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The Dragon and the Eagle: Reforming China's Securities IPO Laws in the U.S. Model, Pros and Cons

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THE DRAGON AND THE EAGLE: REFORMING CHINA'S SECURITIES IPO LAWS IN THE U.S. MODEL, PROS AND CONS

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ABSTRACT

China is about to undergo a major reform of its securities offering and listing processes. Since the inception of China's securities market in the early 1990s, the government has exercised tight control to determine which companies will be allowed to engage in initial public offerings and become listed on a national exchange. The system has led to both corruption and favoritism and has blocked numerable companies from access to capital markets. With the ascension in 2013 of Xi Jinping and Li Keqiang as the heads of the Chinese Communist Party and Premier, the government adopted reform of the market process as a major goal within its economic program. Under the proposal, the China Securities Regulatory Commission (CSRC) will no longer have major power over which companies can go public, what their offering prices will be or whether or where the issuer's shares will be listed. According to the proposed bill, the CSRC's role under the proposed reform has been substantially reduced. The authority to determine whether prospectus disclosure requirements have been met will principally move from the CSRC to the stock exchanges, which will also determine listing applications. The reform process, announced in November 2013, has been delayed as a result of China's stock market crisis in July 2015. It now appears that the reform measures are back on track. Yet, despite a generally favorable attitude towards the reform, significant concerns exist among Chinese government officials and academics as to whether the open registration system will lead to a more efficient market. Unlike the United States, the Chinese securities markets are dominated by individual shareholders, many of whom are relatively inexperienced. Nor does China have the extensive infrastructure of experienced and trustworthy broker-dealers, investment advisors, and enforcement tools that exist in the

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U.S. Other than the principal reform proposal there are few specific regulations currently adopted to address concerns about market access and investor protection. This article examines the background leading to the reform proposal and analyzes whether and to what extent certain measures in the United States might be appropriate for adoption when the open registration system becomes reality.

INTRODUCTION: A MOVE TOWARDS REFORM

The Chinese government has historically exercised tight control over the securities market through the China Securities Regulatory Commission ("CSRC"),1 China's equivalent to the U.S. Securities and Exchange Commission. The principal control has been in determining what companies will be permitted to engage in public offerings. Whether a company can engage in a public offering involves more than meeting the formal application and disclosure requirements listed in the statutes and rules. In addition, a "stock offering review committee" appointed by the CSRC makes an independent judgment as to whether the proposed offering can go forward. Such a screening system may help unsophisticated retail investors, who constitute the mainstream of Chinese investors, to encounter better investment targets, but it possesses several serious drawbacks:

First, the entire system is biased against smaller non-state-owned companies. The fiscal conditions for a company to be allowed to issue shares publicly are high, and there is a demanding profit requirement for three consecutive years.[2] Given the institutional favoritism toward state owned enterprises (the securities market was originally established with a clear goal to save financially distressed and capital thirsty state owned enterprise (SOEs)), it is much more difficult for smaller non-state-owned companies to have access to the market, especially start-ups and new technology companies. Not surprisingly, almost all of the Chinese internet companies, none of which is a SOE, have chosen to be listed outside China. Currently, hundreds of companies are waiting in the queue for the CSRC to review their submitted IPO application files.

Second, the system lacks transparency. Inasmuch as companies being

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1 The agency has an English version of its website. *About CSRC*, CHINA SECURITIES REGULATORY COMMISSION, http://www.csrc.gov.cn/pub/csrc_en/ (last visited Apr. 1, 2018).

2 Measures for the Administration of Initial Public Offering and Listing of Stocks Administrative (promulgated by the China Sec. Reg. Comm., May 17, 2006, effective May 18, 2006, in accordance with the Decision of the China Sec. Reg. on Amending the Measures for the Administration of Initial Public Offering and Listing of Stocks, Dec.30, 2015), specifies that an issuer should have a continuous *profit* record for the latest three accounting years with the aggregate profits exceeding 30 million yuan; the accumulative cash flow deriving from business operations in the latest three accounting years should exceed 50 million yuan or the aggregate business revenues in the latest three accounting years should exceed 300 million Yuan; stock capital before the public offering should be no less than 30 million Yuan; the value of intangible assets must not exceed 20% of the net assets at the end of the most recent accounting year; no unrecovered losses at the end of the most recent accounting year(art. 26). An English version is *available at*http://en.pkulaw.cn/display.aspx?cgid=262012&lib=law(last visited Apr. 1, 2018).

reviewed have met all the explicit IPO requirements, there are no clear standards for the decisions made by the offering review committee. Vital decisions are left to the subjective judgments of the committee members. Rejection decisions cannot be legally challenged. The securities law provides no remedy to the rejected companies which also have no official operative guidance on how to enhance their chances if they intend to submit future applications.

Third, the offering control system becomes even more rigid and paternalistic after IPOs are allowed. The CSRC imposes its own determination upon the offering price, often demanding a lower-than-market figure based on average industry price/earnings ratios.

Fourth, the CSRC approval process is both volatile and unpredictable. As the CSRC retains the unconstrained power to control the number of firms and shares to be permitted in the primary market, it is never certain how the power will be exerted. Whenever the market turns bearish there are discussions and predictions among securities market professionals and investors as to whether restrictive actions will be taken. Administrative suspensions of IPO offerings have taken place nine times since 1994, some of which extended more than one year, seriously affecting the capacities of firms planning to raise capital in the market.

In short, the CSRC controlled IPO system has led to inequalities, inefficiency, and instabilities in the Chinese securities system. The possibility of reforming the system has been a consistent topic in the Chinese law academia. Unfortunately, the discussions produced loud thunders but small raindrops until 2013 when Xi Jinping and Li Keqiang took over the leadership of the country as General Secretary of the Communist Party/Chairman of the State and the Premier, respectively. Xi was educated at Beijing's prestigious Tsinghua University, and Li has both a law degree and doctor's degree in Economics from equally prestigious Peking University.[3] Given the unprecedented higher education backgrounds of these top leaders, it was not surprising that shortly after their ascension to leadership the government announced proposals for a major economic reform.

In November 2013, *The Decision on Major Issues Concerning Comprehensively Deepening Reforms*[4] was passed by the Third Plenary

3 Premier Li has consistently revealed his belief in a smaller state and letting the market do its job. *See,e.g.,*. Jamil Anderlini, *China's Premier Li Keqiang Targets Smaller Role for State*, FINANCIAL TIMES (Mar.17, 2013), http://www.ft.com/cms/s/0/77c70e1a-8ed0-11e2-be3a-00144feabdc0.html.

4 *The Decision on Major Issues Concerning Comprehensively Deepening Reforms in Brief*, CHINA DAILY (Nov. 16, 2013), http://www.china.org.cn/china/third_plenary_session/2013-

Session of the 18th Central Committee of the Communist Party of China. This is intended as the fundamental economic agenda of the party-state for the next five years. The Decision document included statements of economic system reform such as "letting the market be decisive in the resources allocation" and "incompetence in the market system, excessive state intervention and inadequacy in regulation should be curbed."[5] Most significantly, the administrative control of initial public offerings became a target of the reform. A policy goal quickly developed to eliminate CSRC control of market access and "push a registration system reform for stock offering," as described in the Decision.[6]

The resolution of the ruling party left open the technical details of the so-called registration system. The initial common perception of what a "registration system" would look like was a system in which a firm that has met the substantive registration requirements would be qualified to go forward with an IPO without further CSRC or other governmental review, similar to the U.S. registration system. However, this simplistic picture does not exactly reflect the practice in the U.S., given the application of state Blue Sky laws. Moreover, any legal transplant in such a crucial area could be impractical, given the markedly different cultural, experiential, and financial distinctions between China and the United States.

The change from agency approval to a pure registration system was expected to be implemented as early as 2015. However, reform is on temporary hold as a result of China's stock market crisis in July2015, which saw a substantial drop in share prices, suspensions of trading, and a freeze on new offerings.[7] Attention will again turn to reform efforts when the government concludes that the Chinese markets have regained stability. On December 27, 2015, the Standing Committee of National People's Congress formally authorized the State Council to adjust the application of relevant provisions in the Securities Law as it carries out the reform concerning the stock issuance registration system.[8] The authorization became valid on March 1, 2016 and was renewed on Feb. 24, 2018 for another two years

11/16/content_30620736.htm. This is an authorized government portal site, published under the auspices of the State Council Information Office and the China International Publishing Group.

5 *Id.* (translation provided by authors).

6 *Id.*

7 KyoungwhaKwi and Fox Hu, *China Stock Sellers Frozen Out of 71% of Market*, BLOOMBERG (July 8, 2015, 3:34 AM), http://www.bloomberg.com/news/articles/2015-07-08/china-trade-halts-hit-2-2-trillion-as-state-intervention-fails.

8 Decision of the Standing Committee of the National People's Congress on Authorizing the State Council to Adjust the Relevant Applicable Provisions of the Securities Law of the People's Republic of China in the Implementation of Stock Issuance Registration System Reform (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 27, 2015, effective Mar. 1, 2016),*available at* http://en.pkulaw.cn/display.aspx?cgid=261784&lib=law.

before the original two terms expired. Thus, the final overhaul of the securities law may be postponed for as much as two years within which the State Council has the flexibility to implement reform measures. This allows additional time for deliberate thought for how the abstract goal of an open registration system may be achieved within the Chinese market structure.[9]

The primary element of reform, an open registration system, necessarily raises questions as to company eligibilities, stock exchange listings, and investor protections. Inasmuch as the expected registration system is analogous to that in the U.S., we will explore whether and to what extent reforms should be adopted based upon the U.S. experience. This article compares and contrasts Chinese and U.S. securities laws in several major respects and offers recommendations in light of China's particular circumstances and goals.

