloomberg <http://www.bloomberg.com/news/2013-02-05/must-financial-reform-await-another-crisis-.html>

⁴¹ *Ibid*

⁴² Nicolas Veron, “Basel III: Europe’s Interest is to Comply” *VOX* (5 March 2013), online: VOX <<http://www.voxeu.org/article/basel-iii-europe-s-interest-comply>>

⁴³ Eric J. Pan, “Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks” (2010) 11 *Chicago J Int’l L* 243 at Page 246

III. CONSIDER FOR A MOMENT – ‘FUNCTIONAL CONVERGENCE’

Unfortunately, none of the abovementioned approaches to convergence will receive unanimous support anytime soon. Does this therefore relegate the convergence of securities regulation to a mere aspiration? This author is inclined to respond in the negative. It should be noted that these approaches appear unfeasible mainly because there exists no feasible working steps in arriving at them; a leap of logic and faith would inevitably be required should one decide to adopt any of these approaches. As such, what perhaps would be required is the effecting of an intermediate step so that the convergence project appears more feasible. For reasons that will later be explained, this author is of the opinion that functional convergence will show itself to be this intermediate step in the convergence trajectory.

Put simply, functional convergence⁴⁴ looks at the use of different institutions to accomplish similar tasks, rather than placing the emphasis on adopting similar rules⁴⁵. This approach is underscored by the belief that formal legal rules are only part of a large web of market supporting institutions. It is said that if law is only a means to bring systems to relative parity, institutions would be a more proximate means of achieving this end. As such, this approach posits that it is more important to use institutions to enforce standards of conduct against issuers and intermediaries who flagrantly flout the principles of security regulations, rather than tweaking rules at the margin⁴⁶.

The merits of functional convergence are numerous. Firstly, functional convergence does not carry with it much political baggage because it is relatively dissociated from governmental endorsement. In addition, it neither brings with it the detrimental effects of regulatory spill-over, nor does it encourage a ‘race to the bottom’.

⁴⁴ Ronald J. Gilson, “Globalizing Corporate Governance: Convergence of Form or Function” (2001) 49:2 Am J Comp L 329

⁴⁵ Bernard S. Black, “The Legal and Institutional Preconditions For strong Securities Markets” (2001) 48 UCLA L Rev 781 at Page 785

⁴⁶ *Ibid* at Page 844

More practically, functional convergence only requires rules to be based on the established objectives of securities regulation, since different formal rules are arguably able to produce similar outcomes anyway⁴⁷. These principles are perhaps best encapsulated by the International Organization of Securities Commission's ("IOSCO") 3 Objectives of securities regulation – that of (1) protecting investors, (2) ensuring fair, efficient and transparent markets, as well as (3) reducing systemic risk⁴⁸. It is worth noting that these objectives have received the endorsement from over 100 national regulators since their promulgation in September 1998⁴⁹.

We would however need ask ourselves how functional convergence would look like in practice. Given its definition, the scope of activities that would constitute functional convergence is invariably wide. Keeping in mind the abovementioned objectives and current regulatory trends, this author opines that functional convergence is likely to involve – *inter alia* - a disclosure-based model of securities regulation, as well as reputational intermediaries, regulators and the judicial system.

IV. THE CHINESE SECURITIES REGULATORY FRAMEWORK

To what extent will China participate in functional convergence? As with any international project, China's participation would be imperative to providing some form of legitimacy. For one, the endorsement (or lack thereof) by this economic juggernaut is likely to disrupt the equilibrium of the world market. Also, because China is a developing country in transition, its active participation in an international project will bring pressure upon other developing countries to do likewise.

Unfortunately – unlike other convergence approaches – there is no way of assessing if the objective of functional convergence has been met. Compounding this issue of assessment is the fact that functional convergence cannot be determined at face value. For instance, the question is not

⁴⁷ *Supra* Note 44

⁴⁸ IOSCO, "Objectives and Principles of Securities Regulation" (2010), online: <<http://www.compliance-exchange.com/governance/library/ioscoprinciples2010.pdf>> at Foreword and Executive Summary

⁴⁹ IOSCO, Press Release, (13 November 2001) online: <http://www.iosco.org/news/pdf/IOSCONEWS11.pdf>

whether a stock exchange exists, but whether there is an institution that is actively sanctioning errant market players. Precisely because we are looking at substance and not form, our understanding of functional convergence with respect to China must move beyond a mere box-ticking exercise.

It would therefore first be necessary to identify the different institutions present in China's regulatory landscape, and detail how they contribute to the current regulatory scheme. This author will then assess the complementarity of the current regime with global regulatory trends to determine the extent of functional convergence that has taken place in China.

A. Model of Securities Regulation

The prerequisite to functional convergence will require a position to be taken with regards to how to effect regulation – which brings to mind the familiar tension between government intervention and market forces. This author is however of the opinion that securities regulation will not be effected by prohibition or direct intervention, but by requiring adequate disclosure with respect to the transaction and imposing sanctions for false and misleading statements⁵⁰. In other words, regulation will tend towards a disclosure-based regime rather than a merits-based one (looking at the state of efficacy and equity of the securities). Commentators note that in the long term, as capital markets and their investors tend towards maturity, countries are likely to adopt the disclosure-based regime⁵¹. According to them, this allows market participants greater choice and the freedom to take calculated risks, which works to promote a more vibrant marketplace⁵². Indeed, the International Monetary Fund (“IMF”) has noted that most

⁵⁰ Robin Hui Huang, “The Regulation of Securities Offerings in China: Recosidering the Merit Review Element in Light of the Global Financial Crisis” (2011) 41 Hong Kong L.J. 261 at Page 272

⁵¹ *Ibid* at Page 278

⁵² Monetary Authority of Singapore, “Annual Report 2001 / 2002: Developing the Disclosure-based Regime for Singapore's Capital Markets” MAS (2001), online: MAS http://www.mas.gov.sg/annual_reports/annual20012002/developing-annual-c.html

jurisdictions today have shifted away from directly intervening in the markets so long as issuers meet minimum stated requirements⁵³.

i. A Hybridized Regime in China

The Chinese regulatory regime can generally be described as having in place merits-based regulation for the offering of securities, but an on-going requirement of mandatory disclosure pursuant to listing. This hybridized regime goes beyond informational disclosure as it includes a preliminary review by the state of the efficacy and equity of the securities being offered⁵⁴. The regime can be traced back to the promulgation of the Securities Law of the PRC in 1999⁵⁵, with merit review being enshrined in Article 10(1) and on-going continuous disclosure captured within Section III.

