How Securities Regulation Really Works: A Comparative Study of the Regulatory, Principled, and Normative Reputational Approaches to Securities Regulation

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Abstract

This paper compares international securities regulation through the lens of a structural and historical analysis. The regulatory, principled and normative reputational models of securities regulation as exemplified by the U.S., U.K. and China are discussed. A discussion of the foundations of securities markets lays the groundwork for understanding different underlying purposes of securities regulation. The paper follows the development of securities markets from the roots of the 17th century European trading companies, through the statist policies that created the bond markets, to the transatlantic crossing and the development of the investment banking system and creation of governmental agencies enforcing securities laws. Against this backdrop, the paper discusses the characteristics of the enforcement securities regulation system of the U.S., the principled approach as exemplified by the U.K. and the normative reputational system of securities regulation as is practiced by China. Thus, by understanding the differing purposes and structures of securities regulation and by not assuming that all securities regulatory systems aim to provide similar types of investor protection, a fuller comparative understanding of the varieties of securities regulation is gained.

Introduction to Comparative Securities Regulation

The regulation of securities markets effectively results from a broad panoply of regulatory mechanisms. Securities regulation takes a variety of forms. Securities Laws generally regulate the sale of securities, and sometimes mergers and acquisitions, corporate elections and sometimes other issues of corporate governance. For the purposes of this paper, securities laws will be defined broadly as rules which affect the securities markets. This comparative study of securities regulation will look at these rules as well as variety of legal structures and approaches that affect the securities markets. The analysis will not be limited to the systems that have explicit rules and regulations grouped together and identified as ‘securities laws’ and enforced by a single entity known as a securities regulator. Rather, a broad approach looking at a variety of legal and normative structures that regulate the securities markets will be discussed.

This paper will look at securities regulation, focusing on the enforcement model, principled approach and normative reputational system. None of these methods of securities regulation exists entirely independently. Even the most stringent enforcement systems contain normative reputational elements and vice versa. However, when viewed together, each of the systems discussed—the U.S., U.K. and Chinese—adopt a different regulatory stance. The U.S. follows an enforcement model, the U.K. proclaims a principled approach and China may be said to have more of a normative reputational approach.

Generally speaking, the U.S. is considered the most robust example of the enforcement model. The U.S. has a well-developed body of law and has often served as the baseline for comparative securities regulation studies.\(^2\) As discussed in the section on The Enforcement Model, The U.S. enforcement model emanates from the regulatory stance of the SEC, which is often said to have the most stringent of securities regulatory requirements. However, the cost of such a system is high and it is not certain that it alone provides adequate regulation.

As seen in the section entitled The Principled Approach, The U.K.’s principled approach emanates from its generally self-regulatory approach. The U.K. is the most obvious example of a principled approach in part because of the Financial Services Authority (FSA) role in advocating for the primacy of the principled approach. The FSA’s move towards principle-based regulation provides guidance to firms regarding general principles but avoids prescriptive rules and supervisory actions. Rather, the approach

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trusts that firms should bear the responsibility of deciding how they can best align their business objectives and processes to meet specified regulatory aims.

Finally, section entitled *The Normative Reputational System* discusses the Chinese approach to securities regulation. The Chinese normative reputational system does not possess full-disclosure or insider trading laws. Rather, the sanctions tend to be reputational and administrative. Mainland China is said by some to have a ‘weak enforcement record’ but publicly shames transgressors.

Necessarily, this study will also start from the perspective that not all securities regulation schemes are intended to produce like results. For instance, while the common law model generally followed in the U.S. and the U.K. has focused on investor protection mechanisms the Chinese administrative model shows that investor protection is not the primary incentive. Rather the growth of industry—still mainly state owned—is the primary driver of regulation. These very basic differences in the purpose of securities markets lead to very different investor protections, regulatory models and normative structures.

The underlying policy reasons for securities norms seem to derive from four distinct social benefits. These benefits include the: protection of the general public, elimination of negative externalities from financial failures, advancing various equitable and redistributive goals and promoting certain aspects of political economy.³ Howell E. Jackson originally summarized the goals of financial regulation in this way in order to provide a backdrop to understand U.S. regulatory models.⁴ However, this framework can be useful in gaining a comparative understanding of the aims of each of these regulatory securities mechanisms. Each of these policies offers different social benefits. It is likely that distinct social benefits


are best served by specific regulatory securities mechanisms as markets diversify and serve different needs. Thus, this paper will compare these three mechanisms: the enforcement model, the principled approach and the normative reputational system in comparison to look at to garner a better understanding of how these securities regulatory systems really work.

**The Development of Securities Law**

Divergent approaches to securities regulation—the regulatory model, principled approach and normative reputational system—have emerged to meet different market needs at different times. Thus, this section will briefly examine the development of the stock markets from the joint stock maritime companies of the sixteenth and seventeenth century to the emergence of securities regulatory agencies in the early 20th century. What will become clear is that these markets were designed by states to serve states. It has only been relatively recently that the stock markets have diversified into vehicles for private ownership and protection of private investor interests. Thus, during their development securities markets have variably depended on normative reputational systems as well as principled approaches and enforcement models.

The earliest iteration of a security was the ‘stock’ that emerged from joint stock companies such as the Dutch East Indies Company and the British East India Trading Company that emerged under mercantilist regimes in the 16th and early 17th century. These joint stock companies initially emerged to pool capital for costly trade missions and had a quasi-public legal personality. These trade missions

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5 The East India Company began trading in 1688. In 1689 there were about 16 joint stock companies trading approximately £.9M and by 1695, there were 150 joint-stock companies valued at £4.3M, Michie, 15. Trading for these joint stock companies was focused on two coffee shops: Garraway's and Jonathan's. The first efforts to legislate include the 1697 passed to license all brokers and "restrain the number and ill-practice of brokers and stockjobbers" following a number of insider trading incidents. Jonathan's burnt down in 1748 and was rebuilt and became known as a 'stock exchange'. See also Ranald C. Michie, *The London Stock Exchange: A History* (Oxford, 1999).
bought domestic goods, transported them to areas that valued them, traded them for foreign produced goods and then sold the foreign goods when the trade mission ended. The profit was realized as the goods were sold and then those profits were then distributed and sometimes reinvested. Thus, these stocks were periodically liquidated and did not require trading in order to recognize profit.⁶

The growth of stock markets grew out of a need for states to raise money, specifically to fight expensive European wars. Towards the middle of seventeenth century, joint stock companies began diversifying their holdings by investing in government bonds during periods of European warfare. These companies invested their liquid assets into the emerging bond markets looking for a sure rate of interest and on the theory that states would not default. Unlike the returns of the joint-stock companies, which paid out returns generally at the end of a specific time period, state debt continued to accumulate and bonds often had to be traded in order to recognize the returns. The main drivers of security markets growth during this early period was the state.⁷ Since government bonds could—and sometimes needed to—be traded to realize a gain, stock markets became necessary.