Part I of this article describes the historical development of China's stock exchanges, including the authority of the CSRC and its exercise of powers. Part II discusses the potential market reforms being considered. Part III discusses concerns and potential policy issues raised by the proposed reforms and sets forth recommendations for measures to be implemented prior to or concurrent with the reform effort.

I. THE HISTORICAL DEVELOPMENT OF THE CHINESE SECURITIES EXCHANGES

1. The Death and Rebirth of Securities Markets in P.R. China

Before 1949, when the Communist Party had not yet taken over the country, there were flourishing securities markets in China, especially in Shanghai. But after the People's Liberation Army marched into the cities, all forms of capital markets and related financial activities were eliminated as obvious evil symbols of capitalism. On June 10, 1949, police stormed into the Shanghai Securities Exchange and put thousands of people in the building into custody, ending the exchanges.[10]The national economy became one system in which every aspect was planned and directed by the

9*SeeXi Jinping's Failed Promises Dim Hopes for Economic Change in 2nd Term*,N.Y. TIMES (Mar. 4, 2017), https://www.nytimes.com/2017/03/04/world/asia/china-xi-jinping-economic-reform.html("Wu Jinghan, one of China's most promising economists, said at a recent meeting in Beijing that 'the direction of reform laid out in these documents is clear, and the measures are right, but the problem has been implementation.'").

10 *Selected Issues of Culture and History in Shanghai* [shanghai wenshiziliaoxuanji], (Working Committee of Culture and History Materials of the Chinese People's Political Consultative Conference Shanghai Committee, Working Paper No. 60, 1988).

central government.

Following 1956, there was no entity with the name or essence of "company" (gongsi). The usual names of the institutions which had been enterprises were "factories" (chang), machine factory, clothes factory and so on. They were production units whose products would be allocated according to administrative orders. This was the so-called planned economy. The system was a failure and the Chinese economy, without market mechanism and business companies, suffered.

After the death of Mao Zedong in 1976 and the inception of the Reform Era in 1978, the Chinese government began to understand the significance of introducing market mechanisms and financial instruments. In 1981, state treasury bonds began to be issued, followed by bonds issued by state-owned enterprises. Shenzhen Bao'an Company pioneered in issuing shares to the general public in 1983,[11]although most firms continued to raise funds principally from their employees as they were not permitted to engage in financial market transactions.

As a result of the unfolding business development movements supported by the World Bank and reformists within the regime, stock exchanges for corporate shares developed. A number oflocal exchange markets were founded after 1985. Ironically, a catalyst for the direct push for economic reform and financial innovation was the Tiananmen Square episode in June 1989. As a result of the tragedy, international financial sanctions were imposed on China. Pro-reformists within the Party, such as former Premier (1998-2003) Zhu Rongji, then the governor of Shanghai, pushed for the formation of securities exchanges in pursuit of *dual goals*: first, to make more use of domestic funding to support economic development, and second to send a signal to the world that in spite of crackdowns, China would continue to pursue economic reform.[12]

China's two principal exchanges, the Shanghai and Shenzhen securities exchanges, began operation in December 1990. Ironically, the reason why the exchanges were named "securities exchanges" instead of "stock exchanges," as the case in New York, is that old communist cadres would be sensitive to the evil "stock" (gupiao) but they were not so familiar with the conception of "securities" (zhengquan).

11 SHENZHEN ECONOMIC SPECIAL ZONE [SHENZHENJINGJITEQUNIANPU] 48 (Tao Yitao, eds., 2015).

12 In the opening ceremony of Shanghai Securities Exchange on December 19, 1990, Governor Zhu Rongji stated "The fact that we establish Shanghai Securities Exchange shows China's determination for reform and opening up will not change". BREAKTHROUGH: THE DEVELOPING PATH OF THE CAPITAL MARKET IN CHINA 110 (Liu Hongru, eds., China Finance Publisher, 2008) , [tupo: zhongguozibenshichangfazhanzhilu]. Liu was the first chair of the CSRC.

2. *Government Control Over the Exchanges: From Local to Central*

At first, the Shanghai and Shenzhen securities exchanges were under the control of local governments. The Shanghai and Shenzhen municipal governments had the primary authority to run the exchanges. It was stipulated in the 1993 Interim Measures of the Administrationof Securities Exchange that "the exchanges are subject to the administration of the municipalities administration in whose jurisdiction they are established." Economic decentralization and regional competition, the so-called tournament model, depended upon the goals of incentivized local officials. This was regarded by many as the reason why the communist government could achieve tremendous economic success in such a large and diverse country.[13]

Another reason for the decentralization was that the central government was not sure such bourgeoisie concepts as securities exchanges and stock trading would be what they actually wanted. They treated the establishment of exchanges as an experiment. In January 1992 Deng Xiaoping, the de facto top leader of China in 1980s and early 1990s, stated during his famous Southern Tour (which decisively pushed China toward a road to market economy): "Securities, stock market, are these things good or not, hazardous or not, are they unique to the capitalism and unfit for socialism? It is OK to observe, but we should try with determination . . . If it turns out to be right, open up. If wrong, correct it, shut down."[14]By distancing the central government from the capitalism trial, Beijing could be shielded from any negative effects if the newly established markets turned out to be failures.

After nearly a decade of development, the Chinese government acknowledged the necessity of capital market platforms and centralized the control of exchanges in 1997 and 1998.[15] The Securities Law enacted in December 1998 (and effective in July 1999),formally legalized the dominant role of the securities regulator, the China Securities Regulatory Commission (CSRC).[16]Under the 1998 statute the CSRC was granted the authority to "carry out supervision and administration of the securities

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13 *See* Chenggang Xu and Juzhong Zhuang, *Why China Grew: the Role of Decentralization*,*in* EMERGING FROM COMMUNISM: LESSONS FROM RUSSIA, CHINA, AND EASTERN EUROPE (Peter Boone, et al. eds. ,Cambridge: MIT Press 1998).

14 SELECTED WORKS OF DENG XIAOPING VOL. 3, 373 (1993).

15 *See* STEPHEN GREEN, THE DEVELOPMENT OF CHINA'S STOCK MARKET, 1984-2002: EQUITY POLITICS AND MARKET INSTITUTIONS151-54 (David S. Goodman ed., RoutledgeCurzon2004).

16 The formation of Company law and securities law in China are described in JIANFU CHEN, CHINESE LAW: CONTEXT AND TRANSFORMATION 461-91(Martinus Nijhoff Publishers2008).

market" and to be responsible for investigating and punishing any violations of the securities laws. These roles remain the same under the amended Securities Act of 2005.[17]

3. Administrative Powers over IPOs

The Chinese government has retained a tight control of initial public offerings (IPOs), which controls cover almost every major aspect of the stock offering. First, the CSRC exercises the power of granting permission for initial and secondary public offering of securities.[18]No IPO or subsequent issuance can be made without CSRC approval.

Secondly, the government has always tried to shape, if not directly dictate, the issuing price for the securities offering, most often in a conservative manner. Due to these two factors, the securities markets have been under-supplied and share prices have not necessarily reflected company value and/or market demand. Both of these controls appear to be motivated by the government's determination to limit the risk of economic loss, and thus populist unease, among the investing public.

Third, there is an automatic link between an IPO and getting listed.[19]Even after the exchanges formally obtained the right to list and delist a security in the revision of the Securities Law in 2005, they possess no real power to deny a company from becoming listed. The CSRC's decision as to where a company will be listed is overriding. A firm that has obtained IPO permission will be listed on one of the two exchanges as determined by the CSRC. Neither the issuer nor the exchanges have a right to refuse. Nor are the exchanges able to accept a new company without a CSRC-approved IPO.

4. How Are the Candidates for IPOs Selected?

A. Initial Policy: Quotas Allocated to Provinces

In the earliest stage, the first decade after the rebirth of securities exchanges in China, the opportunities for public offering were viewed solely as privileges of state owned enterprises (SOEs). Each year, after the

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17 *See* Securities Law of the People's Republic of China, (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), arts. 178, 179 (China).

18 *Id.*at art. 23.

19 All secondary trading in shares of companies that engaged in a registered IPO must be done on a formal stock exchange. *Id.* atart. 39. Historically the CSRC has determined which exchange new companies will trade on, and since 2001 it has generally assigned larger SOEs and private companies to the Shanghai Exchange, and smaller companies to Shenzhen.

total amount of funds to be raised by various SOEs had been determined by the central government as a part of the macro-economic policy, the privileges were directly allocated to provincial governments and ministries, which could decide which companies under their jurisdictions would be the lucky ones to enter the capital market. [20]

It is not surprising that many of the selected SOEs were not in good financial shape. It was well understood and widely acknowledged that the primary goal of building the capital market in China was to save troubled and thirsty SOEs which could gain access to investor funds and in turn help support local economies through local employment and expenditures. The primacy of the financing needs for SOEs is a fact that the state has not attempted to hide. For example, in November 2015, the *Securities Time*, run by the People's Daily, commented that "[o]ver the past 20 years, the capital market...provided a lot of capital for the development of state-owned enterprises and state-owned banks."[21]

The CSRC's interest clearly diverged from those of the provincial governments since under-qualified listed companies caused regulatory concerns. The CSRC wanted to ensure better firms were recommended. Two prominent commentators found that the CSRC adjusted quotas based on the performance of listed companies previously endorsed by provinces and ministries.[22]

B. The CSRC Takes Control

i) Securities Companies as Sponsors

In January 2001, the Chinese government announced that the three-year campaign of saving SOEs from financial troubles had accomplished its goal.[23]In the same year, the CSRC initiated a new program to replace

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20 Fang Liufang, *China's Corporatization Experiment*,5 DUKE J.COMP. & INT'L L. 149, 169 (1995); *see also* Alex K. L. Lau, *A Study of Listing Applications in the People's Republic of China*,28 COMPANY LAWYER 90, 93(2007).