In essence, the merit-based regulation of securities offering requires prospective offerings to be recommended by qualified securities firms to the China Securities Regulatory Commission (“CSRC”) for approval⁵⁶. It used to be the case that each qualified securities firm had a limited number of channels⁵⁷ to make their recommendations through. Later, when it became quite clear that the channel system was unable to meet market demand, the sponsorship scheme⁵⁸ was instituted to replace it. Today, under the sponsorship scheme, there is no longer any ceiling placed on the number of offerings that can be concurrently sponsored by the same qualified securities firm. This scheme of securities offering has further been noted to increase market

⁵³ Ana Carvajal & Jennifer Elliot, “Strengths and Weaknesses in Securities Market Regulation: A Global Analysis” (2007) International Monetary Fund Working Paper 07-259, online: IMF <<http://www.imf.org/external/pubs/ft/wp/2007/wp07259.pdf>> at Page 6, Para 7. Most developed economies like the U.S., the UK and Australia have adopted the disclosure based regime. Further, in Asia, only China, Indonesia and the Philippines still remain merit-based. See Swati R. Ghosh, *East Asian Finance: The Road to Robust Markets* (International Bank for Reconstruction and Development, 2006) at Page 125

⁵⁴ *Supra* Note 50 at Page 263 - 264

⁵⁵ Securities Law of the People’s Republic of China, online: <http://www.china.org.cn/government/laws/2007-04/16/content_1207338.htm>

⁵⁶ *Supra* Note 50 at Page 264. This system of recommendation is proverbially known as the *tui jian zhi*.

⁵⁷ *Ibid*. Proverbially known as the *tong dao zhi*.

⁵⁸ *Ibid*. Proverbially known as the *bao jian zhi*

competition amongst sponsors, leading to an improvement in the quality of sponsorship services across the board⁵⁹.

Given China's status as an emerging economy, reliance on the merit-based regime is justified since the regulator would be relatively better equipped to identify investment hazard compared to the inexperienced investing public. This is not to say however that the regime is without its share of problems. On one level, it is hard to see how a disclosure philosophy⁶⁰ - *caveat emptor* - is consistent with the merit review standard⁶¹. It would appear unfair that while it is the regulator that decides which offerings are safe enough to be listed, it is the investors who are made to shoulder the responsibility of bad decisions. Strictly speaking, neither mandatory disclosure nor merit review seems to complement the objective of the other.

Secondly, the merit-based regulation of securities offering is premised on the assumption that market regulators are better placed and better informed to decide on behalf of investors⁶². Sadly this does not take into account the possibility of adverse selection that the regulatory entities might also be engage in as a result of informational asymmetry. In this regard, the CSRC has often been criticized as lacking the requisite resources and capacity to evaluate complex financial products⁶³. Coupled with the fact that market participants tend to disclose very little, it is therefore to no one's surprise that the CSRC often delays deciding the merits of an impending issuance. The knock-on effect of such delay has been hailed by some as the "biggest, most stubborn impediment to efficient capital allocation through the nation's stock markets"⁶⁴.

⁵⁹ *Ibid*

⁶⁰ *Supra* Note 55 at Article 27

⁶¹ Zhang Lu & Ma Baojin, "Legal Reflections on China's Stock Market" (2012) 5:1 International Business and Management 62 at Page 63

⁶² S. Ghon Rhee, "It's About Time to Adopt Disclosure-Based Regulation for the Korean Capital Market" (2000) K J Luke Working Paper WP00-09, online: http://www2.hawaii.edu/~fima/Working_Papers/Paper00-09.pdf

⁶³ *Supra* Note 50 at Page 270

⁶⁴ "Can Regulators Turn a Corner for IPO Reform" *Caixin Online* (27 February 2012), online: <http://english.caixin.com/2012-02-27/100360965.html>

Further, one commentator suggests that the need for governmental approval has contributed to a fertile breeding ground for rent-seeking behaviour and corrupt practices⁶⁵. Given that the new Chinese leadership has made anticorruption one of its main focuses⁶⁶, it would only be a matter of time before reforms would be made to stem out institutions which have the potential to introduce corrupt behaviour.

The dissatisfaction towards the merit-based regulation of securities offering has even prompted the previous CSRC chairman to openly express his doubts on the system. Reports indicate that prior to his departure, Mr Guo Shuqing had pushed for the shifting of power from government officials to auditors and investment banks. In his opinion, prospective issuers should be able to launch IPOs when they need capital, and not when they win government approval⁶⁷.

B. Reputational Intermediaries

Reputational intermediaries are non-negotiable features of any mature regulatory framework – accordingly, a focal point of the functional convergence of securities regulation. These reputational intermediaries are essentially institutions that give the investing public reasonable assurance that an issuer is being truthful⁶⁸. Given their status as repeat players in the marketplace, they are very much incentivized to vouch for the quality of securities. Accordingly, they may stand to incur reputational losses should they allow a company to unduly exaggerate its prospects or to falsify information. Moreover, they may also be held liable by investors and may potentially face civil or criminal prosecution⁶⁹. As such, they must be able to conduct due diligence on issuers to satisfy themselves that a company and their managers comply with the regulations. Examples of reputational intermediaries involved in these activities would generally include public auditors, accountants, lawyers and underwriters.