The foundation of the London Stock Exchange was when the English government started borrowing in 1693.⁸ On March 3, 1801 the London Stock Exchange (LSE) officially came into existence and

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⁶ While these stocks did not require trading to recognize profit, they were in fact traded. The first stock exchange emerged either in Bruges (1409), Antwerp (1531) or Amsterdam (1602) and the idea spread globally for the next two hundred years founding the London Stock Exchange in 1773, the New York Stock Exchange in 1792 and the Hong Kong Exchange in 1891, id.


⁸ Michie, 18. Government borrowing created transferable debt rather than short-term debt that was redeemed or refinanced. This required a trading market if proceeds were to be realized. By the middle of the 18th century the East India Company and South Sea Company had lent £42.8M to the government, representing a large percentage of their paid-up capital.
moved from an open market to a closed market with proscribed self-imposed rules. During the Napoleonic Wars the Amsterdam and French markets suffered significantly and the British markets became the beneficiaries of both skilled personnel from these markets as well as an increased market based on the rapid growth of national debt and political uncertainty that fueled the liquidity of the markets. Thus, from 1801 to 1853 the LSE diversified and by 1850 the LSE was the leading stock exchange in the world.

For most of its development, the LSE was self-regulating and depended largely on normative reputational sanctions of its actors. The first regulatory action that affected the LSE was the Companies Act of 1844 which created the first prospectus requirement. However, it was not until the Companies Act of 1907 that the first step towards mandatory disclosure was put into place, requiring publication of

9 Id, 35-40. According to Michie, from the outset the aim of the rules was to restrict members by reputation and character, restricting those deemed untrustworthy due to prior actions, this led to a specialization within the financial markets as those other occupations became deemed ineligible for membership.

10 Id, 22. A London exchange formed in March 1801 to serve this market. Michie also notes the growth of the U.S. national debt following the Civil War, from $64.8M in 1860 to $1,193M in 1913 as well as the growth of the U.S. railroads $318M in 1850 to $19.8B in 1913 as fueling nineteenth century stock market liquidity, leading to a global stock market liquidity of £32.6B in 1910. Michie notes that British investors controlled 24% of this amount followed by the U.S. with 21%, French with 18%, Germans with 16%, Russians 5%, 4% by Austria-Hungary, and 2% for Italians and Japanese. WWI then created a cessation of European markets which meant a dramatic growth for U.S. markets from $144M in 1918 to $1,125M in 1929, see Michie p. 7.

11 In 1801 the London Stock Exchange traded exclusively in government debt and its proxies valued at £465M and by 1853 it traded £1.2B of which 8% was issued by foreign governments and railways and 20% was British companies, id at 68.

12 However specific prospectus requirements were not mandated until The Companies Act of 1900, §§ 63 & 64. John Coffee, Jr., The Rise of Dispersed Ownership: the Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. No. 1 (Oct. 2001) at 42.
an annual balance sheet. The LSE did not take on a stronger self-regulatory role until scandals of the 1920s, which encouraged the exchange to monitor issuer quality, and 1950, which created listing rules requiring the ongoing disclosure of material information. Finally, the U.K. did not have a counterpart to the SEC until the Financial Service Act of 1986.

In the United States the New York Stock Exchange (NYSE) is often presented as an example of a self regulatory organization (SRO) that practices active securities self-regulation. The prominence of the NYSE is in no small part due to the reputational capital it accumulated through its strong self-regulatory stance. The NYSE did not dominate all securities markets in the U.S. through the nineteenth century, for instance the Boston Stock Exchange led industrial securities. However, as the need for railroad capital and the corresponding influence of investment banks emerged the NYSE became the leading U.S. exchange. The NYSE differed from that of other exchanges such as the LSE in that seats were limited and participation had to be gained through the purchase of a seat from an existing member. This exclusivity seems to have encouraged self-regulation and increased the value of reputational capital and

13 Companies Act of 1907 §§19,21. It was not until the Companies Act of 1929 that an income statement and data on earnings was required, Companies Act of 1929, §§19, 20. Self-dealing provisions were not introduced until the 1948 Companies Act. John Coffee, Jr., The Rise of Dispersed Ownership: the Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. No. 1 (Oct. 2001), at 43.

14 Id, 43-44.

15 Id, 44.

16 Having paid more to join the NYSE and holding a valuable transferable seat each NYSE member had a strong reason to self-regulate to protect the value of the seat. Id, 35.

17 Id, 34.

18 In contrast, the LSE was an ‘open’ market where seats were granted comparatively liberally. The limitation on seats at the NYSE led to the growth of financial services firms such as J.P. Morgan & Co, id.35.
created a preference for large, high quality issuers.\textsuperscript{19} The NYSE’s self-regulatory model tended towards exclusivity and led to more stringent rules. For instance, the NYSE listing requirements were seen as more precise than state Blue Sky laws, laying the groundwork for the development of the 1933 Act. In fact it is the establishment of the Securities Act of 1933 and the Securities Exchange Act of 1934 which established the stringent disclosure system which now is generally seen as having the strongest regulatory provisions. After the market devastation of the Great Depression the United States markets worked to maintain their reputational capital in order to secure their prominence in the global securities trading markets, developing the disclosure and enforcement model that was born out of the 1933 and 1934 Securities and Exchange Acts.\textsuperscript{20}

Through this brief historical overview, we can see that stock markets were not always seen as institutions for private investment and that the idea of an exchange to finance the State is deeply rooted in history.\textsuperscript{21} It is clear that stock exchanges as we know it would not have existed but for the advent of state

\textsuperscript{19} Id, 33-35. This preference for large issuers was also an advantage following the Sherman Antitrust Act of 1890, which prohibited cartels (monopolies were prohibited later). The act triggered a wave or horizontal mergers, largely facilitated by the six major investment banks.

\textsuperscript{20} Other sources of securities law that exercise a enforcement-style regulatory mechanism within the U.S. include the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970, the Insider Trading Sanctions Act of 1984, the Insider Trading and Securities Fraud Enforcement Act of 1988 and the Sarbanes-Oxley Act of 2002.