21 Cheng Dan, *Steady Progress and Push Forward the Reform and Development of Capital Market*, SECURITIES TIMES (Dec.12, 2015),http://epaper.stcn.com/paper/zqsb/html/2015-11/12/content_751698.htm.Securities Time is a professional securities newspaper run by People's Daily (the official paper of the China Communist Party)and one of the designated newspapers for disclosure documents of listed companies and financial institutions.

22 Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. L. & ECON. REV. 184 (2005).

23 "The chair of National Economy and Trade Commission announced that the three-year campaign of saving SOEs from financial troubles had accomplished its goal." *Sheng Huaren Announced That the Three-Year Goal of the State-Owned Enterprise Reforms Will Be Realized*, CHINA.COM, http://www.china.com.cn/chinese/2001/Jan/16356.htm (last visited Apr. 1, 2018).

provincial administrations with securities companies (underwriters) as the primary referees and endorsers of offering applicants. In March 2001, the Securities Association of China formally notified securities companies to recommend offering applicants. This was named "channel institution." Based on their underwriting record in 2000, securities companies were given between two to nine so-called channels.[24]For each channel the underwriter was authorized to recommend one issuer. Only after the issuer completed the issuance process could the securities company reuse the channel for a new client.

The channel system lasted only two years and was replaced in 2003.[25]Under the new system, securities companies were explicitly entrusted as "sponsors" with the primary task of ensuring the quality of their sponsored issuers. This practice was borrowed from Hong Kong, whose sponsorship regime was adopted from the nominated advisors (Nomads) employed on the Alternative Investment Market (AIM) of the London Stock Exchange.[26]

For each public offering the issuer must hire a sponsor that is a securities company and two sponsor representatives who are natural persons. The sponsor's major role is tutoring and monitoring the issuer for the whole offering process and for at least one year after the public offering. [27]Normally the same securities company would provide both underwriter and sponsor services. Each sponsor representative is entitled to work for only one issuer until his client has been submitted to the Offering Review Committee. The sponsor and sponsor representatives are required to do extensive due diligence work and keep original records. If fraud is detected with the public offering and the sponsor is at fault, the CSRC would punish the sponsor and representatives, including rescinding the qualification of sponsorship and imposition of fines.[28]

24 Based on the allocations, 83 securities companies possessed 318 channels. Lin Jian, *Securities Association of China Noted That "83 Securities Companies Possessing 318 Channels" Ended*, SHANGHAI SECURITIES NEWS, Jan. 4, 2005.

25 The Interim Administrative Measures for the Stock Issuance and Listing Sponsorship System, (promulgated by the China Sec. Reg. Comm., Dec. 28, effective Feb. 1, 2004) (China). An informal English version is *available at* http://en.pkulaw.cn/display.aspx?cgid=50979&lib=law.

26 Hui Huang, *The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in Light of the Global Financial Crisis*, 41 HONG KONG L.J. 261, 264 (2011).

27 Administrative Measures for the Sponsorship Business of the Issuance and Listing of Securities (promulgated by the China Sec. Reg. Comm., Oct. 17, 2008, effective Dec. 1, 2008, rev'd May 2009) (China). An informal English version is *available at* http://en.pkulaw.cn/display.aspx?cgid=109468&lib=law.

28 Securities Law of the People's Republic of China, *supra* note 17, §192.

ii) The Offering Review Committee

In 1999, a formal Offering Review Committee was founded by the CSRC to vet and decide which companies could undertake an IPO. The establishment of this new organ was required by the Securities Law which came into effect in July 1999.[29]

The Offering Review Committee consists of commissioners from multiple ministry-level administrative organs and external experts including academics, lawyers, and accountants, each appointed for three-year terms. Initially the composition of the committee was kept secret, and after 2005, its membership was openly disclosed. Ironically, in 2005, during the period of confidentiality, a CRSC official was sentenced to thirteen years of prison for selling the secret names to potential issuers.[30]

When the CSRC determines that a candidate firm is to be reviewed, it selects the particular commissioners to serve in a review meeting. The commissioners have complete discretion to decide whether an applicant company will engage in an IPO and become an exchange-listed company. The specific vote from each commissioner is not disclosed, but it is recorded and kept by the CSRC.

In theory, the review committee's major criterion is the sustainability of profitability of the applicant company, which at a minimum under the Securities Act is a record of three consecutive profitable years. But in fact, the committee has wide, discretionary authority and there is no clear restraint on the approval process. The committee's decision is also not legally challengeable. Indeed, from one perspective it appears that the review committee may just be a handmaiden utilized by the CSRC. Given the committee's heavy workload and composition by members indebted to the CSRC for their appointment, it is appropriate to wonder whether the review committee is simply a subterfuge for decisions otherwise made or at least controlled by the CSRC.

iii) IPO Suspensions

Moreover, the CSRC has an even greater power, namely to determine whether there will be IPO offerings at all. On nine occasions the CSRC, acting no doubt in conformance with orders from central government

29 *Id.*

30 *Securities Regulatory Official Punished for Taking Bribes*, PEOPLE'S DAILY ONLINE (Dec. 10, 2015), http://en.people.cn/200512/10/eng20051210_227120.html. PEOPLE.CN is run by PEOPLE'S DAILY.

authorities, has suspended all IPOs applications.[31]A suspension means no meeting for the review of IPO applications is convened by the CSRC, even though quite a number of companies have submitted their applications. The suspension in 2013 lasted an entire year, setting a de facto ban on new issues in an effort to soothe investor concerns and to restore market confidence is a custom carried out by the CSRC. Exactly what standards the CSRC uses for such actions are not clear, but such suspensions have been common over the years as shown by the following table:

Suspensions of IPOs

Measured by the Shanghai Composite Index

NO.	FROM	TO	TRADING DAYS
1	1994/7/21	1994/12/7	98
2	1995/1/19	1995/6/9	96
3	1995/7/5	1996/1/3	128
4	2001/7/31	2001/11/2	64
5	2004/8/26	2005/1/21	101
6	2005/5/25	2006/6/2	249
7	2008/9/16	2009/7/10	198
8	2012/11/16	2014/1/7	274
9	2015/7/4	2015/11/23	95

Source: Compiled According to Public Data.[32]

iv) IPO Price Controls

Price control is also a major regulatory issue. The CSRC is extremely sensitive to the IPO price. The CSRC has been haunted by the concept of the "three highs": (i) high issuing price, (ii) high price/earnings ratio, and (iii) high percentage of over-raised funds. When higher-than-needed funds do not have a specific allocated usage, it is tempting for a company to divert the funds to non-productive uses, to affiliated companies, or to other improper measures.

31 See Suspensions of IPOs Table *infra* note 32.

32 *Counting 9 IPO Suspensions in History: How Will the Stock Market Go After All the Restarts?*, IFENG.COM (Nov. 6, 2015), http://finance.ifeng.com/a/20151106/14059186_0.shtml.

Price control is motivated in part by the fact that the majority of securities investors in China are retail investors, many of whom have little knowledge of finance. Chinese investors do not possess many options and Chinese listed companies seldom distribute dividends, thus making the securities market very speculative based on share price changes. The CSRC's tight control on the issuance opportunities constrains the supply of new stocks. The IPO thus constitutes a major opportunity for speculation. There has always been an "irrational fever," as the CSRC put it, when a new security is offered for sale.[33] In our opinions, the agency does not want the IPO price to be too high, for post-offering speculation may trap initial buyers who bought at a too high price during the initial days of the IPO. Investor anger is inevitably directed at the CSRC. Hence the CSRC has persistently taken measures to cap the IPO price.

The CSRC has attempted to augment its review of the IPO offering price with a price bid solicitation mechanism (xunjia) to help determine the proper valuation of an IPO offering. Institutional investors and wealthy natural persons are invited to bid for the IPO price in a two-phase procedure, the first one to decide a range, and the second to decide a specific price within that range. The 2006 Administration Measures of Securities Issuance and Underwriting[34] made this step an indispensable component for initial public offerings. After May 2012, the result of price bidding became a consultative one for the issuer. This flexibility actually allows the CSRC to press the company to employ a low price when the agency believes that a lower price would be beneficial in a weak primary market, as was the case in the IPO of China Molybdenum in September 2012.[35]

II. PROSPECTS FOR A REGISTRATION SYSTEM REFORM

Xi Jinping and Li Keqiang formally took over the leadership of P.R. China in March of 2013 when they became, respectively, the Chair and Premier of the country.[36] From the start it appeared that a somewhat new

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33 For example, the CSRC issued a notice urging securities companies to diligently prevent and curb speculation over new stocks in March 2012, saying "three highs" and new stock fever is an irrational phenomenon. Liu Wei, *Shenzhen Stock Exchange Again Warned of "Frivolous New Risk, Urges Brokers to do Their Duty*, SHANGHAI SECURITIES NEWS (May 9, 2012), http://westdollar.com/sbdm/finance/news/1345,20120509204605986_1.html.

34 Administration Measures of Securities Issuance and Underwriting (promulgated by the China Sec. Reg. Commission, effective Sept. 17, 2006), art.2 (China).

35 *See* Miao Yinzhi, *A Revisit of IPO Price Bid Solicitation Reform as Reflected by the China Molybdenum Case*, JURISPRUDENCE (FAXUE), 2013.

36 Chris Buckley, *China's New President Nods to Public Concerns, but Defends Power at Top*, N.Y. TIMES (Mar. 14, 2013), http://www.nytimes.com/2013/03/15/world/asia/chinas-new-leader-xi-

ideology was emerging in the relation of the government and economy. Market oriented reform seemed to be accelerating after nearly a decade of stagnation during the Hu Administration.

