Chinese Reverse Mergers, Accounting Regimes, and the Rule of Law in China

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CHINESE REVERSE MERGERS, ACCOUNTING REGIMES, AND THE RULE OF LAW IN CHINA

By Benjamin A. Templin†

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INTRODUCTION

In 2010, federal regulators and politicians became increasingly concerned over the accounting practices of Chinese companies that trade on U.S. stock exchanges.1 In particular, the Securities and Exchange Commission (“SEC”) targeted

1 For purposes of this article, the use of the words “China” or “Chinese” refers to the People’s Republic of China and not Taiwan.
companies that went public through a process called the reverse merger. The instances of fraud became so widespread, regulators and commentators coined the term Chinese Reverse Merger (“CRM”) in order to describe a sector where investors assume the risk of accounting irregularities. Although CRMs must comply with international accounting standards, a weak rule of law in China has resulted in poor implementation and enforcement of its accounting regime. U.S. regulators are hindered in policing accountants since the auditing occurs in China, where they have no jurisdiction. This article explores two related questions: (1) the degree to which China’s weak rule of law as to its accounting regime can be explained by its political economy, and (2) whether U.S. regulatory actions and market responses might help drive change in the quality and enforcement of accounting laws in China?

Part I of this Article provides an account of how Chinese companies access U.S. stock exchanges, the rise of CRMs and the emergence of the accounting scandal. In Part II, the Article discusses different theories in comparative capitalism studies to determine whether the degree to which a country has a strong rule of law is determined by its political economy. Part III contains an analysis of the societal, economic, legal, and political causes of China’s weak accounting regime. Part IV examines the degree to which the U.S. regulatory and market responses to the CRM scandal might help drive institutional change in China.

I. CHINESE COMPANIES TRADING ON U.S. STOCK EXCHANGES

The globalization of the world’s capital markets and China’s transition to a market economy has led to an increase in the listing of Chinese companies on U.S. stock exchanges. Although these companies must comply with U.S. securities laws which require rigorous review of a company’s accounts, the actual audits of U.S.-listed Chinese companies naturally occurs in China under that country’s accounting regime. While China has adopted laws that align with some modern accounting stan-
standards, lax enforcement and an ill-equipped accounting profession has led to material mistakes and, in some cases, fraud. This section examines the different ways in which foreign companies list on U.S. markets, and the development of the CRM accounting scandal.

A. American Depositary Receipts

Foreign companies have historically participated on American exchanges primarily through the use of American Depositary Receipts (“ADRs”). ADRs are not actual shares of a company’s stock but represent a claim for shares of a foreign stock. A U.S. financial institution holds the actual foreign shares in trust for the holder of the ADR. Since ADRs are denominated in U.S. dollars and trade on a U.S. exchange, it is often easier for U.S. investors to hold ADRs than to hold the actual foreign stock. For example, if a U.S. investor wanted to purchase shares in the Chinese oil company PetroChina, one of the biggest companies in the world by market capitalization, it would be easier to purchase the ADRs listed on the New York Stock Exchange using U.S. dollars than to purchase the shares using foreign currency on the Hong Kong or Shanghai stock exchanges, where the company also lists shares.

ADRs are a tool that companies and investors use to help globalize the world’s capital markets. ADRs allow foreign companies to raise capital, achieve liquidity for its shares and raise its profile in the United States. Additionally, U.S. investors benefit when purchasing foreign securities in two ways: (1) by diversifying to limit the risk of a domestic downturn and (2) by participating in growth overseas.

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3 Id. at 49.
4 Id. at 52.
5 International Investing, SEC. & EXCH. COMM’N.
U.S. stock exchanges are one of the most fluid and liquid capital markets in the world, in large part because of the high degree of disclosure provided by the securities laws. The Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") work in tandem in an attempt to require companies to disclose all material financial information to investors.\(^6\) While the U.S. system is far from perfect—as witnessed by the financial crisis of 2007-2009 and numerous accounting scandals over the last decade—the system as a whole is designed to create liquidity and protect investors from fraudulent promoters by providing full and fair disclosure.\(^7\)

Naturally, in order to raise capital in the United States, the foreign company, or in SEC parlance, the "foreign issuer,"\(^8\) must comply with the registration, disclosure and listing requirements imposed by the SEC and the relevant stock exchange.\(^9\) The SEC disclosure system varies somewhat for for-

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\(^7\) The U.S. securities laws evolve as the market changes, but the general principles of investor protection remain the same. See generally JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (3rd ed. 2003). Accounting scandals at several companies, including Adelphi, Enron, Global Crossing, Tyco, Qwest and WorldCom led to increased scrutiny and regulation in the form of the Sarbanes-Oxley Act of 2002. Kevin W. Kelley, The Sarbanes-Oxley Act and Foreign Private Issues, in U.S. SECURITIES LAWS AND FOREIGN PRIVATE ISSUERS 211, 211 (Brian Lane ed., 2007). The Sarbanes-Oxley Act provides only limited exemptions for foreign issuers. Id. at 213.