\textsuperscript{21} The history of continental Europe shows an even deeper relationship between the State and the securities market. For instance, French government control of the securities markets was first established in 1141 when Louis VII chartered the Guild of Moneychangers. This state control continued through John Law’s crisis and the creation of Paris’ first stock exchange in 1784 and the through the Napoleonic era where the exchange was used to fund the State’s expansionist policies. This state’s tight grip on the securities markets continued into the late 1980’s when London’s ‘Big Bang’ forced a restructuring and then later when the European Union began its efforts to harmonize financial practices. See for example John Coffee, Jr., The Rise of Dispersed Ownership: the Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. No. 1 (Oct. 2001). The Bourse is held up as a counterpoint to the United States, United Kingdom and Germany maintained a system of competing exchanges. Coffee’s thesis is grounded in LaPorta et al. and puts forth that dispersed ownership and control is necessary for
debt and the need to actively trade state debt. In fact, the securities markets as primarily markets for
companies to raise capital did not emerge until the late 19th century. Even then, it was not until the turn
of the century that diversification of the markets both in terms of company listings as well as in
ownership of securities emerged. Therefore, the mainland Chinese markets—which are primarily
organized to finance state owned enterprises and serve as alternatives to state owned banks—are not
wholly anomalous. Furthermore, securities rules which protect diversified investor ownership are also
recent developments which may not be universal in their utility to all securities markets. On the contrary,
normative reputational sanctions and self-regulation seem to have emerged as early and persistent
regulatory mechanisms.

**Types of Securities Regulation**

Not all securities markets are enforced in the same or similar manner. Not all securities markets have
been formed to serve the private investor nor are regulatory rules all designed to protect private investors
in the market.22 Rather, regulation may promote certain activities, redistribute wealth, protect the public
or protect the system itself from risk. In fact, there are a variety of reasons why securities markets exist
and a number of ways that they function. Thus, there are corresponding measurable differences in
regulatory mechanisms. For example, in the case of China two distinct types of securities markets exist:

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the development of successful securities markets. Coffee is especially interested in the implications for
transitional economies, especially those of Eastern Europe. John Coffee, The Yale L.J. Vol. 111, No. 1

22 However, certain authors have noted that legal rules protecting the rights of investors and minority
shareholders are essential to developing deep and liquid securities markets. See for example John C.
Coffee, *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of
La Porta, Florencio Lopez-de-Silanes, Andrei Shliefer and Robert Vishny. See also La Porta et al.
*Investor Protection and Corporate Valuation* (1999), La Porta et al, *Agency Problems and Dividend
the Hong Kong market is designed to provide substantial protections for individual investors in the market, while the Shanghai and Shenzhen markets were designed to offer a capital raising alternative to the state owned banks. Both the companies and the investors in the Shanghai and Shenzhen markets are primarily state associated entities and the corresponding regulation advances political economic aims. This model of a securities market varies greatly from the U.K. and U.S. models where a securities market exists in order to provide for a capital raising mechanisms for private markets and where regulation focuses on the protection of the general public and the elimination of externalities from financial failures.

Securities sanctions may have different goals and functions. Generally, there are three broad hypotheses regarding the regulation of securities markets: 1) the null hypothesis, in which the optimal approach is to leave securities unregulated, 2) the government standardization of the private contracting framework, and 3) a public enforcement model utilizing an independent and focused regulator. One element that is relatively silent in this framework is the role of private litigation. Another element that must be considered is the background rules or norms that exist regardless of the formal legal structure.

23 See for example, Rafael LaPorta, Florencio Lopez-de-Silanes, and Andrei Shleifer, What Works in Securities Laws? The Journal of Finance, Vol. LXI, No. I (2006). The Null Hypothesis was developed by Coase and Stigler and later developed by Grossman, Hart, Milgrom and Roberts etc. The private contracting model was put forth by Easterbrook and Fischel and the public enforcement model was developed in Landis, Beker, Polinksy, Shavell, Glaeser, Johnson, Sheifler et al, 1-3.

24 La Porta et al. discuss James Landis, the primary author of the U.S. securities laws, as noting the importance of the ease of private recovery of investor’s losses to harness market participant incentives. However, little comparative information is provided on this point, at 5-10. Typically, there is said to no private right of action available in jurisdictions outside the U.S. That being said, the three systems discussed in this paper all offer some type of private right of action for the recovery of investor losses.

Some authors have postulated that norms may matter most when law is weakest. However, it is accurate to say that the background norms always have some effect on the regulation of securities markets.

These background norms often correspond to policy aims. As briefly described in the introduction, there are four general policy aims for financial services regulation: (1) the protection of the general public; (2) the elimination of negative externalities from financial failures; (3) advancing equitable and redistributive goals and (4) promoting certain aspects of political economy. As Howell discusses, the first of these is defined by a level of protection that depends on fully informed and rational actors. The second focuses on the elimination of systemic shocks. The third redistributes economic gain to enhance development or promote certain activities. The fourth represents political compromises, for instance the barriers to the expansion of banks. These policy aims and corresponding background norms can be found in aspects of any one national economy. However, these descriptions are also helpful to understanding overall policy aims and the corresponding norms that underlay and structure securities regulation.

Thus, there is a great variation in both the types and motivations of securities regulation. Markets have different aims and goals and these require different background mechanisms to regulate the securities markets. Various regulatory models meet different needs within markets. For instance, as the historical discussion illustrates, all securities markets have required reputational sanctions to meet their market needs at one point. However, as these markets diversify to meet additional market needs, they

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27 Howell also notes that this method can take on a paternalistic patina where absolute protection is imposed on the public without the benefit of choice, information or consideration of their preferences. Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications, 24 Yale J. on Reg. 253 (2007).

28 Id. This elimination of the cost of failures can be borne if the public demands and receives ex post compensation for failures.
develop different regulatory models. Certain market characteristics require different normative rules. A normative reputational model may be most successful in markets with known actors and centralized control. More homogenous markets may rely more on more normative and reputational sanctions, more diversification in securities markets may require a more regulatory mode. Thus, the next sections will look at the different background mechanisms for securities market regulation including the regulatory model, principled approach and normative reputational system of securities regulation.

**The Enforcement Model**

The enforcement model of securities regulation depends on a discrete system of rules and regulations which are applied specifically to securities markets. Generally these systems are characterized by a detailed system of rules and regulations as well as a dedicated securities enforcement agency. Often such systems are characterized by use of a disclosure model system, under the theory that the free flow of information allows markets to effectively price securities and allocate risks. This disclosure model aims to protect the public by fully informing investors, depositors, insurance policy holders and other actors in the securities markets. The United States has often been described as the epitome of the enforcement model of securities regulation; however it is fair to say that all securities regulatory systems based on the common law model of share certain characteristics of the enforcement model of securities regulation.

Because of the relatively discrete nature of the system of rules and regulations that characterize the enforcement model of securities regulation, regulation intensity is often offered as a measure of the effectiveness of the enforcement model of securities regulation. Regulatory intensity has been measured

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29 For instance, the Scandinavian markets have been noted for their normative function. This has been attributed to their low crime rates and high social cohesion. See also John C. Coffee, *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. Rev. 2151 (2000). See also Coffee regarding the effect of strong social norms on corporate fraud.
though the investment in regulation as well as the number of regulators and the number and sanctions of regulatory actions. Specifically, regulatory intensity measures a variety of inputs including regulatory institution staffing and budgets, and as well as regulatory outputs, such as enforcement actions or monetary sanctions.