China's capital market is poised to undergo an overhaul with a commitment to eliminate the CSRC's veto power over proposed IPOs. The reasons are easy to find:[37] (i) the current system denies too many firms the access to capital, especially young, private companies; (ii) bureaucrats lack expert knowledge or adequate information to distinguish good companies from bad ones; and (iii) non-transparency in the approval process provides a fertile ground for corruption. As evidence of the latter, in November 2015, Yao Gang, vice chair of the CSRC, was arrested in an anti-corruption crackdown on the financial sector. The man was nicknamed "king of IPOs" for the area he had been in charge of for thirteen years.[38]

1. The Tentative Framework in the Draft of the New Securities Law

In a draft of the new Securities Law submitted to the Standing Committee of National People's Congress,[39] the prospective new registration system has the following major features:

(1) All IPO submissions will go directly to one of the two principal securities exchanges (Article 21);

(2) The stock exchange to which the IPO issuer has made application will review the draft prospectus to determine their "completeness, consistency and intelligibility" (Article 22);

(3) The requirement for a profit record for three consecutive years will be eliminated (Art.20);

jinping-takes-full-power.html.

37 Similar attacks have been imposed on the blue-sky laws in the U.S. *See, e.g.*, Rutheford B. Campbell Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L.553 (1985); Charles H. B. Braisted, *State Registration of Securities: An Anachronism No Longer Viable*, 78 WASH. U. L. Q. 401 (2000); C. T. Farson, *At What Cost Paternalism? A Call to State Legislatures to Reconsider the Propriety of Merit Review of Securities Offerings*,22 ARIZ. ST. L.J. 963, 986 (1990); Marianne M. Jennings, *The Efficacy of Merit Review of Common Stock Offerings: Do Regulators Know More than the Market?*,7 BYU J. PUB. L. 211, 218-222 (1993).

38 Liyan Chen, *China's 'King of IPOs' Is Arrested on Corruption Probe*, FORBES (Nov. 13, 2015, 2:43 PM), http://www.forbes.com/sites/liyanchen/2015/11/13/chinas-king-of-ipos-is-arrested-on-corruption-probe.

39 *The People's Republic of China Securities Law (Revised Draft)*, FINANCIAL SERVICE LAW (May 2, 2015),www.financialservicelaw.com.cn/article/default.asp?id=4777. Though there has never been an official version of the bill, which is typical of the non-transparency in the Chinese legislation, this informal copy is consistent with other copies obtained from various sources; its authenticity is confirmed by a number of leading scholars and officials of the CSRC.

(4) The CSRC will not review disclosures based on consistency, completeness or intelligibility;

(5) If the exchange intends to grant a registration for offering, the decision along with the examination opinions are to be sent to the CSRC, which has 10 days in which to object to the registration, otherwise the exchange's decision will become effective (Art.23);

(6) The CSRC may conduct site inspections of the applicants or entrust a securities intermediary institution to examine applicants if it deems such to be necessary (Art.24);

(7) A refusal to or interference with the above inspection or examination, or misrepresentation in the registration documents will lead to a cessation of registration (Art.26).

The principal reform from the current norm is that the CSRC will no longer be able to refuse or sit on the application of a company desiring an IPO. All companies that satisfy the IPO standards, as determined by the exchange to which they have applied, will be able to go forward with an IPO. However, there is a major caveat. The proposal allows the CSRC tento object to an exchange's decision (Article 23). At present, there are no standards developed on which to base such an objection. Although the proposal clearly intended to remove substantial authority from the CSRC, it did not eliminate entirely the CSRC's decision-making capacity. The absence of standards relative to the CSRC's power leaves the door open to potential favoritism, selectivity, and corruption that has been witnessed in the past. Moreover, until the process begins, one cannot be sure that the CSRC will not have strong influence over decisions made by the exchanges. If an open registration process is the goal, allowing a veto power to the CSRC without clear enumerated standards is a mistake.

Perhaps the positioning of one more safety valves made the legislators feel more relieved in considering the potentially tumultuous market. The dual check structure utilizing both the CSRC and stock exchanges was likely inspired by the dual filing regime in Hong Kong. In Hong Kong, the system is disclosure-based, with the applicant sending duplicate materials to the exchange and the regulator respectively.[40]But the Chinese and Hong Kong histories differ, and what will actually transpire when and if the regulations are adopted is uncertain.

40 BERRY HSU, ET AL., FINANCIAL MARKETS IN HONG KONG: LAW AND PRACTICE 175-76 (Oxford University Press, 2006).

Two facts create some concern: first, the exchanges in China Mainland are by no means autonomous; they are likely to be heavily influenced by the CSRC. Second, the exchanges would be very cautious to carry out the power to open wide their entrance gates. Thus, whether the open registration system will in fact lead to a major rise in IPOs is uncertain. By passing offering approval authority onto the exchanges, subject to CSRC review, it may be feared that the exchanges, under pressure or guidance from the ever-cautious CSRC, may adopt or impose standards that significantly limit the number or types of first-time issuers. If this scenario develops, the open registration system would be an unfortunate change in form, but not substance.

2. Reform Suspended: The 2015 Market Crash

The push for market reform, initiated in 2013, was significantly stalled by the market crash of 2015.In the summer of 2015 the Shanghai Composite index fell from 5178 to around 3000,[41]marking a catastrophic event in the history of China's securities market. Many, including government regulators, are still in a state of shock from the plummeting of over 30% in the Shanghai Index (and over 40% in Growth Enterprise Market) in the three weeks from June 15 to July 8. On July 8, 2015, half of the listed exchange stocks voluntary announced temporary suspensions in trading.[42] Though less catastrophic than the 2008 market crisis in the U.S., China's market crash was more significant in its impact upon both regulatory attitudes and Chinese speculative fever.

One factor that triggered the rapid market decline was margin trading, a relatively new phenomenon in China. Margin trading was first allowed by the CSRC in 2006.[43] However, broker firms were not allowed to carry out margin trading until March 2010 due to the 2008 financial crisis. Driven by lucrative opportunities offered by the bull market of the first half of 2015, many investors employed internet-based software (*e.g.*, Hundsun Management System (HOMS)), with implicit permission of securities companies, to build multiple layers of "virtual" securities trading accounts

41 Mark Thompson and Charles Riley, *World Markets Plunge as China Stocks Crash*, CNN MONEY (Aug. 24, 2015), http://money.cnn.com/2015/08/23/investing/world-stock-markets/index.html.

42 Sophia Yan, *Over Half of China's Stocks Have Stopped Trading*, CNN (July 8, 2015, 5:07 AM) http://money.cnn.com/2015/07/08/investing/china-stocks-suspended ("At least 1,430 of the 2,800 companies traded in China have elected to pull their shares as markets continue their crazy roller-coaster ride").

43 Notice of China Securities Regulatory Commission on Promulgating the Measures for the Administration of Pilot Securities Lending and Borrowing Business of Securities Companies (promulgated by the China Sec. Reg. Comm., June 20, 2006, effective Aug. 1, 2006) (China), *available at*http://en.pkulaw.cn/display.aspx?cgid=77564&lib=law.

within one formal account. Underground margin trading financed by sources other than securities companies boomed, and a leverage of 1:5 to 1:10 was common.

When the CSRC announced a curb on underground margin financing on June 12, 2015,[44] no one anticipated the tremendously adverse market consequences. On June 26, a CSRC spokesperson stated that the then ongoing market decline was simply a natural adjustment.[45] However, the decline began to resemble a furious bear. The forced unwinding of high ratio financing caused stock prices to drop and put even those with lower margin ratios in danger, resulting in many investors being forced to rush out of the market for fear of further declines.

The days abounded with unusual responses from the government. The CSRC tried various measures to restore the market, including a suspension of IPOs, a suspension of the statutory ban on short swing trading by insiders[46] who want to purchase stocks within six months of an earlier sale, and a six-monthban on the selling of any shares by insiders.

Eventually the market stabilized. But the pace and content of securities law reform was clearly influenced. The 2015 crisis caused a suspension in regulation reform. It was well understood that the state needs a bull market to support proposed changes to a system that will substantially increase the supply of stock offerings. It is only now, two years after the market crash, that confidence has revived in the market to the extent that significant reforms can be considered and adopted. However, the crash has affected the psyche and it remains to be seen whether a more open-ended market will in fact be achieved.[47]

III. REFORM CONCERNS AND RECOMMENDATIONS

There is, as might be expected, considerable concern that movement to a pure registration system will open the floodgates to innumerable public

44 *China Market Regulator Seeks to Cap Margin Trading, Short Selling*, REUTERS (June 12, 2015), https://www.reuters.com/article/china-margin-financing/update-1-china-market-regulator-seeks-to-cap-margin-trading-short-selling-idUSL3N0YY3H620150612.

45 *Press Conference June 26, 2015*, CSRC (June 26, 2015), http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwfbh/201506/t20150626_279827.html.

46 The insiders include directors, supervisors, executives and shareholders with 5% or more of stocks in the listed companies. *See* Securities Law of the Peoples Republic of China, *supra* note 17, art. 47.

47 *See* Lingling Wei, *Beijing Faces Setback With Its State Sector*, WALL ST. J. (Aug. 18, 2017), http://www.foxbusiness.com/features/2017/08/18/beijing-faces-setback-with-its-state-sector-wsj.html) ("While the leadership has stated its desire to channel more private capital in sectors long monopolized by inefficient state firms, like telecommunications, it has also set out to strengthen Communist Party control over the companies and prevent any losses of state assets.").

offerings by poorly managed, under-financed and possibly corrupt companies. Those concerns must be taken seriously, as China has experienced poor and sometimes corrupt public offerings even with the CSRC's supervisory authority. The concerns are exacerbated by the lack of a sophisticated investing public and a rather inexperienced and inadequate securities industry infrastructure relative to investor protection matters. It is therefore recommended that the reform movement to a registration system not be implemented unless and until certain additional reform measures are taken in advance or concurrently with adoption of the new law.