⁶⁵ *Supra* Note 62

⁶⁶ Tania Branigan, “Xi Jinping vows to fight ‘tigers’ and ‘flies’ in anti-corruption drive” *The Guardian* (22 January 2013), online: The Guardian <http://www.guardian.co.uk/world/2013/jan/22/xi-jinping-tigers-flies-corruption>

⁶⁷ Ling Ling Wei & Bob Davis, “Beijing to Sideline Top Securities Regulator” *The Wall Street Journal* (13 March 2013), online: Wall Street Journal <http://online.wsj.com/article/SB10001424127887324392804578358303154198298.html>

⁶⁸ *Supra* Note 45

⁶⁹ *Ibid* at Page 787

However, in order for these first-tier reputational intermediaries to earn the trust of the investing public, they would need second-tier ones to vouch for them⁷⁰. These would perceptibly include the involvement of the financial press and the securities analysis profession – who will be tasked mainly to voice criticism, as well as to actively uncover and publicize misleading disclosure. Their involvement is necessary since it further levels the informational asymmetry between listed companies and the investing public.

How developed then are these reputational intermediaries in China? This author will now explore in detail the profile of these various reputational intermediaries in order to determine the degree of functional convergence that has taken place.

i. Public Auditors and Accountants

According to IMF's Detailed Assessment Report ("the IMF Report"), the PRC is in need of increasing the quality and the size of the accounting and auditing profession⁷¹. News reports indicate likewise – the big four accounting firms have been known to lack qualified local partners, in part due to the notoriously difficult accounting exams in China, where pass-rates are well below 20%⁷². Even then, only a paltry 32% of the new graduates hired by the big four accounting firms are actually accounting majors⁷³. Also, there is a relatively high partner-staff ratio in Chinese accounting firms; 927 professional staff for each partner in 2008, compared to the 9:1 ratio in the U.S.⁷⁴. Such high partner staff ratios are understandable where work involved is simple and clerical in nature. However, where the task at hand requires the judgement of well-seasoned personnel, the

⁷⁰ *Ibid*

⁷¹ IMF, *People's Republic of China: Detailed Assessment Report: IOSCO Objectives and Principles of Securities Regulation* (April 2012) IMF Country Report No. 12/80 at Page 15, online: <http://www.imf.org/external/pubs/ft/scr/2012/cr1280.pdf>

⁷² Rachel Armstrong, "Big Four Auditors Brace themselves for Big Changes in China" *Reuters* (28 February 2012), online: Reuters <http://www.reuters.com/article/2012/02/28/us-china-accounting-idUSTRE81R07V20120228>

⁷³ "Audit Quality of the Big Four in China" *China Accounting Blog* (25 March 2012), online: China Accounting Blog <http://www.chinaaccountingblog.com/weblog/audit-quality-of-the-big.html>

⁷⁴ *Ibid*

lack of experienced partners to help monitor and supervise can only mean a lower quality output.

More recently, the state of the accounting profession in China has also been criticized by the Public Company Accounting Oversight Board (“PCAOB”) and the Securities Exchange Commission (“SEC”). In the wake of recent accounting scandals involving U.S.-listed Chinese companies, the PCAOB has requested for permission to carry out inspections on some Chinese auditing firms⁷⁵. The SEC has also tried to issue proceedings against a few big international accounting firms based in China⁷⁶. Indeed, despite CSRC’s guarantee of the quality of accountants and auditors in China, there seems to be an overwhelming amount of evidence pointing to the contrary⁷⁷.

ii. Lawyers

A brief introduction of the Chinese legal services market would be necessary at this point. While the Chinese bar has made remarkable progress with increasing the quality and quantity of practitioners since 1979, the profession is still pretty much in a primitive stage of development with regards to international aspects of legal practice⁷⁸. As such, the government has allowed foreign lawyers into the market in order to meet demand for international services – with the result that as of 2013, over 220 foreign law firms and 60 Hong Kong law firms have been granted permits to practice in China⁷⁹.

The liberalization of the legal market however has failed to achieve significant impact in raising the quality of domestic lawyers. Chinese lawyers today are notably inexperienced in international practice – especially in areas such as finance and securities, which have only been in Chinese consciousness after the advent of the open-door policy and

⁷⁵ Edward Wyatt, “S.E.C. charges 5 firms over audits in China” *Dealbook* (3 December 2012) online: Dealbook <http://dealbook.nytimes.com/2012/12/03/s-e-c-charges-the-chinese-affiliates-of-5-big-accounting-firms/>

⁷⁶ *Ibid*

⁷⁷ *Supra* Note 71 at Page 24

⁷⁸ Xiao Hongming, “The Internationalization of China’s Legal Services Market” 1:6 Perspectives, online: http://www.oycf.org/Perspectives2/6_063000/internationalization_of_china.htm

⁷⁹ Robert Lewis, “China Watch – A foreign lawyer’s view from the inside” *The Lawyer* (18 January 2013), online: The Lawyer <http://www.thelawyer.com/china-watch-a-foreign-lawyers-view-from-the-inside/1016559.article>

economic reform⁸⁰. One commentator notes that Chinese corporate lawyers are often not competent enough to handle the complex international legal issues because of language barriers and an inadequate understanding of foreign laws and cultures⁸¹. In another study, it was also noted that associates in law firms had very little control the cultural machinery of professionalism, making them very susceptible to client influence⁸².

iii. Underwriters

During the IPO process, underwriters act as financial intermediaries and information providers, which is why credibility and reputation is of utmost importance to them⁸³. The underwriter's role is an important one – not only do they have to help issuers price their issue correctly, they also have to use their credibility and reputation to certify that an offer price represents the true value of an issuer⁸⁴.

