LEGITIMACY MANAGEMENT: THE POLITICAL LOGIC OF SECURITIES REGULATION IN CHINA

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Main argument

- A political approach to explain the philosophy and practices of securities regulation in China
- Argument: securities regulation is part of the Chinese government’s efforts to manage its political legitimacy; hence securities regulation cannot be understood from the perspective of economic regulation/regulation theories
- Securities regulation is a government-controlled process to rebuild and maintain the political legitimacy of the Chinese state
Securities Regulation as Economic Regulation

- It is a process of promulgating and enforcing rules that creates, limits, or constrains a right, creates or limits a duty, or allocate responsibility.

- It is a vertical process in which “a specific set of commands” are used by the state to influence industrial or social behavior.

- In essence, it gives the state the power to “regulate” the society.
Two different models of Securities regulation: China vs. other jurisdictions

Legitimacy management model (China) vs. investor protection model (U.S. and other countries)
Traditional Theories Explaining Regulation

- Public interest grounds
- Interest group grounds
- Public choice grounds
Public interest: address “market failure” or “private law failure” for public interest

- Monopolies and natural monopolies;
- Information asymmetry
- Public goods
- Frauds
Interest group theories: balancing different and competing interests in a particular political framework
Public choice theory: individuals, including politicians/regulators, aim to maximize their personal interests in the political market
- Regulatory rent
- Regulatory capture
- Regulatory failure
The China problem

- These theories were originally developed to explain how regulation arises, develops and declines in Western democracies.

- China’s differences
  - State-ownership based state-business relations
  - Authoritarian political system
  - Socialist ideology
  - Nationalism
In China,

Significant public ownership of industrial assets inevitably leads to conflict of interest for the government in its roles as both owner and regulator...Powerful provincial governments have discretion over a wide range policy and can act autonomously, often undermining the coherence of national policy. Moreover, limited private-sector involvement in the economy and the policy-making process itself, as well as the lack of electoral competition, means that public actors are largely insulated from external pressures when they develop institutions. This is in contrast to Western experience where private-sector interests often lead institutional development. Stephen Green (2004)
Political legitimacy deals with “who deserves to have political authority and why”; popular acceptance of a governing regime as an authority.

- Two elements: control of power, and popular acceptance.
- Legitimacy cannot be taken for granted; it “involves the capacity of a political system to engender and maintain the belief that existing political institutions are the most appropriate and proper ones for the society” (Lipset 1983, 64).

- In other words, legitimacy must be managed.
Legitimacy management

- Gaining power and legitimacy
- Maintaining legitimacy
- Repairing legitimacy
Tasks to be pursued concurrently and balanced

- Concentration and preservation of power
- Promotion and maintenance of the rulership’s ideology
- Coordinating interest group politics
- Control of corruption
- Pursuance of good policy
Political legitimacy management in China

- Political legitimacy in China: original justification and utilitarian justification (Guo 2003)
  - Original justification: tianming, dezhi, minben, hefa
  - Utilitarian justification: limin and junfu
Political legitimacy in China

A ruler, who has the mandate of heavy, possess the quality of virtue, shows respect to his subjects, following the rules of the ancestors, and tries to win the hearts and minds of the people, will be considered a just and legitimate one. A just ruler will strengthen his legitimacy by promoting policies that will benefit the people, not himself, by ensuring relatively equal distribution of these benefits, and by allowing the people do do what they do the best. (Guo Baogang 2003)
Managing political legitimacy in an authoritarian system: the objectives/concerns

1. Preserving the CCP’s economic power base
2. Pursuance of good policy for minsheng
3. Maintaining official ideology
4. Maintaining political and social stability
5. Managing interest groups/factional politics
6. Controlling official rent-seeking (corruption)
Factors normally not under consideration, or are considered in different ways

- Democratic accountability
- Independence
- Efficiency
- Investor protection

- Considered only when they serve legitimacy management
Political Legitimacy Management and Securities Regulation
Legitimacy Management and the Establishment of China’s Securities markets

- Securities markets to rescue and empower SOEs
  - SOEs are the CCP’s economic powerbase, which are tightly controlled by the Party.
  - The “cornerstone” of the CCP’s ruling
  - Securities markets were created to (1) raise funds for ailing SOEs and (2) improve SOE corporate governance
  - China’s stockmarket is one mainly for SOEs