1. *Merit Review of Proposed Offerings*

The single most important question is whether the proposed registration system should involve some conditional elements analogous to merit review standards. It appears from initial indications that the current requirement for three years of profits will be eliminated. That is appropriate, as there are many companies, especially in the high-tech field, that offer great promise for investors but have not yet recorded profits. There is no such profit requirement in the United States or in most developed countries. Elimination of the requirement in China would be appropriate. However, once the doors open to companies that have not recorded a stream of profits, it may be expected that numerous IPO applicants will come forth. A mature market should not worry about too many new issuers, but in China this is a real concern. It is typical for Chinese investors to believe that investing in the new issues, whose offering prices may have been restricted by the regulator, may be preferable to holding onto older stocks. It may be expected that many Chinese investors will discard older holdings in pursuit of speculative chances in new ones. Since this foreseeable tendency will pull down the entire market, other investors will sell their shares as a preemptive measure. This cycle can readily cause an acute bearish market.

The distorted speculative opportunities are traced to the fact that the supply of new shares has historically been constrained by administrative control. There is an imminent concern that the market will become more volatile than ever when the door to listing suddenly becomes fully opened and a flood of issuers appears. The concern is fueled by both the potential numbers of new issuers and the potential lack of effective quality-control measures.

The U.S. Securities and Exchange Commission does not engage in merit review. If a company meets all of the disclosure requirements it can go forward despite loss records and poor future prospects. But there is a safety net in the U.S. in the form of state Blue Sky laws. Every public offering must be registered both federally with the SEC and in every state where the securities are being offered.[48] Each state has the power to apply its own merit review standards to the offering. If a particular state securities commission believes that an offering creates too high of an investment risk for its citizens, or perhaps has unfair elements such as a disproportionate distribution of securities to insiders, the state can reject the offering within that state.[49] This does not happen often, mainly because companies capable of going through the expense and rigors of a federal registration usually are sufficiently viable to withstand state merit reviews. However, the possibility of a state veto exists, and state merit review standards could be responsible for limiting the number of offerings that create high risk to investors.

Empirical studies in the United States have noted the positive effects of merit review.[50] If merit review has its advantages in a market as well developed as the United States, it would appear to be a given that merit review would be important in an immature market. Under the present circumstances in China, in which the competence and independence of securities professionals may not warrant adequate confidence for investor protection, merit standards may be appropriate.

Taking these concerns into consideration, we recommend that the exchanges should impose a substantive, quality-based control over proposed IPO applicants in order to foster investor protection and market stability. Merit review standards, analogous to those adopted by many states in the United States, could effectively serve as quality-control measures if conscientiously and regularly applied. Professor Roberta Karmel has noted that U.S. state merit regulators actually worked to "acts as a negotiator in getting a better deal for investors," they "directly intervene to require changes in the internal structure of a securities issuer, the relations among insiders and outsiders, and the terms of the offering."[51]

One significant factor in China is that, unlike mature Western markets, Chinese securities trading is mainly composed of and driven by unsophisticated retail investors. According to theChina Securities Depository and Clearing Statistic Yearbook (CSDC), by the end of 2014,

48 UNIF. SECURITIES ACT, § 301, ¶ 5531(NAT'L CONF. OF COMMISSIONERS ON UNIF. STATE LAWS 2005) (state registration required for offers or sales of a security "in this state.")

49 When the author, Stuart Cohn, was in the practice of law in Chicago, Illinois, the first public offering he worked on was a hotel company that had suffered several years of substantial losses. Because of the economic risks of the offering, the offering was rejected by all but nine states.

50 *See* Jennings, *supra* note 36, at 240; E. Walker and B. R. Hadaway, *Merit Standards Revisited: An Empirical Analysis of the Efficacy of Texas Merit Standards*,7J. CORP. L. Law 651 1982), (evaluating the efficacy of the merit standards in Texas by using financial data to compare companies who received permissions to issue securities with companies that withdrew their requests to issue securities).

51 Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 105, 116 (1987).

72.75% of the accounts established by natural persons or institutions held floated shares with market value below 100 thousand RMB (less than $15,000).[52] In 2011, a CSRC study revealed that professional institutional investors only held 15.6% of the floated capitalization, while natural persons held 26.5%, and the other 57.9% shares being retained by shareholders who normally would not trade.[53]The data released by the Shenzhen Stock Exchange showed that in 2012 natural person investors held 42.8% of floated capitalization, while professional institutional investors, including investment funds, pension funds, insurance companies, broker-dealers, and qualified institutions, held only 18%.[54]A survey conducted by the Securities Association of China and the China Securities Investor Protection Fund Company revealed that 70% of natural person investors are low-or middle-income, of which 35.2% earn an annual income below 24,000 RMB (less than $4,000).[55] Nearly one-half of such investors received no higher education.[56]

In addition, retail investors engage in active trading. The Shenzhen Stock Exchange reported that natural persons account for 85.6% of the trading volume measured by Yuan, while institutional investors account for only 9.8%.[57] A Chinese economist drew a similar conclusion based on the data of the 2012-2014 Shanghai Stock Exchange Statistic Yearbooks.[58] The CSRC has acknowledged that "currently individual investors dominate the trading," and that"professional institutional investors cannot work as stabilizers of the market, but rather passively accept the market quotation."[59]

Retail investors in a highly speculative market are at great risk. Many of them have neither the capacity nor the time to digest financial-related information in order to have an informed trading strategy. A pure

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52 CHINA SECURITIES DEPOSITORY & CLEARING CORPORATION, CHINA SECURITIES DEPOSITORY AND CLEARING STATISTIC YEARBOOK (2014), http://www.chinaclear.cn/zdjs/editor_file/20150603151710498.pdf.

53 *SFC: Natural Person Holding a Share Market Share Accounted for 26.5%*, SECURITIES TIMES (June 21, 2012), http://kuaixun.stcn.com/content/2012-06/21/content_6016241.htm.

54 SHENZHEN STOCK EXCHANGE, SHENZHEN STOCK EXCHANGE MARKET PERFORMANCE REPORT OF 2012, at 22 (2013), http://www.szse.cn/main/files/2013/02/28/148177440107.pdf [hereinafter "SHENZHEN STOCK EXCHANGE"].

55 SECURITIES ASSOCIATION OF CHINA & THE CHINA SECURITIES INVESTOR PROTECTION FUND COMPANY, AN ANALYTICAL REPORT ON THE SURVEY OF INVESTORS IN CHINA'S SECURITIES MARKETS 4 (July 2007), http://www.sipf.com.cn/images/dczx/dccg/2009/10/24/FDB3AFFCDA07A69E70596513588ECBB1.pdf.

56 *Id.* at 5.

57 SHENZHEN STOCK EXCHANGE, *supra* note 54, at 22.

58 Deng Haiqing, *Data to Speak: Retail is Indeed the Protagonist of A Shares!*, CAIXIN (July 15, 2015), http://opinion.caixin.com/2015-07-15/100829029.html.

59 *June 13, 2014 Press Conference*, CSRC (June 13, 2014), http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwfbh/201406/t20140613_256025.html.

disclosure-based system may not be able to protect investors or necessarily result in a rational market. This concern is illustrated by the manner in which Hong Kong exchange investors ignored the risks revealed in disclosures of certain structured securities in the 2008 financial crisis. After suffering substantial losses, many investors took to the streets, turning bad investments into social unrest.[60] Some Chinese scholars refer to the Hong Kong experience as an example of the potential danger of relying too much on a pure disclosure system.[61] The CSRC has good reason to be worried about investor protests, as it is not unusual for investors who have suffered losses to go to the CSRC headquarters begging for mercies or demonstrating anger. Given these circumstances, it is not improper to inquire whether this is the right time to create a pure disclosure-based system in a transitional market.[62]

We are of the opinion that merit review standards are appropriate to determine which issuers are eligible for an IPO. The Chinese market is still young, retail investors are relatively inexperienced, enforcement procedures and powers are under-utilized, and too few investors have access to qualified securities analysts.

Although we favor merit review, we do not favor placing that power in the CSRC. There is too great a chance for favoritism, arbitrary exercise of authority, and potential corruption. The CSRC history with regard to non-SOE companies seeking IPOs is not been a good one. Although it is possible to create a new agency for the sole purpose of establishing and determining merit standards, we believe that the analytical expertise currently existing within the two major stock exchanges is sufficient to avoid creating yet another tier of authority. We therefore recommend that the stock exchange for which the IPO applicant seeks listing be given the authority and duty to veto the IPO application if the issuer fails to meet the exchange's adopted merit standards.

We recommend that the Shanghai and Shenzhen exchanges mutually agree to a single set of merit requirements. At a minimum we believe that the following elements should be considered in creating the standards:

60 *See* Andrew Godwin, *The Lehman Minibonds Crisis in Hong Kong: Lessons for Plain Language Risk Disclosure*, 32 UNSW L.J. 547, 561 (2009).

61 *See* Robin Hui Huang, *Private Enforcement of Securities Law in China*, 61 AM. J. COMP. L. 757, 774 (2013).

62 *See* S.M. Solaiman, *Adoption of the Disclosure-Based Regulation for Investor Protection in the Primary Share Market in Bangladesh: Putting the Cart Before the Horse?*, 1 CORP. GOVERNANCE L. REV.115, 117 (2005).