Regulation intensity costs may be measurable but may not explain very much. For instance, there are public as well as private regulatory costs that must be taken into consideration when measuring regulatory intensity. For instance, a fraction of the cost of a general counsel’s salary at a financial institution may be a regulatory cost but it is not an easily measurable cost. Furthermore, reputational sanctions are very difficult to measure. Thus, threats or perceived threats to one’s reputation may contain regulatory costs which are not immediately quantifiable. There are many factors other than regulation intensity that may affect regulatory structures such as: differences in composition and sophistication of the financial services industry, differences in regulatory objectives, different national endowments, and different levels of lawlessness of the population. However, these are all very difficult to measure.

Relatively speaking, however it has been noted that the regulatory costs in the United States are substantially higher than those in other states. It’s true that the U.S. spends approximately four times as much.

30 Howell quotes a series of FSA studies designed to estimate the private cost of regulatory compliance can come up with an estimate of £600M, approximately twice the budget of the FSA. Howell Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications, 24 Yale J. on Reg. 253 at 260-261. See also Report of Real Assurance Risk Management Estimation of FSA Administrative Burdens http://www.fsa.gov.uk/pubs/other/admin_burdens.pdf (last viewed March 5, 2011).


much to regulate financial markets as other developed nations. However, the specific cost of securities regulation as measured as costs per billion of stock market capitalization are lower in the U.S. than in Australia, Canada, and the UK while the U.S. costs are roughly equal to those in Singapore and Hong Kong. However, the U.S. also spends a larger percentage of its regulatory agencies budget specifically on enforcement than other states. The U.S. also imposes far greater financial penalties.

There has also been a general consensus that the U.S. leads the world in enforcement intensity of securities regulation. For example, in 2005 the SEC imposed $1.8 billion in penalties as opposed to the £30 million imposed by the FSA, a 60-to-1 ratio. John Coffee has noted in his discussion of enforcement intensity that between 1997 and 2005 U.S. enforcement increased ‘hyperbolically’ and that in comparison the FSA has brought a mere 269 actions (while simultaneously regulating banking,

Additionally, there was an average of 2,824 private actions with $3.5 billion of additional awards. Howell (2007), p. 256. Jackson’s study corrects for the size of financial markets. It may be worth noting that Jackson works with a bias towards exporting models of public enforcement and writes with an idea of influencing how jurisdictions should go about designing financial regulatory systems. Also, the study includes the SEC, CFTC and FDIC, for instance the 2004 SEC budget accounted for only 28% of this total at $1.6M and 16% of total staff.

33 Jackson refers to France and Germany in particular. See Jackson (2007), 257. It is worth noting that these costs do not include the costs of private litigation as a regulatory tool.


35 The FSA spends approximately 8% of its budget on enforcement while the SEC spends approximately 40% of its budget on enforcement. See the comments of John Coffee at the 4th Session on Comparative Law at the 2007 Transatlantic Corporate Governance Dialogue. A transcript of the 2007 Transatlantic Corporate Governance Dialogue on Comparative Law is available online at http://www.ecgi.org/tcgd/2007/transcripts/Session%204%20final.pdf (last viewed February 27, 2010).

36 Once adjusting for market capitalization the ration falls to 10-to-1 but this does not correct for the fact that the FSA covers all financial services and not just securities. See the comments of John Coffee at the 4th Session on Comparative Law at the 2007 Transatlantic Corporate Governance Dialogue. A transcript of the 2007 Transatlantic Corporate Governance Dialogue on Comparative Law is available online at http://www.ecgi.org/tcgd/2007/transcripts/Session%204%20final.pdf (last viewed February 27, 2010).
insurance, pensions and other financial elements) where the SEC brought 630.37 The U.S. has been known for its enforcement model of securities regulation and the model has been critiqued both internationally and within the United States.38 However, given the dominance of the U.S. securities markets the enforcement model has also been widely viewed as the best solution for market regulation.39

Some have postured that the higher regulatory costs of the U.S. model has a global effect that result in a reduction of agency costs for cross-listing foreign firms. The existence of this premium is known as the “bonding hypothesis,” which says that by subjecting themselves to the SEC’s higher disclosure standards and the greater prospect of enforcement in the United States, foreign firms thereby reduce their agency costs.40 This conclusion seems to run contrary to those that have criticized the U.S.’s tough regulatory

37 A transcript of the 2007 Transatlantic Corporate Governance Dialogue on Comparative Law is available online at http://www.ecgi.org/tcgd/2007/transcripts/Session%204%20final.pdf (last viewed February 27, 2010).

38 Roberta Karmel, Regulation by Prosecution (1982). A later article coined the phrase “Regulation by Enforcement.” In that book, Karmel criticized the tendency of the SEC to make policy through enforcement actions. As a result, Karmel found that the SEC was unnecessarily antagonistic towards business. Karmel focused on prosecutions only tangentially related to securities including the extraterritorial reach of the SEC in the 1970’s as they pursued cases regarding bribery in states other than the U.S. See also, James Park, The Competing Paradigms of Securities Regulation, Duke Law Journal, Vol. 57:625. See also Harvey L. Pitt & Karen L. Shapiro, Securities Regulation by Enforcement: A Look Ahead at the Next Decade, 7 Yale J. on Reg. 149, 149 (1990). This article advanced the next variation of the critique. Pitt and his co-author Shapiro used the phrase ‘regulation by enforcement’ to criticize the SEC’s efforts against insider trading and the SEC’s practice of using “enforcement proceedings to develop new legal theories and remedies” creating a problem where the public does not have adequate notice of what qualifies as insider trading.

39 For a summary of securities market indicators see for example the World Federation of Exchanges (WFE) which calculates statistics based on approximately a dozen separate indicators on monthly and yearly bases and in a variety of currencies. See http://www.world-exchanges.org/statistics/ytd-monthly (last visited March 13, 2009). For a discussion of the success of the U.S. model see Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, Law and Finance, The Journal of Political Economy, Vol. 106, No. 6 (Dec., 1998), pp. 1113-1155 The ‘law matters’ theory was developed based on assumptions prevalent in U.S. securities regulation, that legal enforcement is necessary to a well functioning legal system.