Chinese underwriters however are notably inexperienced. As such, there have been instances where individuals from securities firms have participated in 'grandstanding' in order to make themselves more attractive to potential issuers⁸⁵. The extent of 'grandstanding' in the industry has even garnered the attention of the authorities – many individuals have in recent years been identified and disqualified after they were found to have falsified their resumes⁸⁶. Indeed, the lack of faith in the Chinese underwriting industry can also be observed from the rampant and frequent switching of lead underwriters by Chinese listed companies in their seasoned equity offerings⁸⁷.

⁸⁰ *Supra* Note 78

⁸¹ Ding Xiangshun, "Chinese Corporate Lawyers Face Challenges in Maintaining Corporate Social Responsibility in the Age of Globalization" (2011) 21 *Ind Int'l & Comp L Rev* 509 at Page 518

⁸² Sida Liu, "Client Influence and the Contingency of Professionalism: The Work of Elite Corporate Lawyers in China" (2006) 40 *Law & Soc'y Rev* 751

⁸³ Jian Jiao & Xuan Guo, "Do Chinese Underwriters Grandstand to Attract More Firms When They are Ready to go Public?" (Master Thesis, Umea School of Business, 2010) at Page 1

⁸⁴ *Ibid* at Page 10

⁸⁵ P.A. Gompers, "Grandstanding in Venture Capital Industry" (1996) 42:1 *Journal of Financial Economics* 133

⁸⁶ Daniel Ren, "Regulator goes after Erring IPO Underwriters" *South China Morning Post* (1 April 2012), online: SCMP <http://www.scmp.com/article/696085/regulator-goes-after-erring-ipo-underwriters>

⁸⁷ Liu Jianguai, "Why Chinese listed companies frequently switch lead underwriters in seasoned equity offerings: A perspective of listed companies' loyalty" (2011) 1:3 *China Fin Rev Int'l* 280

iv. *The Financial Press*

The domestic press in China has been observed to perform the function of an informal discipline mechanism through its relentless coverage of sanctions, affected firms and scandal-tainted individuals⁸⁸. Their coverage of securities broadens the public exposure of the fact that a company has received scrutiny and criticism⁸⁹. Contrary to popular belief, the Chinese media enjoys significantly more autonomy in reporting on financial misconduct that they do on most areas of Chinese law and society. They have yet been barred from running such news even though they are still under intense supervision and tight control of the state⁹⁰. There is perhaps no reason for the government to repress debate in this area since the topic is hardly political in nature⁹¹.

v. *Securities Analysts*

Traditionally, securities analysts look to a few avenues in performing their task as consultants – publicly available information regarding company financial position, industry information, firm specific stock market data, company visits, as well as meetings with company management⁹². The good news however is that top analysts in China have in recent times geared towards relying on first-hand information (through company visits and interview of management) before making recommendations to investors⁹³. This is due in part to the fact that much of the publicly available information about these Chinese companies are known to have undergone some form of manipulation.

In a bid to encourage the positive contribution and influence of analysts in China, the Securities Analysts Association of China (“SAAC”) was officially established in Beijing

⁸⁸ Benjamin L. Liebman & Curtis J. Milhaupt, “Reputational Sanctions in China’s Securities Market” (2008) 108 Colum L Rev 929 at Page 933

⁸⁹ *Ibid* at Page 934

⁹⁰ *Ibid* at Page 935

⁹¹ Lindsay Wilson, “Investors Beware: The WTO will not Cure all Ills with China” (2003) Colum Bus L Rev 1007 at Page 1024

⁹² Jing Wang, Jim Haslam & Claire Marston, “The Appraisal of Ordinary Shares by Chinese Financial Analysts” (2011) 19:1 Asian Review of Accounting 5 at Page 17-18

⁹³ Chen Te-Ping, “Meet China’s Best 2011 Stock Analysts” *The Wall Street Journal* (14 May 2012), online: Wall Street Journal <http://blogs.wsj.com/chinarealtime/2012/05/14/meet-china%E2%80%99s-best-2011-stock-analysts>

in June 2000⁹⁴. Officially, the SAAC seeks to direct the healthy development of the securities investment consultation industry and to promote rational investment in China's securities market⁹⁵. Arguably, the association has achieved considerable success in meeting its objective – it has instituted national examination programs that are accredited by the Association of Certified International Investment Analysts (“ACIIA”) since 2006 as well as a continuing professional development program in 2007⁹⁶.

C. The Regulators

It is necessary for any well-functioning regulatory framework to be helmed by institutions which are able to rule-write and punish misbehaving members⁹⁷. In the context of a securities regulatory framework, there is the further expectation that these institutions would be able to license, suspend, fine and revoke the licenses of intermediaries and issuers where misconduct is detected. Where there has been a serious case of fraudulent conduct, there must also be regulators to initiate criminal proceedings against intermediaries, issuers, directors and managers. As such, another benchmark that can be used to assess China's extent of functional convergence would be the maturity of its regulators – the CSRC and the Chinese stock exchanges.

i. The CSRC

China's national securities regulator, the CSRC, is a public institution of ministry rank directly under the State Council⁹⁸. Under the 1998 Securities Law, the CSRC has been granted clear regulatory authority over China's stock exchanges⁹⁹. The CSRC keeps a relatively well maintained website with regular updates on – *inter*

⁹⁴ “Securities Analysts Association of China Launched” *People's Daily* (6 July 2000), online: People's Daily http://english.peopledaily.com.cn/english/200007/06/eng20000706_44807.html

⁹⁵ Asian Securities Analysts Federation, *Yearbook* (2004) (ATC: Killarney Heights, 2004) at Page 27-30

⁹⁶ “The Securities Association of China” ASIF, online: ASIF <http://www.asif.org.au/members/saac/saac.htm>

⁹⁷ *Supra* Note 45 at Page 788

⁹⁸ OECD, *Corporate Governance of Listed Companies in China: Self-Assessment by the China Securities Regulatory Commission* (OECD Publishing, 2004), available at <http://dx.doi.org/10.1787/9789264119208-en> at Page 25

⁹⁹ *Supra* Note 55 at Article 9

alia – state laws, administrative laws, judicial interpretations, department rules as well as other important updates and announcements¹⁰⁰. On the international front, the CSRC has been a member of IOSCO since 1995 and also been elected as a member of IOSCO’s Executive Committee since 1998. More recently, in 2009, the CSRC has also joined the ranks of the IOSCO Technical Committee, the standard-setting agency within IOSCO¹⁰¹.