1. If the offering succeeds, will the company have sufficient capital to achieve its economic goals?
2. Has the issuer or any of the directors or officers been guilty of or liable for securities or other financial misdeeds?
3. Is the offering price reasonable in light of the company's history and financial circumstances?
4. As a result of the proposed offering, will the founders and other insiders have a disproportionate amount of securities and control relative to their financial and managerial contributions?
5. Does the issuer have in place corporate governance standards that mandate objective decision-making by directors and officers and fair decision-making responsibilities for shareholders?
6. If the proposed offering is successful, will there be a sufficient public float to assure a viable secondary market?
7. Are the entire proceeds from the proposed IPO to be used to further the business operations of the company?

In determining the merit review standards, we recommend that the exchanges examine the complete set of merit review standards in the U.S. set forth as "Statements of Policy" by the North American Securities Administrators Association (NASAA).[63] Many states have adopted one or more of those standards and incorporate them into their state review of proposed offerings. In addition, approximately twenty states have adopted a general standard of merit review that allows administrators to refuse to allow a registered offering in that state if the offering is found not to be "fair, just and equitable" to potential investors.[64] This generalized standard may be an appropriate back-up to the more specific merit review standards where a company's financial, management, or historical experience does not lend itself precisely to analysis under specific guidelines.

2. CSRC Disclosure Review

The current proposal subordinates the CSRC's authority to review an IPO applicant's disclosures. The primary authority has been delegated to

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63 *Statements of Policy*, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION (2017), www.nasaa.org/regulatory-activity/statements-of-policy.

64 A listing of such states and a description of merit review standards adopted in various states in the Unites States can be found in STUART R. COHN, SECURITIES COUNSELING FOR SMALL & EMERGING COMPANIES §12:8 (Oct. 2017 Update).

the exchanges. The much-reduced role of the CSRC is understandable given the CSRC's history, but the proposal has, we believe, undercut the need for careful and experienced review of issuer disclosures.[65] We believe, given the CSRC's experience and expertise with regard to disclosure requirements, that the CSRC should retain authority to review an applicant's disclosures, raise questions regarding possible inaccurate or incomplete statements, require corrected amended disclosure documents, and conduct appropriate investigations where disclosures appear to lack completeness or credibility. The CSRC should be able to act similarly to the U.S. Securities and Exchange Commission, which undertakes a comprehensive examination of applications to assure that all disclosure requirements have been satisfied. The CSRC's review role should precede and therefore be of service to the responsibility accorded to exchanges to conduct their own review and analyses of a proposed issuer's disclosures. Unlike the past, however, the CSRC's role should be limited to disclosure concerns only. The ten-day CSRC review role provided in the proposed legislation should be limited to disclosure issues that the CSRC believes may not have been fully treated by the exchange review.

3. The Link between an IPO and an Exchange Listing

An IPO and an exchange listing are distinct commercial activities, although the success of the former usually depends heavily on the probability of the latter. Currently the CSRC directs where IPO issuers will be listed, and all IPOs would go onto one exchange or another. Under the proposed registration system, if exchanges are given autonomy to determine whether such issuers will enjoy the privileges of listing, it is quite possible that many new issuers will not be able to list on an existing exchange. The proposed new Securities Law empowers the CSRC to promulgate conditions and procedures for IPOs not to be listed in the exchange.[66]

We agree with the proposed legislation that distinguishes exchange listing from the ability to undertake a registered IPO. Any legitimate operating company should have the right to raise capital through a registered public offering. That leaves open, however, a principal unresolved question of where securities will be traded if an issuer is denied an exchange listing.

65 Ironically, the CSRC will retain authority to review and veto proposed offerings of corporate bonds. The People's *The People's Republic of China Securities Law (Revised Draft)*, *supra* note 39, at 35. The issuing process for bonds was perhaps not seen to have as sullied a CSRC history as that of ordinary shares.

66 *Id.* at 19.

One possibility is the so-called "third board," the National Equities Exchange and Quotations limited Company (NEEQ), an over-the-counter market launched in 2013 as a new exchange platform in Beijing. However, trading in shares listed on NEEQ is limited to accredited investors, a substantial handicap to a robust secondary market. Most companies listed on NEEQ have engaged in prior private offerings. But the NEEQ has an existing framework for accepting IPO companies, as it is mandatory for all "unlisted public companies" to be traded in the NEEQ.[67] Any company which either has more than 200 shareholders accumulatively, even if the number of current shareholders is less than 200, or which makes a public offer to transfer some if its securities, falls into the category of "unlisted public companies."[68] Moreover, all delisted companies from the Shanghai or Shenzhen exchanges are moved to the NEEQ. So, theNEEQ exchange has the infrastructure and experience to develop an alternative trading market for companies that engaged in registered IPOs but fail to meet Shanghai or Shenzhen listing requirements.

A second alternative is ChiNext, the third tier of the Shenzhen securities exchange established in 2009 for smaller companies unable to meet the listing qualifications of the exchange's main and small and medium market (SME) tiers.[69] ChiNext was created to allow trading in the shares of smaller, developing companies. Currently, it's principal financial requirement is that the issuer must have been profitable in the most recent two consecutive years, with accumulated profits no less than RMB 10 million Yuan (approximately $1.5 million), or the issuer must have been profitable in the most recent year with net profits of no less than RMB 5 million and revenues of no less than RMB 50 million.[70] In our judgment, these standards are too strict for many developing companies that have promising prospects but have yet to become profitable. This is not consistent with its primary aim of serving the start-up (chuangye) companies. It is worth noting that Amazon, Inc. had its IPO in 1997 but did not record its first profit until the fourth quarter of 2001, a year in which it cumulatively lost $149 million.[71] Not all

67 CHINA SECURITIES REGULATORY COMMISSION, ADMINISTRATIVE MEASURES FOR THE SUPERVISION OVER UNLISTED PUBLIC COMPANIES, art. 4 (Revised 2013), http://hk.lexiscn.com/law/administrative-measures-for-the-supervision-over-unlisted-public-companies-revised-in-2013.html.

68 *Id.* at art. 2.

69 The listing requirements for the Shenzhen's main, SME and ChiNext tiers can be found at *Listing Requirements*, SHENZHEN STOCK EXCHANGE, http://www.szse.cn/main/en/ListingatSZSE/ListingRequirements/ (last visited Apr. 16, 2018.

70 In addition, the issuer must have net assets of no less than RMB 20 million at the end of the most recent reporting period with no uncovered losses and a total share capital of no less than RMB 30 million after the IPO. *Id.* art. 10.

71 For a discussion of Amazon's history, *see Amazon.com, Inc. History*, FUNDING UNIVERSE,

companies will become success stories like Amazon, but investors should not be precluded from investing in companies simply because they have yet to show a net profit. We therefore recommend that the Shenzhen exchange amend its listing requirements for ChiNext to eliminate the profit requirement, an amendment that is consistent with the current proposal that eliminates from IPO standards the three-year profit history.

A third alternative is to allow companies not listed on the Shanghai or Shenzhen exchanges to be listed on a provincial exchange center in the province where the issuer's principal office is located. We do not favor this alternative over NEEQ or ChiNext, as provincial exchanges centers lack an adequate trading infrastructure and the supervisory expertise of the established exchanges. However, if neither NEEQ nor ChiNext are prepared to amend their current limitations, the provincial exchanges centers are likely to become the trading market of last resort for smaller public companies.

With appropriate disclosure and merit review regulation there should be no prohibition against public capital raising by high risk companies. Among the risk-reducing factors would be the requirements that all publicly-traded companies must file periodic reports similar to the Forms 8-K, 10-Q and 10-K in the United States.[72] The Form 10-Q is an especially important disclosure document because it provides quarterly financial information, thus giving investors a current running account of the company's financial results. In addition, the exchanges should impose a limit on a company's volume of daily trading and price movement as safeguards against volatile swings in market price. With appropriate limitations and disclosure requirements, China's securities market can allow for both capital-raising by small, developing issuers and for secondary market trading by investors willing to invest in what may be high-risk companies.

4. *Eliminate Mandatory IPO Sponsor*

Currently all IPOs approved by the CSRC must have a sponsoring underwriter and two sponsor representatives.[73] That is not so in the United States, where issuers can engage in registered public offerings without an underwriter or other sponsor. The principal advantage of mandating a

www.fundinguniverse.com/company-histories/amazon-com-inc-history (last visited Apr. 2, 2018).

72 15 U.S.C.A. § 78o(d) (West)mandates periodic filing requirements for companies who have engaged in a public offering and have not less than 300 shareholders.

73 Administrative Measures for the Sponsorship of the Issuance and Listing of Securities (promulgated by the China Sec. Reg. Comm., Aug, 14, 2008, effective Dec. 1, 2008), art. 48 (China), http://www.csrc.gov.cn/pub/csrc_en/laws/overRule/Decrees/200910/t20091028_166900.html.

sponsoring underwriter is to attempt to assure the quality of the process, offering terms and disclosures. Underwriters and other sponsors are intended to serve as a check on issuer excesses and unreasonable expectations.

However, the downside is that a mandatory requirement will prevent some, perhaps many, smaller and developing companies from raising capital if unable to attract a sponsoring underwriter. For reasons that might have little to do with the issuer's quality, such as lesser broker compensation, higher risks relative to commissions, issuer's location or sponsors' desire for larger, more prestigious clients, securities firms might be reluctant to sponsor smaller, fledgling firms.

We believe that all legitimate operating companies should have the opportunity to engage in IPOs to raise needed capital. We recognize that this recommendation appears to fly in the face of the "floodgates" concern posed by an open registration system. Yet, given the large number of companies in China seeking additional capital instead of additional burdensome debt, and the limited number of broker-dealer firms that may be willing and able to be sponsoring underwriters, we believe that smaller companies should not be precluded from raising capital through an IPO because of an inability to attract a formal sponsor.[74] While their offerings are likely to be more difficult to achieve, they should not be prohibited. In the United States, smaller companies unable to find or afford underwriters can engage in a so-called "direct public offering," utilizing the internet as their primary marketing tool.[75] Such offerings are generally not as successful as underwritten offerings, but companies that desire to raise capital by these means should not be thwarted by the lack of a willing sponsor.