Furthermore, it is more difficult to quantify the effectiveness of other approaches to regulation. For instance, a principled regulatory system may not have the same easily determinable inputs and outputs thus the costs may be more difficult to measure. While it is true that the SEC imposed more penalties than the FSA at a 60-to-1 ratio, this does not necessarily show that the principled approach is more effective or efficient. The FSA has designed a system of nine outcome indicators that are intended to measure the effects of the principled approach.\footnote{These indicators have three strategic aims: help retail consumers achieve a fair deal; promote efficient, orderly and fair markets; and improve our business capability and effectiveness. The indicators are listed in the FSA’s publication \textit{Principles-based Regulation: Focusing on the Outcomes that Matter} (2007). Available online \url{http://www.fsa.gov.uk/pubs/other/principles.pdf} (last viewed March 14, 2009).} However, these indicators are very difficult to compare with other regulatory regimes. Perhaps the best measure of the effectiveness and efficiency of a principles system is the general success of the securities market, which also is difficult to measure.

The costs of normative reputational measures are still more difficult to quantify. While measurable costs regarding enforcement intensity in the Shanghai and Shenzhen markets are difficult to determine, the anecdotal information that is available points to much lower costs in terms of enforcement budgets but perhaps higher reputational costs which reverberate through the market to produce higher contracting and borrowing costs.
Thus, it seems that certain types of securities regulation is easier to measure than other types. Discussions regarding regulation intensity have often privileged the enforcement model of securities regulation due to the easily quantifiable nature of the inputs and outputs. On the other hand, measurements of effectiveness for other types of regulatory approaches, such as the principled and the normative reputational approaches are more difficult to quantify. As an example, the measures that have been developed to analyze the success of the British approach, such as the FSA’s outcome indicators, are at least somewhat indeterminate and do not lend themselves easily to cross-comparison.

The Principled Approach

Principled-based enforcement actions offer a more confrontational approach directed at conduct that violates societal values, reflecting what some have called the ‘public values paradigm’.43 While there is no clear line between a principled approach and an enforcement rule-based approach, a principled approach intends to use more broad guidelines rather than specific standards. A common analogy is a reference to speeding limits where an enforcement based model would say ‘do not exceed 55 miles per hour’ while a principled approach would say ‘do not exceed a reasonable speed given the conditions’. According to the Financial Services Authority (the FSA) principles-based regulation means moving away from dictating through detailed, prescriptive rules and supervisory actions regarding how firms should operate their business in order to give firms the responsibility to decide how best align their business objectives and processes with the specified regulatory aims.44


The effect of the principled approach is often characterized colloquially as ‘the raised eyebrow of the regulator’ where the regulator may note that a principle has been compromised without beginning a formal action. Rather, the very action of noticing the potential infraction is deemed enough for the violator to take action to cure the deficiency. The principled approach is widely seen as compatible with the U.K.’s traditional self-regulatory approach. The traditional self-regulatory approach in the U.K. points to a regulatory philosophy within the U.K. where regulatory officials prefer to resolve investigations without formal actions. Private parties often take steps to cure the deficiencies indicated by the regulatory officials without formal compulsion.  

Prior to the Financial Services Act of 1986, U.K. regulation did not rely on a comprehensive securities act and rather depended on SRO listing standards and the importance of self-regulation by market players. This regulatory framework was strengthened in 2000 through the Financial Services and Markets Act (FSMA), which enhanced investor protection and eliminated the complex system of overlapping self-regulation. The Financial Services Authority (FSA) in the UK moved to a ‘principled approach’ system in 2003. This move to a principled approach has been correlated with a shift of IPOs from the U.S. to U.K. markets. The principle based approach is not unknown in the U.S. and has been adopted by some U.S. agencies such as the Commodity Futures Trading Commission (CFTC).

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45 For example, in 2005-2006 64% of the FSA’s cases are resolved without the use of formal sanctions. See Financial Services Authority Annual Report 2005/2006, available online http://www.fsa.gov.uk/pubs/annual/ar05_06/ar05_06.pdf (last viewed March 13, 2009).
The FSA clearly outlines its expectations in terms of principles rather than detailed rules. The FSA simplified and updated its listing company rules between 2002 and 2005 reducing the length of the rules by 40% and adding six listing principles and guidance. Much of this revisiting of the FSA rules coincided with the implementation of European Union directives regarding financial markets. The FSA legal reform is ongoing, as the FSA states that it “…over the next few years we will move to more principles-based regulation, supplementing our risk-based and evidence-based approach.”

However, it must be considered that there is some evidence that the development of EU law has allowed for the growth of the principled approach. EU company law essentially adds a layer of governance over the U.K. regulation. EU company law intends to ensure the freedom of establishment for companies throughout Europe, provide for protection for shareholders and stakeholders, foster efficiency and competitiveness of business and promote cross-border cooperation between companies in different Member States. The Financial Services Action Plan of 1999 (FSAP) aimed to eliminate market

48 See 11 key principles and their definitions In the FSA Handbook, available online at http://fsahandbook.info/FSA/html/handbook/PRIN/2/1 (last viewed February 26, 2010). The FSA outlines its key principles in section 2.1.1 of this handbook. This section describes 11 principles, and the next section provides guidelines for the application of the principles.


50 E.U. Directives require member states to implement polices to reach a certain result but do not dictate the means of implementation.

fragmentation and reduce the costs of raising capital, creating a relatively comprehensive EU financial and securities law based on detailed disclosure requirements.\textsuperscript{52}

Furthermore, the 2001 Lamfalussy Report created a four part financial law making procedure to more efficiently harmonize financial law and streamlined the process to meet EU financial policies and goals.\textsuperscript{53} The process involves a variety of actors including the European Securities Committee (ESC), the European Banking Committee (EBS), The Committee of European Securities Regulators (CESR) and the Committee of European Banking Supervisors (CEBS).\textsuperscript{54} The EU perspective seems to be that the approach has been successful with the FSAP making the European harmonization broader and the Lamfalussy approach making it deeper. Some authors have criticized the EU approach as going too far and being too rigid, technical and detailed.\textsuperscript{55}

Thus, while a more principled approach may be favored and much may be made out of the ‘raised eyebrow of the regulator’ rather than clear enforcement actions there is still a detailed and technical full-disclosure securities regime enacted at the European level. The technical securities regulatory approach of the European Union has undoubtedly allowed for a more ‘principled’ approach at the national level.

\textsuperscript{52} Mathias M. Siems, \textit{The Foundations of Securities Laws} (2008), 25. The 42 measures of the FSAP were completed in 2005. For a discussion of the disclosure oriented focus of the regulations see \textit{id} at 28.

\textsuperscript{53} \textit{Id}. At the first level framework directives or regulations are promulgated, at the second level the Commission and committees adopt implementing rules, the third level the committees provide recommendations, guidelines and common standards and at the fourth level the commission enforces the more detailed European law.

\textsuperscript{54} The Commission Decision 2001/528/EC of June 6, 2001 created the ESC; Commission Decision 2004/10/EC of November 5, 2003 established the EBC; Commissions Decision 2001/527/EC of June 6, 2001 established the CESR and the Commission Decision 2004/5/EC of November 5, 2003 established the CEBS.