The CSRC however faces its own set of challenges which may arguably hamper its ability to function well. According to the IMF Report, the CSRC’s budget is relatively insufficient – to the extent that CSRC staff has been notably underpaid compared to their corollaries¹⁰². The CSRC is also noted to be understaffed compared to its U.S. counterpart, the SEC. In particular, only 200 investigators are hired specifically to deal with security investigations, compared to the SEC’s full strength of 1,200 investigators¹⁰³. Another report also notes that the deployment of CSRC personnel to areas with developed markets within China is grossly inadequate. In cities like Shenzhen, Zhejiang, Beijing and Jiangsu, local securities inspection offices are staffed with only between 10 to 19 individuals, evidently disproportionate to the amount of workload they have to shoulder¹⁰⁴.

ii. *The Shenzhen Stock Exchange and The Shanghai Stock Exchange*

The 2005 revision of the Securities Law granted upon both Chinese exchanges the power to accept listings¹⁰⁵, temporary suspend trading, as well as to delist companies¹⁰⁶. Both exchanges were also designated as self-regulatory

¹⁰⁰ CSRC, “Laws & Regulations on Securities and Futures” CSRC, online: CSRC http://www.csrc.gov.cn/pub/csrc_en/laws

¹⁰¹ *Supra* Note 98

¹⁰² *Supra* Note 71 at Page 13

¹⁰³ Shen Hu et al, “Watchdogs Growl over Concept-Stock Probes” *Caixin Online* (11 March 2012), online: Caixin Online http://english.caixin.com/2012-06-11/100399298_1.html

¹⁰⁴ Lu Yuan, Wang Ziwu & Zheng Fe, “Can Anyone Save Stock Market Supervision?” *Caixin Online* (19 March 2012), online: Caixin Online <http://english.caixin.com/2012-03-19/100369865.html>

¹⁰⁵ *Supra* Note 55 at Article 56

¹⁰⁶ *Ibid* at Article 102

organizations (“SROs”), providing them with a high degree of regulatory authority over the securities industry.

Aside from the formal powers vested unto them by statute, both exchanges also have regulatory tools at their disposal. These include oral warnings, letters of oversight and supervision, notices of criticisms as well as public criticisms and declarations of unsuitability¹⁰⁷. These public shaming tools have been noted by some commentators as the functional portion of a decentralized enforcement regime. The effects of these tools are also notably far-reaching in the Chinese context – research has shown that investors in Chinese markets take very much into consideration criticisms allayed at issuers by the exchanges¹⁰⁸. To most investors, news of investigation by the stock exchange (commonly equated as an arm of the government) carries with it an implication that a company has fallen out of political favour. Investors are thus particularly sensitive to these public announcements since one single announcement could possibly jeopardize a corporation’s future profitability¹⁰⁹.

In fact, these public-shaming tools that the exchanges wield have been credited as contributing to an environment that encourages disclosure of material information. On one level, a public reprimand by the exchange threatens the availability of near-term financing options such as private placements¹¹⁰, bonus issuance of shares¹¹¹, as well as the ability to obtain bank loans or issue commercial paper¹¹². Also, public sanctions have reputational repercussions that may be detrimental to an individual’s career prospects as well as a company’s financial performance.

¹⁰⁷ *Supra* Note 88 at Page 947 – 948

¹⁰⁸ *Ibid* at Page 964

¹⁰⁹ *Ibid*

¹¹⁰ *Supra* Note 55 at Article 39

¹¹¹ Shouci gongkai faxing gupiao bing shangshi guanli banfa [Measures for the Administration of Initial Public Offering and Listing of Stocks] (promulgated by the CSRC, 17 May 2006, effective 18 May 2006), Article 23, translated in LawInfoChina, online: <http://www.lawinfochina.com/display.aspx?lib=law&id=5167&CGid=>

¹¹² *Supra* Note 88 at Page 970

D. The Judicial System

A final non-negotiable feature of securities regulation today would be that of a well-functioning judicial system. While the courts have been criticized by some as being too far removed from the market to carry out any regulatory function, this author is of the opinion that the courts assume an indispensable role in securities regulation. In cases of securities fraud, courts must be able to produce decisions without delay, or act to freeze an insider's assets pending the outcome of a case, so as not to prejudice the shareholders and the investing public. Additionally, the courts also shoulder the responsibility of developing jurisprudence in the area of securities regulation and fraudulent activity¹¹³.

Unfortunately, Chinese judges have not been known to give reasoned opinions that would stimulate the development of jurisprudence¹¹⁴. They have further been criticized by commentators as being lowly educated and vulnerable to corruption and political pressure – due in part to the fact that most judges owe their positions to local political authorities¹¹⁵. Perhaps most damaging is evidence of how the Chinese courts have proven to be unreliable and reluctant to preside over litigation involving large, state-connected enterprises¹¹⁶. To date, the only cases which the People's courts have found worthy of their attention are 'real crimes' such as insider trading involving bribery and corruption¹¹⁷.