- Negative consequence:
  - “listing resources” allocated mainly to SOEs
  - State tolerance of corporate scandals involving SOEs
论加强党对国有企业的领导

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◎ 胡问鸣

中国共产党是中国特色社会主义事业的领导核心，这是历史的选择、人民的选择。它昭示着中国共产党不仅是执政党、是执掌国家政权的政治核心，而且是统筹国家事务、领导国家政治经济、社会文化全面发展的核心。我们党的性质和肩负的历史使命，决定着党的生存发展与国家的前途命运息息相关，党的利益与国家利益、人民利益高度一致。

国有经济控制国民经济命脉，对于发挥社会主义制度的优越性，增强我国的经济实力、国防实力和民族凝聚力，具有关键性作用。作为国有经济发挥主导作用的主力军，国有企业是我国基本经济制度的构成主体和国民经济的“顶梁柱”，是国家直接掌控的应对突发事件和重大经济风险的可靠力量。从这个意义上讲，国有企业是党的事业和国家利益在经济社会发展中高度统一的集中体现。坚持和加强党对国有企业的领导，是我们党的性质和宗旨的必然要求，是建设中国特色社会主义事业的应有之意。
Managing the ideological debate on the securities markets

- The revival of the debate on socialism/capitalism after 4 June 1989. Criticism on “capitalist road” had a chilling effect on the reformers.
- Jiang Zemin’s art of balancing
- Deng’s South Tour: “Securities and stock markets, are these things good or bad? … Are they peculiar to capitalism? Can socialism make use of them? We allow people to reserve their judgment, but we must try these things out”.
- Compromise: the Split-share-structure
Nationalism

- Shang Fulin (the CSRC chairman): “capital markets ... important components of national competitiveness”

- Qi Bin argues that international experience suggests that the rise of all great powers had all been supported by a strong capital market (such as the role of Wall Street in supporting US hegemony)
Power concentration for central control

- Securities markets activities were largely regional initiatives.
- Legitimacy management related considerations:
  - (1) Power: state takeover of the control over securities market;
  - (2) good policy: to have a national market based on uniform laws and regulations to balance the popular demands for shares and curb irregular securities activities.
- The CSRC took over the regulatory powers gradually from the locals through a variety of political maneuvers, coupled with institutional changes.
Legitimacy management and the battle of regulatory philosophies
Battle of regulatory philosophies: development, supervision, and stability

- Development: market growth
- Supervision: law enforcement to punish violation of laws
- Political and social stability: CSRC as a regulator or market savior
Regulation of issuing, listing and trading of securities

- Regulatory practice:
  - CSRC’s exclusive power to approve public offering and private placement (initially listing): from the quota system to the current verification and examination system
  - Pricing of securities
  - The role of intermediaries
  - State control of exchanges
Legitimacy management related considerations in IPO Regulation

- Social stability (as seen from public opinion)
- Industrial policy: State-control of capital flow to benefit SOEs, or serve economic or policy goals of the state
- Crisis management and disasters relief
Enforcing investor protection and anti-fraud rules

- Before the 2006 revision of the Company and Securities Law: weak rules, weak enforcement;
- Thereafter, strong rules, weak enforcement

Legitimacy management related considerations:
- Loss of state-assets (both power and ideology related)
- Political stability: organized shareholders pose a political threat
- Social stability: inconsistent court practices across the country may cause shareholders to protest
Recent legislative and judicial changes are driven both by ideas and the rise of motivated constituencies.
Limits of the current legitimacy management model

- Chinese model of securities regulation?
- Several disadvantages limit its success
State-intervention per se is not a problem

- Too early to judge whether the legitimacy management model is successful or not, or whether it works in China.
- It has been suggested that China’s *regulatory state* model, which features active state intervention, is appropriate for China (Du, Lu and Tao 2009).
- However, some problems in the current system illustrate its limits.
1. The government often misperceives and misplaces priorities
   - Taking excessive care of the SOEs, while limiting the private sector’s access to the capital market
2. Political considerations always prevail over regulatory legitimacy considerations.

- Government uses administrative acts to control the price movement as well as the pace of IPOs.
3. It leaves enormous administrative discretionary power to the regulator, namely the CSRC, without imposing meaningful checks and balances, as well as, accountability.
Conclusion

- From legitimacy management to investor protection?
- From administrative governance to legal governance?