\textsuperscript{55} Siems (2008), p. 27. Siems quotes the critiques of G. Ferrarini an N. Maloney regarding this revised framework. There is also a critique regarding the lack of transparency and democracy in the approach as the EU Parliament has a limited role.
Thus the multilayered governance model of the European Union may have had a liberalizing influence on the national regulation of the U.K. Thus, the measurement of enforcement intensity that may indicate the success of a more principled approach would necessarily take into consideration not only the FSA involvement in enforcement but also a variety of EU actors who are involved in both the promulgation of rules and the guidelines for enforcement.\textsuperscript{56}

Furthermore, it is much more difficult to quantify the ‘raised eyebrow of the regulator’ than it is to measure the costs of specific enforcement actions. Thus, the principled approach is by its very nature more difficult to measure than the regulatory approach. Inputs and outputs are simply less discrete and thus less measurable. As is mentioned in the discussion of effectiveness in the section on regulatory approaches, the FSA has developed a number of indicators that purport to measure the effects of the principled approach.\textsuperscript{57} However, the indicators are not easily quantified and do not easily correlate to the metrics used in enforcement intensity. Thus, while a conceptual comparison between the principled and enforcement approaches can be made a quantitative comparison is difficult.\textsuperscript{58}

\textbf{The Normative Reputational System}

\textsuperscript{56} See Howell Jackson and John Coffee for a detailed discussion of enforcement intensity. A transcript of the 2007 Transatlantic Corporate Governance Dialogue on Comparative Law is available online at http://www.ecgi.org/tcgd/2007/transcripts/Session\%20final.pdf (last viewed February 27, 2010).

\textsuperscript{57} See note 58 above.

\textsuperscript{58} That being said, La Porta et al. compare the British and U.S. systems. However, the system is flawed in its assumptions, which attempt to quantify specific regulatory structures which are based on US law. See for example the Siems critique of La Portal et al in note 7 and Mathias M. Siems, \textit{What Does Not Work in Comparing Securities Laws: A Critique on La Porta’s Et Al’s Methodology}, International Company and Commercial Law Review 2005.
As can be seen in the historical analysis, the normative reputational sanctions of the securities market has been the dominant method of regulation over time.\textsuperscript{59} The normative reputational model depends on the actors in the system adopting and adhering to norms where the primary sanction on transgressions is damage to reputation. It is clear that the LSE grew out a normative reputational model and that the same model was adopted in the early operations of the NYSE. The regulatory model of securities regulation emerged much later, finally coalescing towards the beginning of the twentieth century. It is also clear that historically a variety of actors have enforced the normative reputational model, whether the enforcement came from SROs or market peers, such as the investment banking model that grew out of the early development of the NYSE.\textsuperscript{60} It is also clear that the early model of the British securities markets also depended on a traditional self-regulatory model which depended on normative reputational sanctions that then grew into a principled approach. It has also been noted that certain smaller securities markets, such as the Scandinavian markets, rely largely on normative reputational sanctions.\textsuperscript{61} However, the most interesting application of the approach in contemporary securities markets is probably the Chinese model.

The Chinese securities markets differ from those of the previous examples above in that it possesses a variety of exchanges that cater to both public and private actors. The Hong Kong Exchange (HKSE) is an established exchange with well developed protections for both private and minority investors. The HKSE can be characterized as an exchange that focuses on private actors with strong


\textsuperscript{61} For a brief discussion of the Scandinavian model see id at 2167.
enforcement mechanisms. On the other hand, the Shanghai and Shenzhen markets have less well
developed formal investor protections, operate to primarily serve public investors, and are use a
normative and reputational approach to regulation. Thus, the regulation of Chinese exchanges is both
complex and multifaceted. The regulatory system is also difficult to understand due to the general lack of
public information readily available regarding the regulation of securities markets.

The HKSE was first established in 1891, formalizing exchanges that had been in place since the
1860’s. The HKSE was largely untouched by government regulation until the mid-1970’s. The HKSE
followed the typical common law model and was largely a self-regulating system, operating under some
of the same principles as the LSE. The principal regulator of Hong Kong’s securities and futures markets
is the Securities and Futures Commission (SFC), which is an independent statutory body established in
1989 by the Securities and Futures Commission Ordinance (SFCO). The SFCO and nine other securities
and futures related ordinances were consolidated into the Securities and Futures Ordinance (SFO), which
came into operation on April 1, 2003.

Hong Kong is included in La Porta et al. (2006), 15. The HKSE indicators Indicies of Regulation of
Securities Markets show high disclosure requirements (.92 compared to the U.S. 1.00); Liability Standard
(.66, equal to that of the U.K.); rule making power (1.00 compared to the U.S. 1.00); investigative power
(1.00 compared to the U.S. 1.00); criminal sanctions (1.00 compared to the U.S. 1.00); and public
enforcement (.87 compared to the U.S. .68). It is worth noting that Hong Kong scores rather law in
‘Supervisor Characteristics’ (.33 compared to 1.00), where the supervisor characteristics is the arithmetic
mean of appointment, tenure and focus. Other definitions are found on page 7. It is also worth noting
that Hong Kong seems to have the highest regulatory cost per billion of GDP, for the purposes of
comparison, Hong Kong’s costs are $663,341 as opposed to the U.S. $497,984. Thus, comparatively, the
HKSE can be fairly characterized by a enforcement intensive approach to securities regulation.

The mainland Chinese markets are omitted from many of the leading studies of securities markets
including recent studies by La Porta et al.

http://www.sfc.hk/sfc/html/EN/aboutsfc/background/background.html (last viewed March 12, 2009) as
well as http://www.hkex.com.hk/rulereg/introreg/introreg.htm (last viewed March 12, 2009). See also
The mainland Chinese securities markets, on the other hand, tell a different story. It is no doubt that the mainland securities markets can be considered successful. They have undergone impressive growth. Since the opening of Chinese markets in 1978, the Chinese economy has grown at an average rate of 10%. The mainland Chinese securities markets are generally younger than other international exchanges, having developed after the economic shock of the Great Leap Forward and have developed at a very rapid rate. It has been reported that the Shanghai and Shenzhen exchanges—together capitalized at $3.9 trillion—are the third largest in the world after the U.S. and Japan. This has been accomplished “without a legal system which meets conventional notions of functionality and predictability”. In terms of securities regulation, there are no full-disclosure laws and investment risks include full-blown Communist expropriation, bad accounting, insider trading, market manipulation and fraud. However, the one check that these comparatively successful securities markets have had are normative reputational sanctions.

Unlike the market privatizations in Russia and Eastern Europe, the Chinese impetus to create mainland securities markets was not to move assets from state control to private hands rather the markets were created to create an alternative to the debt financing provided by China’s state owned banks.