E. Analysis: A High Degree of Functional Convergence?

Given the degree of maturity of some Chinese institutions, a compelling case can be made that China is indeed functionally converging. For one, the Chinese regulators do not differ very much from their corollaries in terms of the role they play. The CSRC – in particular

¹¹³ Donald C. Clarke, "Law Without Order in Chinese Corporate Governance Institutions" (2010) 30 Nw J Int'l L & Bus 131 at Page 182

¹¹⁴ *Ibid*

¹¹⁵ Donald C. Clarke, "Power and Politics in the Chinese Court System: The Enforcement of Civil Judgments" (1996) 10 Colum J Asian L 1 at Page 41 – 49

¹¹⁶ Katharina Pistor & Chenggang Xu, "Governing Stock Markets in Transition Economies: Lessons from China" (2005) 7 Am L & Econ Rev 184 at Page 193

¹¹⁷ Hongming Cheng, "Insider Trading in China: The Case for the Chinese Securities Regulatory Commission" (2008) 15:2 Journal of Financial Crime 165 at Page 173

– has been observed to participate in international standard setting, which perhaps signals a willingness to conform or an intention to shape international practices¹¹⁸. While China’s reputational intermediaries are not yet fully capable of equalizing the informational asymmetry for investors, reforms are currently underway to integrate them more tightly into the regulatory landscape. As the Chinese market slowly matures, we can expect to witness in the near future a complete transition into a full-fledged disclosure based regime.

Empirical evidence seems to suggest likewise as well. According to the IMF Report, the China has satisfactorily implemented the internationally recognized Principles of Securities regulation as promulgated by the IOSCO¹¹⁹. In particular, the Chinese regulatory system has been observed to have fully implemented 18 IOSCO principles, broadly implemented 8 IOSCO principles, and partially implemented 3 IOSCO principles. This result is comparable to many other established and mature capital markets such the UK and the U.S. (*See Appendix*). Equally noteworthy is the fact that China has adopted basic accounting standards similar to the IFRS, a standard that has been adopted in over 100 countries worldwide¹²⁰. According to reports, China also is well in the process of converging with the International Standards of Auditing (“IAS”), which it has pledged to adopt since 2005¹²¹.

V. OBSTACLES TO FURTHER CONVERGENCE IN CHINA?

Given the above, it seems almost natural to assume that China will (inadvertently or otherwise) continue on the path to convergence with regards to securities regulation. This author would however hazard against making such an assumption without looking at the possible factors motivating or discouraging China from attempting to further converge.

¹¹⁸ *Supra* Note 98

¹¹⁹ *Supra* Note 71

¹²⁰ Jimmy Chung, “New Standards to Lift Investor Confidence” *South China Morning Post* (190 August 2012), online: South China Morning Post <http://www.scmp.com/article/546542/new-standards-lift-investor-confidence>

¹²¹ “China Pledges Support for ISA Convergence” *The Accountant* (11 November 2010), online: The Accountant <http://www.theaccountant-online.com/news/china-pledges-support-for-isa-convergence>

A. Possible Motivations For Further Convergence in China

i. *The Need to Build Investor Confidence*

A key motivation that would spur China into further converging is the promise of increasing the confidence of the investing public in China's capital market¹²². Traditionally, the consolidation of rules, the levelling of playing fields and the uniform implementation of safeguards have been found to contribute towards building investor confidence¹²³. It is indeed not difficult to see why investors will feel more confident about moving their money about in an environment where capital markets stakeholders speak in a uniform language¹²⁴. In fact, the lack of laws that are comparable across jurisdictions have traditionally deterred investors from participating in the Chinese markets. Foreign investors only hold about 1.5% of the Chinese stock market, which is currently valued at \$3.2 trillion¹²⁵. This is in spite of the Chinese government's attempts at liberalizing the market – the most recent being the increase in the quota of shares that Qualified Foreign Institutional Investors can hold, up from USD 30 billion to USD 80 billion¹²⁶.

ii. *The Internationalization of the RMB*

Another reason why the Chinese may seek to functionally converge would be to further the internationalization of the Renminbi ("RMB"). RMB internationalization has been one of the Chinese government's priorities following the global financial crisis in 2008, as it was seen as a way to mitigate China's over-

¹²² IFRS, "China Affirms Commitment to Converge with IFRSs" *IFRS* (15 February 2006), online: IFRS <http://www.ifrs.org/News/Announcements-and-Speeches/Pages/China-affirms-commitment-to-converge-with-IFRSs.aspx>

¹²³ Bob Gasser, "Six Steps to Restore Investor Confidence" *Financial Times* (24 January 2013), online: Financial Times <http://www.ft.com/intl/cms/s/0/4e4620de-64b0-11e2-ac53-00144feab49a.html#axzz2OQonrE14>

¹²⁴ *Supra* Note 24

¹²⁵ Neil Gough, "China aims to open up investment" *The Boston Globe* (15 January 2013), online: The Boston Globe <http://www.bostonglobe.com/business/2013/01/15/china-allow-foreign-investment-increase/xuwgEo184OKX5KhgddxnKI/story.html>

¹²⁶ *Ibid*

dependency on the U.S. dollar¹²⁷. Beyond using the RMB defensively, China's central bank (People's Bank of China) has openly announced plans in 2010¹²⁸ to (1) drive a higher demand for RMB in the market, (2) have most of the world's trade settled in RMB and (3) have central banks hold a substantial part of their reserves in RMB¹²⁹. To that end, many overseas banks outside China have recently been authorized as offshore RMB centres. The issuance of dim-sum bonds – RMB denominated papers issued in Hong Kong – is also fast gathering pace. To date, numerous liquidity swap arrangements have also been signed with many countries¹³⁰. In the latest series of developments, a new system to settle cross-border RMB transactions and boost the convertibility of the currency is currently being set up in Beijing. Reports indicate that this new institutional feature will be ready by 2014¹³¹.

The volatility present in the Chinese stock markets however stands as an obstacle to the promotion of the RMB as the international currency. This hardly comes as a surprise since the state of financial market development in a home country is a crucial determinant of a currency's international status¹³². Accordingly, greater alignment with the global regulatory regime through further convergence may put China in a better position to introduce its currency as the world's reserve currency.