\(^8\) For purposes of the securities laws, "foreign issuer" is defined as “any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country.” 17 C.F.R. § 230.405 (2011).

\(^9\) Christopher J. Walton, Rights Offerings, Spin-offs and other Corporate Transactions for Foreign Private Issuers with US Shareholders, in U.S. SECURITIES LAWS AND FOREIGN PRIVATE ISSUERS 109, 167 (Brian Lane ed.,
eign issuers—attempting “to balance the goal of investor protection . . . with the free trade goal of facilitating the free flow of capital among nations, a goal that suggested reducing the reporting burdens of foreign private issuers.”

The Securities Act of 1933 provides that any offer or sale of stock in the United States requires that the issuer file a registration statement with the SEC or have a valid exemption.

Filing a registration statement in an initial public offering is a costly and timely process regardless of whether the issuer is foreign or domestic.

B. Reverse Mergers

In recent years, however, Chinese companies that want to raise capital in the United States have turned to using a reverse merger instead of ADRs in order to merge Chinese operations into the shell of an already listed U.S. company. Reverse mergers are an alternative way for private companies to go public without incurring the time and expense of having an initial public offering (“IPO”).

In a reverse merger, an established private company merges with a shell company that has zero or only nominal operations and assets. The shell company, however, does have registered securities that comply with the Exchange Act. The shell may have been formed solely for the purpose of doing a reverse merger or it may have ceased operations. In the former case, promoters who specialize in reverse mergers form the company and bring it public cheaply, because compliance with the Exchange Act is much easier if the company has no operations. In the latter case, promoters

2007).

14 See id. at 743-45.
15 Id. at 744.
purchase the shares of a company that once was active, but which has ceased operations.\textsuperscript{16} Since the company has no operations, it will often trade for a fraction of a penny per share on the over the counter bulletin board, thereby making the acquisition of a public company inexpensive for the promoter.

A reverse merger is generally considered to be less expensive than an IPO and can be done more quickly.\textsuperscript{17} No new funds are raised with a reverse merger, however, unless it is accompanied by a securities offering, such as a PIPE financing.\textsuperscript{18} Moreover, unlike an IPO, there is likely no underwriter who keeps an active market in the shares; consequently, there may not be much liquidity for a company that has gone public through a reverse merger. Generally, there is a stigma associated with reverse mergers that may depress the share price.\textsuperscript{19} The reason for the existence of reverse mergers is

\textsuperscript{16} Id. Although the company has ceased operations, the shares may still trade on the over-the-counter exchange. \textit{Id.} at 745.
\textsuperscript{17} Id. at 748. Some experts estimate that a reverse merger “can take as little as three months and cost under $1 million in fees.” Dune Lawrence, \textit{Worthless Stocks from China}, BLOOMBERG BUSINESSWEEK (Jan. 13, 2011, 5:00 PM), http://www.businessweek.com/magazine/content/11_04/b4212058566865.htm.
\textsuperscript{18} Sjostrom, \textit{supra} note 13, at 749. PIPE (short for Private Investment in Public Equities) is one method by which a public company raises capital. In a typical PIPE financing, securities are initially sold as unregistered shares—i.e. the shares cannot be traded on a public exchange—to a small group of sophisticated investors in order to qualify for an exemption from the registration requirements of the securities laws. After a holding period elapses, the shares are later registered thereby making the PIPE issued stock publicly tradable. PIPEs legally skirt some of the more rigorous registration regulations of a direct public offering; thereby raising concerns about potential fraud. William K. Sjostrom, Jr., \textit{PIPEs}, 2 ENTREPRENEURIAL BUS. L.J. 381, 383 (2007).
\textsuperscript{19} See, e.g., Aden R. Pavkov, \textit{Ghouls and Godsend? A Critique of “Reverse Merger” Policy}, 3 BERKELEY BUS. L.J. 475, 488 (2006). Not everyone is critical of the PIPE structure of financing. Some practitioners maintain that PIPE provides an important financing outlet for companies that need to raise
to make the public markets available to “embryonic companies with high growth potential” which would not otherwise attract the attention of the investment bankers who guide companies through the process of an IPO.  