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66 *In the stocks: Shame fills a vacuum in China's financial law enforcement*, the Economist (February 28, 2008, print edition). This excludes the HKSE, which is capitalized at US$2.124 trillion, the fifth largest international exchange.

67 Milhaupt and Pistor, 125.

68 Milhaupt and Pistor. Specific indicators regarding the securities markets are not included in other studies such as LaPorta et al.

69 Milhaupt and Pistor, 138. This is a different view from other scholars who have stated that the strongest of these Chinese markets developed in 1990 in order to access private resources to fund the restructuring
Thus, these exchanges are not characterized by a desire to create ‘deep and liquid’ securities markets. Rather the mainland markets were intended to develop alternative forms of financing for state owned and operated enterprises. In fact, nearly all of the companies on the Shanghai and Shenzhen exchanges are owned by the state and only 40% of the shares are traded and 60% of the shares are held by the state or state controlled agents. Many of the listed companies consist of monopolies on key sectors of the Chinese economy. The corporate governance model has been characterized as ‘administrative’ one with a high level of centralization and coordination and not one given to the development of protections for private investor rights.

This administrative model is characterized by strong mechanisms of state control and vertical regulatory mechanisms where the State exhibits extensive influence on the securities markets. The China Securities Regulatory Commission (CSRC) was created to regulate the markets in 1992. The Shenzhen and Shanghai markets were under the oversight of local governments until they came under the CSRC in 1997. The CSRC uses three mechanisms to exercise its regulatory power: correction orders, formal

70 La Porta et al. have put forth that legal rules protecting the rights of investors and minority shareholder are essential to creating deep and liquid securities markets. See note 22.


72 Milhaupt and Pistor, 143. For more on how China’s administrative structure governs the securities markets see Pistor and Xu (2005) who argue that administrative governance built on the quota system allowed the Chinese market to avoid information problems investors face and created incentives for local bureaucrats to choose the best IPO candidates, Pistor and Xu (2005), 185.

73 The exchanges are becoming more somewhat more autonomous, for example, have been able to delist companies, suspend listings and suspend trading since 2005, previously only these powers belonged to the CSRC, see the 2005 Securities Law Article 56, 60 & 61. However, the CSRC still retains the power to appoint senior exchange officials and is under the control of the CSRC.
warnings or fines and may prohibit individuals from serving as senior manager or director of a company.\textsuperscript{74}

The stock exchanges still exhibit some of the characteristics of SRO’s and have four mechanisms with which they regulate companies: they give oral warnings, letters of oversight and supervision, notices of criticisms, and public criticism.\textsuperscript{75} Generally sanctions are issued for six different reasons: false or materially misleading disclosure, inaccurate or late profit forecast, failure to make timely disclosure of major corporate matters, failure to undertake approval procedures for related party transactions, failure to issue periodic reports on time, and failure to carry out other legal obligations.\textsuperscript{76} It is also worth noting that the exchanges do not sanction at the same rate, the Shenzhen market sanctions at about twice the rate of Shanghai despite having fewer companies.\textsuperscript{77}

Despite the lack of specific legal investor protections, in 2001 the first investor lawsuits were brought against Shenzhen and Shanghai traded securities.\textsuperscript{78} The Supreme People’s Court first denied the actions on the basis that there were regulatory uncertainties, however, the Court partially reversed itself within a year allowing the lower courts to hear suits involving false or misleading statements if the firm had been previously sanction by the CSRC or the ministry of finance or if the principals had been found

\textsuperscript{74} Liberman & Milhaupt, p. 941. Fines range from 300,000 to 600,000 yuan, approximately $42,000–$85,000. There are relatively few of these mechanisms used, Liberman & Milhaupt present a table of sanctions which shows a total of 17-49 enforcement actions in each year from 2001-2006.

\textsuperscript{75} Liebman and Milhaupt note that the Chinese word for sanction and public criticism or public censure is similar, 947. The practice of public criticism originated in the London Stock Exchange. It was extended in the Financial Services and Markets Act, under which the Financial Services Authority (FSA) may publicly censure any director knowingly involved in a breach of the stock exchange listing rules. This practice supplements other sanctions. The Hong Kong Stock Exchange borrowed this practice and the two Chinese stock exchanges, in turn, modeled their practice on Hong Kong, 948.

\textsuperscript{76} This list was compiled by Liebman and Milhaupt and does not seem to be codified, 942.

\textsuperscript{77} Id, 957. Shenzhen also specializes in smaller companies than the Shanghai exchange.

\textsuperscript{78} See for example Pistor and Xu (2005), 194 for a table of private enforcement lawsuits in China.
criminally liable. The suits were only brought against approximately 20% of the companies eligible to be sued. There is no class action model in China, however a type of collective action may be brought. Thus there are formal legal rules—both public and private—that provide for legal securities regulatory sanctions.

However, there is significant evidence that reputational sanctions play a very important role in the regulation of Chinese securities markets. In fact, public criticisms issued by the Shenzhen and Shanghai stock exchanges have had a significant effect on the development of the Chinese stock market and securities regulation. It has been noted that reputational sanctions within the Chinese market have rippling effects through the securities market and have significant secondary effects in corporate life as well as in private social interactions. Some postulate that the generally weak legal enforcement has encouraged the development of other sources of securities regulation. Sanctions by Chinese exchanges coupled with shaming in the media have become central to the system of securities regulation.

79 Milhaupt and Pistor, 143.
80 Milhaupt and Pistor, 2008.
82 Benjamin L. Liebman and Curtis J. Milhaupt, Reputational Sanctions in China’s Securities Market, Columbia Law Review Vol. 108:929. It should be noted that these are very young stock markets, the Shanghai Stock Exchange was established on November 26, 1990, and the Shenzhen Stock Exchange was established on December 1, 1990, id p. 934.
83 See Katharina Pistor & Chenggang Xu, Governing Stock Markets in Transition Economies: Lessons from China, 7 Am. L. & Econ. Rev. 184, 185 (2005) (“China has only slowly developed a legal framework for stock markets and has a weak law enforcement record.” See also the La Porta et al index which ranks Chinese protections as very low.
84 However, China’s two stock exchanges are not independent of the state and lack significant autonomous regulatory authority, thus Chinese SROs are not necessarily exercising a non-governmental role, Libman & Milhaupt, p. 931.
Companies on the Shanghai and Shenzhen securities markets are required to disclose both the fact that they have been subject to criticism from the stock exchange and the reasons for such criticism. Criticisms, particularly multiple ones, can signal the designation of a company’s stock as high risk by the stock exchange. Perhaps more importantly, the criticisms are virtually always reported in the Chinese media. These public criticisms are especially damaging given the role of reputation in Chinese society. The effects of the stock exchange criticisms extend beyond investor protection. The CSRC now ties capital raising and independent director criteria to the stock exchange sanctions. Furthermore, the central bank is making use of the information in building a national credit rating system, and banks seem to make loan decisions based on public criticism.