B. Factors Militating Against Further Convergence in China

¹²⁷ PBOC, "Further Reform the RMB Exchange Rate Regime and Enhance the RMB Exchange Rate Flexibility" *PBOC* (19 June 2010), online: PBOC <http://www.pbc.gov.cn/publish/english/955/2010/20100622144059351137121/20100622144059351137121.html>

¹²⁸ *Ibid*

¹²⁹ "China: Internationalization of the Renminbi (RMB)" *J.P.Morgan*, online: J.P.Morgan <http://www.jpmorgan.com/tss/General/China_Internationalization_of_RMB/1288220029583>

¹³⁰ David Pilling, "The Renminbi won't replace the dollar anytime soon" *Financial Times* (5 September 2012), online: Financial Times <http://www.ft.com/intl/cms/s/0/798813bc-f681-11e1-9dff-00144feabdc0.html#axzz2NzyKQ0Vy>

¹³¹ Kenneth Rapoza, "China Yuan Inches Closer to Global Currency" *Forbes* (4 December 2012), online: Forbes <http://www.forbes.com/sites/kenrapoza/2012/04/12/china-yuan-inches-closer-to-global-currency>

¹³² Eswar Prasad & Lei Ye, "Will the Renminbi Rule?" *IMF* (March 2012), online: IMF <<http://www.imf.org/external/pubs/ft/fandd/2012/03/prasad.htm>>

i. Possible Resistance from the Private Sector

Further convergence in regulation of securities may conceivably face opposition from many factions in the private sector. Many influential bureaucrats who carry with them a ‘controlled-economy’ mentality fear losing economic rent as a result of convergence¹³³. Chinese securities companies and investment banks may also be reluctant to further converge because their income is heavily dependent on the volume of listings they are able to push for. It would be relevant here to point out that the CSRC’s recent push for increased quality of Initial Public Offers (“IPOs”) has negatively impacted these securities companies and banks. Since late last year, the Chinese regulator has ordered several investment banks to review the financial statements of nearly 900 companies seeking to list on the domestic exchanges, which had contributed to a freeze on new listings. Due to this dearth of IPO activity in China, investment banks are currently in the midst of handing out their biggest layoffs and bonus cuts in Chinese history¹³⁴. Chinese securities companies are also no better off, given that up to 84% of their estimated sponsor and underwriting fees come from IPOs¹³⁵.

The investing public may also not be ready for further convergence. Retail investors especially may not be able to grasp the concept of ‘risk’ in disclosures. In fact, some commentators have noted that many retail investors tend to read ‘risk’ as disclaimers rather than warnings¹³⁶. Therefore, even if the reputational intermediaries are able to get their act together, there is no guarantee that the information asymmetry problem may be resolved.

ii. Possible Resistance from the Government

¹³³ *Supra* Note 20 at Page 118

¹³⁴ Elzio Barreto & Ken Wang, “China Investment Banks Hunker Down as Regulator Shuts IPO Tap” *Reuters* (23 January 2013), online: *Reuters* <http://www.reuters.com/article/2013/01/23/us-china-ipos-fees-idUSBRE90M1FQ20130123>

¹³⁵ *Ibid*

¹³⁶ Jenny Hamilton and Lorna E Gillies, “The Impact of E-Commerce Developments on Consumer Welfare-- Information Disclosure Regimes” (2003) 11:4 *Journal of Financial Regulation and Compliance* 329 at Page 336

While the Chinese government has yet to publicly oppose convergence with international regulatory trends, there may be reasons to suggest why they may not actually intend to converge. Firstly, it is hard for the Chinese government to accept the existence of an institutional framework independent from the state¹³⁷. This is especially relevant since further convergence entails a gradual dissociation from merit review, which has for years allowed the government to enjoy broad, discretionary powers over the judgment of securities offerings¹³⁸. Also, the Chinese government has been observed to fiercely defend itself against allegations of state capitalism made by other national regulatory bodies. This defensive practice seems to discourage any possibility of true international cooperation, which is a crucial element in any convergence approach. Lastly, removing from the government the power to conduct merit review may also affect the pocketbooks of certain privileged individuals within government ranks¹³⁹. This in itself is perhaps likely to trigger very strong resistance against attempts to further converge.

iii. Alternatives to Traditional Fundraising

It bears reminder that the fundraising through an IPO on an exchange is not the only means for companies today to access capital. Accordingly, Chinese issuers can always look towards less regulated channels of fundraising should they find difficulty in complying with thickets of securities regulation. China is presently giving greater access to the Over-the-Counter (“OTC”) market, which focuses on facilitating private placements for smaller companies. The potential number of participants in this market can be incalculably large – new rules published by China’s National Equities Exchange and Quotations Co. Ltd now allow individuals, trust funds, and wealth management funds to invest in OTC shares¹⁴⁰. Also, many listed companies have in recent times turned to the bond market to

¹³⁷ *Supra* Note 113 at Page 136

¹³⁸ *Supra* Note 50 at Page 260

¹³⁹ *Supra* Note 64

¹⁴⁰ Pete Sweeney, “China Widens Investor Access to Over-the-Counter Market” *Reuters* (18 February 2013), online: Reuters <http://www.reuters.com/article/2013/02/18/china-markets-derivatives-idUSL4N0BIOHW20130218>

raise capital. Corporate bonds are likely to soon emerge as a most favourite means of raising capital seeing in lieu of the CSRC's plan to shorten the time taken for reviewing bond issuance applications to one month¹⁴¹. Given the presence of these alternatives (and others still in the pipeline), there would be indeed little motivation for China to further converge.

So what does this all mean? Clearly, the Chinese regulatory framework as a whole seems fairly predisposed to functionally converge and would in fact benefit from further convergence. The irony however is that opposition to such an endeavour may be voiced by various actors within China because while the system as a whole may stand to gain, individuals within the public and private sector may not. In any case, it should also be noted that alternatives to traditional fundraising may act as to reduce any impetus to converge. Altogether, this author finds it difficult to allege with impunity that further convergence will materialize in China within the near future.