“Small cap” Chinese companies seemed to align with the policy goals behind reverse mergers well and began to take advantage of the transactional structure in large numbers after China loosened restrictions on the ability of Chinese companies to go public on foreign exchanges through reverse mergers in 2005. While some companies operating “a business in a ‘sensitive industry,’ or which incorporates a well-known Chinese brand” have to receive government approval, most companies seeking a reverse merger merely need to file registration forms with the State Administration of Foreign Exchange office, the PRC’s central government agency regulating foreign exchange. Although the Chinese government has historically been worried about foreign ownership of Chinese companies, the loosening up of the rules was seen as assisting small “companies in obtaining growth capital and investment liquidity.”

From January 1, 2007, to March 31, 2010, there were 159 Chinese companies that accessed U.S. markets through money quickly and that shareholders ultimately benefit if the markets provide a way for a cash-strapped to remain liquid. Douglas J. Hoffer, Quagmire: Is the SEC Stuck in a Misguided War Against PIPE Financing?, TRANSACTIONS: THE TENN. J. OF BUS. L., Spring 2011, at 9, 11-12. Pavkov, supra note 19, at 489.

21 David N. Feldman, China: Land of the Panda, the Great Wall, and Reverse Mergers, 1757 PRACTICING L. INST. CORP. L. AND PRAC. COURSE HANDBOOK SERIES 197, 200 (2009). The actual definition of “small cap” varies but a company is generally considered to be “small cap” if the market capitalization is between $300 million and $2 billion. Definition of ‘Small Cap,’ INVESTOPEDIA.COM, http://www.investopedia.com/terms/s/small-cap.asp#axzz1DwGdH00 (last visited Feb. 11, 2012).

22 Feldman, supra note 21, at 199-200.

23 Id. at 202.
reverse mergers, whereas only 56 Chinese company had IPOs during the same period.  Given the number of reverse mergers involving Chinese companies and the issues that have arisen over accounting practices, the Public Company Accounting Oversight Board (“PCAOB”) coined the term “Chinese Reverse Merger” or “CRM” in order to single out these transactions for special scrutiny. The PCAOB has a regulatory role in the oversight of accounting firms to “establish . . . auditing, quality control, ethics, independence, and other standards” and “conduct investigations and disciplinary proceedings” against auditors that violate those standards. The Sarbanes-Oxley Act of 2002 mandates that accounting firms that audit public companies must register with the PCAOB regardless of whether the company or auditor is located in another country.

In some cases, Chinese company IPOs have been very successful. Given China’s annual economic growth rate of 10%, many large institutional investors increased their purchases of Chinese companies operating in the energy, internet, and technology sectors. The trend was helped in part because more Chinese companies are following U.S. accounting and securities rules and regulations. Institutional buying support for a stock often drives up the price, given that

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25 See id.
27 Id. § 7211(c)(4).
28 Id. § 7212(a).
30 See id.
institutions typically make large purchases and often hold stock for long periods of time. The returns on some large capitalization Chinese stocks significantly outperformed the U.S. market in early 2011. Even though first quarter gain in 2011 for the Dow Jones Industrial Average was the largest in 10 years—6.7%—many Chinese large cap stocks easily outpaced U.S. equities—recording gains of as much as 40% in some cases for the first three months of 2011.

The success of a few stalwarts was seriously dampened, however, by the news that several small capitalization Chinese companies had misstated financial statements resulting in a drop in value of some companies of as much as 75%. Not surprisingly, many of these Chinese companies used reverse mergers to access U.S. stock markets. As a sector, the CRMs came under attack with allegations of accounting fraud. The loss in value was estimated by one source to be $34 billion over the last five years. Not all CRMs are necessarily reporting false financial information, but one estimate puts the number at “as many as a third of Chinese companies listed on major U.S. exchanges.”

Chinese reverse mergers present several problems for regulators. In addition to the less rigorous analysis given to reverse mergers than IPOs, there are also problems in the U.S. regulatory scheme for accountants who service foreign reverse mergers. In order to sell shares on a U.S. stock exchange, the

31 See, e.g., id.
33 Id.
34 Robert Holmes, SEC Probes China Stock Fraud Network, THE STREET (Dec. 21, 2010, 9:00 AM), http://www.thestreet.com/story/10952277/sec-probes-china-stock-fraud-network.html. An analyst at The Street measured loss for 150 CRMs “from a stock’s peak price at any time over the past five years to its present price.” Id.
35 Id.
Exchange Act requires that a company post financial results approved by a registered U.S.-based public accounting firm. In practice, however, the U.S. accounting firms outsource all or most of the tasks involved in the audit to either another firm located outside of the United States or to assistants in the firm who are located in China without following PCAOB standards as to supervision. While PCAOB rules allow a principal auditor to rely on an outside auditor’s work in some circumstances, the principal auditor must investigate the reputation and independence of the other auditor as well as the procedures used and the information relied upon during the audit.