As a necessary corollary, the Chinese media enjoy significantly more autonomy in reporting financial misconduct than they do reporting on most other areas. According to Liebman and Milhaupt, “…the media are perhaps the most effective regulator of corporate wrongdoing in China today. China’s leadership has clearly recognized the valuable role the media can play in curbing corporate misdeeds—even as they continue to limit the media’s ability to report on many other areas.”

Thus, it would seem that the reputational and normative sanctions issued by the exchange and publicized through the media have had a variety of regulatory effects. Such reports result not only in a signaling of an increased risk of a stock, but the cost of raising private capital through other means increases, individual director’s credibility is called into question and any available credit ranking is likely to decrease. Thus, these normative sanctions seem to have real regulatory effects that ripple through the system providing a regulatory mechanism.

Historically shaming played an important role in China’s legal system including the wearing of the cangue in the imperial Chinese legal system and prior to the reform era. Shaming as a mechanism of political and social governance played a major role during the Cultural Revolution, suggesting some type of cultural or social affinity for this tool of public ordering.

\[85\] Historically shaming played an important role in China’s legal system including the wearing of the cangue in the imperial Chinese legal system and prior to the reform era. Shaming as a mechanism of political and social governance played a major role during the Cultural Revolution, suggesting some type of cultural or social affinity for this tool of public ordering. 979.

\[86\] *Id* 980.
Securities regulation is often characterized as most successful when laws protecting the private and minority investors are the strongest. While this holds true for the U.S., U.K. and even Hong Kong securities markets, the mainland Chinese markets are clearly divergent. The Shanghai and Shenzhen markets clearly follow a path led by ‘Capitalism with a Chinese Face’. As these markets are very young and rapidly developing they may still transition to the dominant common law model protecting private and minority investors. However, it may also be the case that the Chinese markets will continue to adopt policies found most conducive to their goals.

It would seem that the normative reputational sanctions of the mainland Chinese securities markets may continue to find laws and policies that can be adapted to their specific economic needs. For instance, the policy of normative reputational sanctions seems to have originated in the self-regulated U.K. markets, had been transplanted to the Hong Kong market and then adapted by the Chinese markets. Given the sheer size of the mainland Chinese markets coupled with their successful economic hybrid approach, successful new economic policies may emerge in a similar fashion. The question of what economic policies are successful within the Chinese markets and why are clearly outside the scope of this project. However, the normative reputational sanctions seem to be built on a traditional Chinese shaming model and at first glance do seem to be effective. It is not clear that external economic policies will force a change in Chinese policy that is more in line with global securities regulation norms.

**Conclusions**

The broad panopoly that is securities regulation depends on a wide variety of sanctions regulatory mechanisms. As is discussed in this paper, securities regulation may follow an enforcement model that lays out detailed system of rules and regulations imposes heavy legal sanctions for violations. Or, securities regulation can follow a more principled approach which relies more on the ‘raised eyebrow of the regulator’ than imposing sanctions. Finally, we look at the normative reputational system where any perceived infractions are reported through the media and subject to personal and professional sanctions.
It is not useful to determine if any one of these systems is more or less ‘developed’ or preferable. Rather, the juxtaposition of these differing methods of securities regulation provides an insight into the essential characteristics of each system. While some authors have attempted to evaluate comparative securities system based on metrics of regulatory intensity, as is discussed in the section on the enforcement model, these factors are specific to systems that offer easily quantifiable regulatory factors. The principled approach and the normative reputational system are less easily quantifiable than the enforcement model of enforcement.

The regulatory model of securities enforcement often becomes the baseline for metrics of comparative securities system because of its easily quantifiable measures of success. This method of comparison may privilege the enforcement model of securities regulation and does not provide a full understanding of how securities regulation really works. Rather, by comparing the U.S. enforcement model, the U.K. principled approach and Chinese normative reputational system a fuller understanding of how securities regulation really works.

Furthermore, by looking at the development of securities law we see that the purposes of securities regulation are many. Not all systems aim to protect the individual investor, rather systems may operate to protect state-owned companies, institutional investors or a number of other actors. Thus, while certain regulatory structures may develop deep and liquid securities markets, this is neither the intent nor the effect of all securities regulation. The normative reputational system, which developed the London Stock Exchange (LSE) and played a leading role in the development of the exclusivity of the New York Stock Exchange (NYSE) did not encourage investor diversification.87 Rather, the system depended on the

87 The investment bankers in the United States operated as agents of European concerns and then developed exclusive, reputation driven exchanges such as the NYSE. The NYSE differed from that of other exchanges such as the LSE in that seats were limited and participation had to be gained through the purchase of a seat from an existing member. This exclusivity seems to have encouraged self-regulation and increased the value of reputational capital and created a preference for large, high quality issuers. For
peer reputations of the limited number of known players in the market. This same normative reputational system is also used in contemporary mainland Chinese markets. This mainland Chinese approach is also similar to the approach of the historical continental European markets and grows out of the same concern for State fundraising.

As is described in the section on the normative reputational system, the Chinese securities markets grew out of a desire to offer fundraising mechanisms other than those of the state controlled banks. The historic State-centric administrative approach of continental Europe also grew out of a concern to fund state activities. The mainland Chinese system is similar, although the activity that the Chinese wish to fund is the economic growth of state owned businesses rather than purely Statist expansionist policies that were behind the development of continental European securities regulation.88

The underlying policy reasons for securities norms seem to derive from four distinct social benefits. These benefits include the: protection of the general public, elimination of negative externalities from financial failures, advancing various equitable and redistributive goals and promoting certain aspects of political economy.89 Each of these policies offers different social benefits. It is likely that distinct social

more on the growth of the normative reputational system on the NYSE see John Coffee, Jr. The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. at 34-36.

88 Of Course, China possesses securities markets that employ a variety of regulatory approaches. The Hong Kong market, for instance, employs what can be considered an enforcement approach while the mainland Shanghai and Shenzhen markets employ quite different regulatory mechanisms utilizing an administrative approach with a focus on reputational and normative sanctions.

benefits are best served by specific regulatory securities mechanisms as markets diversify and serve different needs and actors.

Thus, to achieve a fuller understanding of how securities regulation really works one must do away with the assumption that all markets serve the same policy aims equally. In order to fully understand securities markets in comparison, there must be an acknowledgement that the U.S. enforcement model may aim for more protection of the general public, the principled approach may weigh differently the elimination of negative externalities and the Chinese normative reputational system may privilege certain types of political economy and state interests. Only through a comparison of the underlying regulatory, principled and normative approaches through the lens of a structural and historical analysis can we truly understand how securities regulation really works.