VI. CONCLUDING THOUGHTS

This author recognizes that there is good in internationalizing securities regulation – unlike the debate on human rights or other sensitive aspects of the law, there is hardly any room to argue for relativity in this sphere. Unfortunately, the reality is that competition, centralization and harmonization are unlikely to eventuate as the approach to convergence in the near future. As such, this author proposes that we are perhaps better off looking to first converge at a functional level – no less through the building and developing of institutions identified as being crucial to the development of securities regulation. Accordingly, it is this author's opinion that an intermediate step of 'functional convergence' will go some way in preparing us for full scale convergence in securities regulation.

While China has been observed to have functionally converged to some extent, the analysis above seems to suggest that further convergence may not take root in China. Aside from the

¹⁴¹ Yeh Wen-yi, "Chinese Firms Turn to Corporate Bonds to Raise Capital" *Want China Times* (27 November 2011), online: *Want China Times* <http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20111127000031&cid=1102>

possible resistance from private and public entities, there may also perhaps be little motivation to further converge given the presence of alternatives to fundraising through IPOs.

Beyond this, it is important to recognize that that further convergence may perhaps have no measurable effect on the Chinese regulatory framework. It bears reminder that convergence does not guarantee any success in the area of enforcement, which has been identified by many as the main issue plaguing securities regulation in China today. As pointed out in the IMF Report, the enforcement of laws and regulations in China are less than adequate – stymied in part by the institutional investor’s market discipline and in part by the inadequacy of the courts¹⁴². There are also notable inefficiencies on the part of the stock exchange – abrupt policy changes and scarcity of information have been responsible for the limited enforcement of disclosure regulations¹⁴³. The enforcement problem is further exacerbated in the Chinese context because of the geographical segmentation of key markets, as well as the significant shortage of relevant expertise¹⁴⁴. It is therefore difficult to see how the convergence project could solve the enforcement problem – and perhaps more importantly – how the benefits of convergence can even materialize without solving the enforcement problem.

¹⁴² *Supra* Note 71 at Page 9

¹⁴³ Cai Wei, “State Control and Weak Stock Market in China” (2010) 17:2 *Journal of Financial Crime* 179

¹⁴⁴ R. Mookerjee & Q. Yu, "An empirical analysis of the equity markets in China" (1999) 8:1 *Review of Financial Economics* 41 at Page 57

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APPENDIX A

NO.	ISOCO PRINCIPLE	PRCⁱ	UKⁱⁱ	U.S.ⁱⁱⁱ
1.	The responsibilities of the regulator should be clear and objectively stated	BI	BI	PI
2.	The regulator should be operationally independent and accountable in the exercise of its functions and powers	PI	BI	BI
3.	The regulator should have adequate powers, proper resources and capacity to perform its functions and exercise its powers	PI	BI	PI
4.	The regulator should adopt clear and consistent regulatory processes	FI	FI	FI
5.	The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality	FI	FI	FI
6.	The regulator should have or contribute to a process to monitor, mitigate and manage systemic risk	FI	-	FI
7.	The regulator should have or contribute to a process to review the perimeter of regulation regularly	BI	FI	BI
8.	The regulator should seek to ensure that conflicts of interests and misalignment of incentives are avoided	FI	FI	FI
9.	SROs should be subject to oversight of the regulator and observe standards of fairness and confidentiality	BI	FI	FI
10.	The regulator should have comprehensive inspection, investigation and surveillance powers	BI	BI	PI
11.	The regulators should have comprehensive enforcement powers	FI	FI	FI
12.	The regulatory system should ensure an effective and credible use of powers and an effective compliance program	FI	FI	FI
13.	The regulator should have authority to share both public and non-public information with domestic and foreign counterparts	FI	FI	FI
14.	Regulators should establish information sharing mechanisms	BI	FI	BI
15.	The regulatory system should allow for assistance to be provided to foreign regulators who need to make enquiries in their discharge of functions and exercise of powers	FI	FI	FI
16.	There should be full, accurate and timely disclosure of financial results, risk and other information which is material to investor's decisions	PI	FI	FI

17.	Holders of securities in a company should be treated in a fair and equitable manner	BI	BI	PI
18.	Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality	FI	FI	BI
19.	Auditors should be subject to adequate levels of oversight	FI	FI	FI
20.	Auditors should be independent of the issuing entity they audit	FI	FI	FI
21.	Audit standards should be of a high and internationally acceptable quality	FI	BI	BI
22.	Credit rating agencies should be subject to adequate levels of oversight	BI	BI	PI
23.	Other entities that offer investors analytical or evaluative services should be subject to oversight	BI	BI	BI
24.	The regulatory system should set high standards for those who wish to enter the market or operate in a CIS	FI	BI	FI
25.	The regulatory systems should provide rules governing the legal form and structure of CIS and segregation and protection of client assets	FI	FI	BI
26.	Regulation should require disclosure necessary to evaluate the suitability of a CIS for a particular investor and the value of the investor's interest in the scheme	FI	FI	FI
27.	Regulation should ensure that there is a proper and disclosed basis for asset valuation and pricing and redemption of units in a CIS	FI	BI	FI
28.	Regulation should require that hedge funds and managers are subject to appropriate oversight	FI	FI	BI
29.	Regulation should provide for minimum entry standards for market intermediaries	FI	FI	FI

Source: FSAP PRC Detailed Assessment of Observance – IOSCO Objectives and Principles for Securities Regulation

ⁱ IMF, *People's Republic of China: Detailed Assessment Report: IOSCO Objectives and Principles of Securities Regulation* (April 2012) IMF Country Report No. 12/80, online: <http://www.imf.org/external/pubs/ft/scr/2012/cr1280.pdf>

ⁱⁱ IMF, *United Kingdom: Detailed Assessment Report: IOSCO Objectives and Principles of Securities Regulation* (July 2012) IMF Country Report No. 11/8232, online: <http://www.imf.org/external/pubs/ft/scr/2011/cr11232.pdf>

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