5. *Improve Class Action Procedures for Civil Actions*

The Chinese Securities Law has relatively sophisticated provisions covering civil liabilities for material misrepresentations (xujiachenshu) including false or misleading disclosures and omissions in disclosure documents. When there is a proven misrepresentation, established by a regulatory sanction or a criminal conviction, which has resulted in a loss to

74 This recommendation is consistent with the policy behind the 2002 law promoting small and medium-sized businesses, which in Article 16 states that "the state should take measures to broaden the channels of direct financing for small and medium-sized enterprises." Law of the People's Republic of China on the Promotion of Small and Medium-Sized Enterprises (promulgated by the Standing Comm. Nat'l People's Cong., Sept. 1, 2017, effective Jan. 1, 2018) (China) (the statement now appears in Article 18 after the 2017 revision of the law).

75 A description of the direct public offering process can be found in COHN, *supra* note 64, § 4:10.

investors, the issuer is liable for the loss thus caused. The directors, supervisors, executives, and sponsor/underwriter of the issuer are jointly and severally liable for the loss thus caused, unless they can prove that they are not at fault.[76]

Despite the existence of apparently adequate statutory sanctions, civil actions in China are rare. Moreover, directors seem to be treated favorably. A study of the sixty-five suits from 2002-2011 found that in only fourteen cases natural persons (such as directors) were named as co-defendant alongside the companies; in the cases that were settled or mediated by the courts, claims against directors and executives were almost invariably dropped as a tradeoff for a more favorable settlement plan for the plaintiffs.[77]

There is no U.S. style class action mechanism in China. There is a multiple-party joint suit mechanism in the Civil Procedure Law,[78] which allows suits without a determined number of claimants at the time the case is brought. The court is empowered to issue an announcement notifying potential plaintiffs to register with the court. The judgments eventually rendered would be binding for all registered plaintiffs registered. This is an "opt-in" mechanism, a major difference from the U.S. "opt-out" class action.

Courts rarely employ the plaintiff registration method. Instead, the customary way is to divide plaintiffs into small groups of fifteen-twenty persons, even when there are thousands of affected investors.[79] The case is tried in a collective way, but multiple individual cases are filed consisting of distinct groups of plaintiff investors. It is uncertain whether this process is driven by courts desiring to charge more fees, or because judges simply intend to avoid the influx of hundreds of aggrieved litigants in a courtroom,

76 The Supreme Court expanded the list of potential defendants to include directors, supervisors, managers and other senior management personnel employed by such entities, and market professional service agencies (such as accounting firms, law firms, and asset valuation firms) and people working in these entities who are directly responsible for the misrepresentation. *See* SEVERAL PROVISIONS OF THE SUPREME PEOPLE'S COURT REGARDING TRYING CIVIL COMPENSATION CASES ARISING FROM FALSE STATEMENT IN SECURITIES MARKET, http://www.chinacourt.org/law/detail/2003/01/id/81833.shtml (last visited Oct. 21, 2017) [hereinafter "SEVERAL PROVISIONS"].

77 Huang, *supra* note 60, at 788.

78 Civil Procedure Law of the People's Republic of China Article (2012 Amendment), (promulgated by the Standing Comm. Of the Nat'l People's Cong., Aug. 31, 2012, effective Jan. 1, 2013), art. 54 (China), *available at* http://en.pkulaw.cn/display.aspx?cgid=183386&lib=law.

79 For example, in the Dongfang Electronics Case, the court accumulatively handled 2,716 suits brought by 6,989 plaintiffs individually and in group. *See* THE 2006 INTERIM TERM REPORT, YANTAI DONGFANG ELECTRONICS INFORMATION INDUSTRY CO., LTD. 7(2006), http://disclosure.szse.cn/finalpage/2006-08-24/18102574.PDF.

potentially posing a threat to sensitive social stability.[80] At the same time, judges can get impressive records as their workloads are calculated by the amount of cases, regardless of magnitude. Though this process has been criticized as inefficient,[81] in a well-designed proceeding the tribunal could adjudicate the case for one exemplary group and then copy, sometimes with adjustments for technical measurements of damage, the fact findings for the other groups that share the same scenarios.[82] When considering the potential harm that fraudulent IPOs may cause to the investing public, we believe that the development of an effective class action procedure is superior to the current system of fragmented and disjointed multiple actions.

Class action litigation can have a positive effect upon transparency, as the potential of a large class action is likely to cause companies to be more careful in adhering to their disclosure obligations.[83] Although there are litigation processes in China that partially emulate the U.S.-type class action, the class action process in the United States is far less cumbersome and much more inclusive of all potential plaintiffs. The experience in Korea, which enacted the Securities Class Action Act in 2003,[84] also suggests that the risk of frivolous suits is low,[85] which would also be the likely result in China given similar historical and cultural restraints on litigation.

Some have argued that a civil action led by an empowered public institution is more feasible.[86] An example of this form of litigation occurred in January 2017 when representatives from the Zhongzheng Medium and Small Investor Protection Service Center Limited Liability Company, which isa special entity newly founded by the CSRC, appeared in a Shanghai Court for its first case helping investors bring a civil case against a listed company, potentially pointing towards a new trend in civil litigation.[87] It is anticipated that the protection center will play an active role

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80 *See* Nicholas C. Howson, *Corporate Law in the Shanghai People's Courts,1992-2008: Judicial Autonomy in a Contemporary Authoritarian State*, 5 E. Asia L. REV. 303, 401-07 (2010).

81 Guo Li &Allan V. Y. Ong, *The Fledging Securities Fraud Litigation in China*, 39 HONG KONG L.J.697, 710-11 (2009).

82 *See* Huang, *supra* note 61 at,783-84.

83 *See* Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 108-111 (2006).

84 *See* Bernard Blacket. al., *Corporate Governance in Korea at The Millennium:*

Enhancing International Competitiveness (Final Report and Legal Reform Recommendations to The Ministry of Justice of The Republic of Korea), 26 J. CORP. L.537, 546 (2001).

85 *See* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1507–25 (2004). Choi is a Korean American who argued for a less stringent law for class action in Korea.

86 This is what Taiwan and Singaporean scholars argued for China Mainland and maybe the whole East Asia. *See* Wallace Wen-Yeu Wang &JianLin Chen, *Reforming China's Securities Civil Actions: Lessons from US's PSLRA Reform and Taiwan's Government-Sanctioned Non-Profit Organization*, 21 COLUM. J. ASIAN L. 115 (2008).

87 *See The First Case of Securities Support Lawsuit in China Opened in Shanghai Today*, SINA.COM (Jan. 23, 2017), http://news.sina.com.cn/c/2017-01-23/doc-ifxzutkf2426490.shtml. Sina.com is a

in suing misbehaving listed companies as a surrogate for investors. However, this process has two drawbacks. The first is that the Protection Service Center is an arm of the CSRC, which therefore has final say as to whether litigation will be brought despite investor concerns and desires. The second drawback is that such a Center has limited resources and is therefore constrained as to the number of actions it can pursue. That is why the notion of "the private attorney general" is important, allowing the affected investors to act when the government agency will not or cannot. While the special litigation entity concept is a step in the right direction to afford economic relief to affected investors, it should not be regarded as the substitute for private class actions.

6. *Eliminate Prerequisite of an Administrative Sanction for Civil Actions*

There is no provision in the Chinese securities or civil procedure laws that prohibits a civil action from being brought without prior CSRC or other governmental action. However, in practice such a suit would not be accepted by a court without a prior administrative punishment or a criminal verdict. The courts have given very clear notice of this prerequisite with regard to any case based on a material misrepresentation or omission.[88]

When the 2001 market decline exposed a string of underlying securities scandals and set in motion numerous lawsuits filed against listed companies, the Supreme People's Court instructed that in light of the legal and regulatory uncertainties surrounding these cases, lower courts were not to hear civil compensation suits, basing its reasoning on the supposed unpreparedness and incompetence of such courts.[89]

Lacking expertise is not a proper pretext for courts avoiding securities cases. In 2002 and 2003, after much criticism for such a denial of access to the courts, the Supreme People's Court partly reversed its position and issued guidelines[90] providing that investor suits for false or misleading

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leading news website in China.

88 SEVERAL PROVISIONS, *supra* note 75. *See also* Sanzhu Zhu, *Civil Litigation Arising from False Statements on China's Securities Market*, 31N.C. J. INT'L L. & COM. REG. 377, 381 (2005).

89 *See* NOTICE OF THE SUPREME PEOPLE'S COURT ON REFUSING TO ACCEPT CIVIL COMPENSATION CASES INVOLVING SECURITIES FOR THE TIME BEING (2001),http://www.law-lib.com/law/law_view.asp?id=16373(English translation *available at* http://en.pkulaw.cn/display.aspx?cgid=36895&lib=law); *see also* Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 CHINA ECON. REV. 451(2003).

90 NOTICE OF THE SUPREME PEOPLE'S COURT ON THE RELEVANT ISSUES CONCERNING THE ACCEPTANCE OF CASES OF DISPUTES OVER CIVIL TORT ARISING FROM FALSE STATEMENT IN THE SECURITIES MARKET (2002), http://www.law-lib.com/lawhtm/2002/16956.htm.

disclosure could be brought, but on the condition that the defendant had been administratively sanctioned by the CSRC or other administrative agencies or had been found liable in a criminal proceeding.[91]

Curiously, despite administrative sanctions by the CSRC, the potential for civil actions in China is far from being fully exploited. In the U.S., a high percentage of SEC enforcement actions are accompanied by civil actions,[92] but in China, even in the cases of CSRC-sanctioned companies with actual factual findings of wrongdoing, approximately 85% of such eligible easy target companies for investor lawsuits have not been sued, according to a study for the period 2001–2006.[93] In a similar survey based on data from 2002-2011, it was estimated that securities civil actions "represent only about 25.7% of all the eligible criminal/administrative sanctions. . . ."[94]

One principal reason why Chinese investors are reluctant to piggy-back onto the public enforcers is that the majority of potential defendants are state-owned enterprises (SOEs) whose corporate misdeeds may have been implicitly permitted by their government controllers. Transfers of wealth of listed companies to their SOE parent companies are rooted in the government controllers' desire to utilize the listed companies to serve local economies, relieving the local budget of the burden of financing investments, and facilitating economic development at the expense of investors nationwide. The career prospects of powerful local bureaucrats are closely connected with their regions' performance.[95] Punitive judgments against SOEs in their jurisdictions obviously would impact not only the economic resources ultimately controlled by the local governments, but also cast shadows on their ruling abilities. Thus, bureaucrats would act to influence courts and reduce enforcement rates against local firms. A further concern in China is that the judiciary, especially in significant cases, is subject to government interference.[96]

91 SEVERAL PROVISIONS OF THE SUPREME PEOPLE'S COURT REGARDING TRYING CIVIL COMPENSATION CASES ARISING FROM FALSE STATEMENT IN SECURITIES MARKET, *supra* note 76; *see also* Zhu, *supra* note 88.

92 Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation*, 49 J.L. & ECON. 365, 370(2006);Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1134 (2008) (estimating a ratio of 55%).

93 Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 COLUM. L. REV. 929, 942-44 (2008).

94 Huang, *supra* note 61, at 766.

95 *See e.g.*, YASHENG HUANG, INFLATION AND INVESTMENT CONTROLS IN CHINA 27–57, (Cambridge University Press 2006).

96 *See e.g.*, STANLEY B. LUBMAN, BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO 120-21 (STANFORD UNIVERSITY PRESS 1999); RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW 26-28 (CAMBRIDGE UNIVERSITY PRESS 2002); Donald C. Clarke, *Power and Politics in the*

Although factors that inhibit robust civil actions continue to exist, the prerequisite of government sanctions for private civil actions should be eliminated. The CSRC and other government agencies are not necessarily aggressive or competent prosecutors of financial crimes. As the professional regulator, which boasts a higher ratio of Western-educated staff than most Chinese ministries, the CSRC may have good intentions but it is ill equipped, overworked, subject to resource constraints, and without adequate political breathing room.[97] Commentators have noted that "[t]he institutional and political constraints within which the CSRC operates seem apparent,"[98] and that the agency often "comes under extensive external pressure not to take actions."[99] The CSRC is especially reluctant to take enforcement actions against politically-connected SOEs,[100] whose controllers are government organs or super SOEs groups that may have almost as high official rank as the CSRC has in China's political system. Unsurprisingly, an evaluation of administrative punishments given by the CSRC from 2001-2006 was deemed to be "modest" against the actual severity of the wrongs in the market.[101] The number of sanctions actually issued by the CSRC looks rather small given the extravagant unpunished, frequent, and severe market abuses, while enforced punishments often come later, "two or more years after the wrongdoing occurred."[102]

In sum, two factors militate against courts continuing to prohibit civil actions in the securities field absent administrative or criminal sanctions. One is the relative paucity of actions taken by the CSRC and other agencies, which may be due in part to political concerns. A second factor is the lack of governmental capacity to pursue all apparently meritorious actions. The S.E.C.'s Enforcement Division in the U.S. has approximately 450 attorneys, yet even their aggressive enforcement efforts pale in number compared to the total amount of civil securities litigation. One may say that there is too much private litigation in the U.S., but that notion does not ring true in the securities field. Although civil plaintiffs in China may too often fail to realize the full potential of utilizing a valid administrative penalty,

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Chinese Court System: The Enforcement of Civil Judgment,10 COLUM. J. ASIAN L. 1, 42 (1996) (discussing "the dependence of local court personnel upon local government at the same level for their jobs and their finances.").

97 *See* Liebman & Milhaupt, *supra* note 93, at 977.

98 *Id.* at 942.

99 *Id.* at 955–956.

100 William T. Allen & HanShen, *Assessing China's Top-Down Securities Markets*, (Nat'l Bureau of Econ. Res., Working Paper No. 16713).

101 *See* Liebman & Milhaupt, *supra* note 93, at 942.

102 *See id.*at 955. *See* Pistor & Xu, *supra* note 22, at 185.

nevertheless we do not see the necessity of setting such a prerequisite for private actions.

7. *Improve Liability Provisions for Misleading Prospectus Disclosures*

Article 69 of China's Securities Law[103] is the principal liability provision regarding misleading statements in a prospectus. It imposes liability upon the issuer for losses to investors without regard to fault, and upon directors, senior managers, control shareholders, sponsors and underwriters "unless one can establish a lack of fault on one's part." The strict liability of issuers is similar to Section 11 of the 1933 Securities Act in the United States,[104] but the Chinese statutory provision fails to impose upon other potential defendants an affirmativeduty of due diligence with regard to the review of the prospectus. The "lack of fault" phrase in Article 69 may suggest no affirmative obligation on the part of each director and all other potential defendants to undertake a reasonable investigation into the statements contained in the prospectus.

China's statutory reference to "lack of fault" contrasts with the U.S. requirement that each director and other defendant "had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact. . . ."[105] Unlike the U.S. standard, it may be too easy in China for those in charge of an issuer's misleading IPO to avoid personal liability for investor losses byshowing that they were too far removed from the drafting and review of the misstatements. We recommend that the Securities Law be amended to impose a clearer requirement of due diligence upon all potential non-issuer defendants. This measure will enhance the obligation on directors, senior managers, sponsors, underwriters, and others connected with the drafting of the prospectus, likely resulting both in greater transparency and fewer fraudulent offerings.

103 Securities Law of the People's Republic of China, *supra* note 17, §69.
104 *See*15 U.S.C.A. §§ 77a–77aa. (West).
105 *See* Securities Act of 1933 §11(b)(3), 15 U.S.C. § 77k(b)(3).

8. *Create Enforceable Suitability Requirements for Securities Dealers*

Stockbrokers and other securities dealers selling shares during an IPO should be under both ethical and legal duties to know that their recommended investments are suitable for their customers. As noted, the great majority of purchasers in an IPO are individual investors. Many such investors lack experience and sophistication in the securities market. In the future registration system environment, with an expected substantial increase in IPOs and investment opportunities, Chinese investors are likely to rely increasingly on advice and recommendations from their stockbrokers.

Although substantial reliance may increasingly be placed upon one's stockbroker, brokers are compensated only by sales commissions and are therefore in an inherent conflict of interest situation. Because brokers are likely to play a major gatekeeper role in the new securities world, it is imperative that brokers be subject to appropriate standards of conduct in recommending share purchases. Therefore, prior to implementation of the open registration system, we recommend that the CSRC assure that all brokers and securities dealers are subject to standards and requirements analogous to those that apply in the United States, namely suitability and knowledge of the securities offerings. As stated in Rule 2111 issued by the Financial Industry Regulatory Authority (FINRA):

> A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.[106]

Suitability requirements can be an important safeguard for investors, protecting them against broker recommended purchases that are inappropriate due to the investor's age, inexperience, investment goals, or

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106 FINRA, RULE 2111 (2014).

economic condition. In light of the concern that the open registration system will result in many low-quality offerings, a well-defined and enforced suitability standard may act as one safeguard against inappropriate broker recommendations and investor purchases. Failure to adhere to the suitability standards in the U.S. can lead to civil liability by the broker for losses incurred and disciplinary action by FINRA. We recommend that similar results obtain in China.

9. Increase Training of Prosecutors, Lawyers, and Judges

An effective enforcement system requires competent prosecutors, lawyers and judges who understand the securities laws and their appropriate application. Currently in China such competence is quite limited, especially outside major metropolitan areas. During this period prior to adoption of securities reform, and thereafter on a regular basis, we recommend that periodic formal training sessions be developed for prosecutors, lawyers and judges. Without such increased understanding and competence levels among those involved principally in enforcement procedures, enforcement levels will not keep pace with investor needs. On a positive note there has been an increase in the teaching of finance and securities matters in Chinese universities. It will take time, however, for a substantial and experienced securities bar to develop. Meanwhile, potential issuers and investors will have growing needs for adequate professional advice and guidance.

CONCLUSION

China is on the cusp of major securities reform for the deregulation of public offerings. The reform will allow greater access to capital markets for numerous young companies. Yet, current proposals appear inadequate and not fully articulated, given the anticipated substantial increase in companies seeking capital through registered IPOs. Notwithstanding the demerits regarding the CSRC's veto power over the IPO process, removing all barriers to the registration process would be a mistake. The Chinese securities market has experienced several major crises in its relatively short period of existence. The move to an open registration system is a healthy step for China's capital markets but must be accompanied by sufficient safeguards and policies consistent with the twin goals of capital access and investor protection.

There is enormous potential in China's securities market for growing companies and for expanding investor opportunities. At the same time, because of the domination of the Chinese securities markets by small, individual investors, and the enormous diversity of size and quality likely among companies that will be undertaking IPOs, we have recommended a series of measures that should be implemented prior to, or concurrent with the open registration reform. The reforms in China cannot and should not emulate the securities laws and regulations in the United States. Differences in history, practice, and political factors require accommodation to the singular characteristics of the respective markets. Yet, much is to be learned from the U.S. experience. Our recommendations, including merit review and stronger private enforcement capacities, are based on that experience. China's reform is a work in progress. Before any open registration measures are implemented, additional reform elements along the recommended lines are necessary to create and sustain an efficient and viable securities market.