The PCAOB found disturbing evidence that U.S. auditors for CRMs relied on auditors who did not follow U.S. accounting standards and procedures, even though the principal auditors signed off on the opinion filed with the SEC. The PCAOB explained that audits of a company with substantially all of its operations outside of the United States and in China are hindered by language difficulties, the outsourcing of tasks to local accounting firms, the need to travel to the foreign country, and by the fact that U.S. auditors may not understand the business environment in China. Consequently, even if an auditor understands the language and the business environment of China, investors might not ever be able to rely on the accuracy and integrity of an audit of a Chinese company if the rule of law as to the accounting regime is weak.

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38 Id. at 4-5.
39 Id. at 6.
40 See id. at 7-10.
The result of the scandals has had severe consequences for shareholders. In mid-2010, it was reported that CRMs had lost 60% of their value.\textsuperscript{41} In the first eight months of 2011, Bloomberg reported that its index of CRMs had lost an additional 53% of its value.\textsuperscript{42} It is not just U.S. investors who have been hurt by the scandal. Chinese investors also lost money by investing in the U.S.-listed CRMs.\textsuperscript{43}

The problems endemic to Chinese accounting laws and enforcement are a rule of law issue that can be explained, at least in part, by examining the differences in the political economies of the United States and China. The next section will provide a theoretical basis for analyzing rule of law issues in the context of research on political economy.

\textbf{II. POLITICAL ECONOMY, COMPARATIVE CAPITALISM STUDIES, AND THE RULE OF LAW}

Scholars identify many factors that might shape a country’s accounting system including culture, legal systems, economics and politics.\textsuperscript{44} To what degree does political economy help explain the differences in the strength of the rule of law as to accounting rules between the United States and China? Socioeconomics assists in describing the character and development of different political economies through two related areas of study—institutionalism and comparative capitalism. Institu-
tionalism, broadly defined, is the study of the development of social, economic, and political rules and norms.\footnote{45} Comparative capitalism study refers, in part, to the analysis of characteristics and benefits of centrally planned economies and liberal market economies.\footnote{46}

This section provides a framework for studying rule of law issues in a developing economy by examining theoretical work in institutionalism and comparative capitalism studies. As a preliminary matter, however, I will first adopt a definition of the rule of law generally and discuss how perceptions of the rule of law differ between China and the United States.

A. Rule of Law Definitions and Measurement

This part considers differences between the United States and China in its implementation of the rule of law generally and also specifically as to laws surrounding accounting and disclosure for the purpose of the sale of public equities. Academics disagree on how to define the rule of law. Some scholars advocate a “thin” definition that would “focus narrowly on whether existing rules and laws are enforced.”\footnote{47} Other

\footnote{45} As a theory of rules, new institutionalism has been used across many disciplines including socio-economics, sociology, political science, and law and economics; however, each discipline takes a different approach. Colin Crouch, Capitalist Diversity and Change, Recombinant Governance and Institutional Entrepreneurs 5-6 (2005).

\footnote{46} Much has been written about the transition of political economies in China and the Soviet Union from socialism to market economies. After the fall of the Berlin Wall in 1989, research in political economy started to focus on the comparative capitalism—i.e. the differences in the market economies that emerged out of the former Soviet Union and within China when compared to the market economies in the west and developed eastern nations. In this body of comparative capitalism literature, rule of law issues play an important role. Peter A. Hall & David Soskice, An Introduction to Varieties of Capitalism, in Varieties of Capitalism: The Institutional Foundations of Comparative Advantage 1-5 (Peter A. Hall & David Soskice eds., 2001).

\footnote{47} Daniel Kaufmann, Aart Kraay & Massimo Mastruzzi, The Worldwide
scholars adopt a “thick” definition, which “emphasizes more the justice of the content of the laws.” The World Bank takes a middle ground approach defining the rule of law in its World Governance Indicators (“WGI”) project as “capturing perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.”

Rule of law is normally thought to encompass all types of laws and not one specific category. In subject matter, the concepts measured under the rule of law are varied and often unrelated—spanning areas from crime, such as tax evasion and drug trafficking, to property rights, such as the enforcement of contracts. The unifying theme in measuring the rule of law is the perception of the effectiveness and efficiency of government governance.


48 *Id.*

49 The World Bank is one of the largest advocates and supporters of the rule of law. By some measures, the World Bank has spent $2.9 billion on approximately 330 projects on the rule of law since 1990. Gordon Barron, *The World Bank & Rule of Law Reforms* 9 (Development Studies Institute, Working Papers Series No. 05-70, 2005).

50 Kaufman et al., supra note 47, at 4. The WGI research project classifies the rule of law as just one indicator of a country’s governance. Governance is defined as “the traditions and institutions by which authority in a country is exercised. This includes (a) the process by which governments are selected, monitored and replaced; (b) the capacity of the government to effectively formulate and implement sound policies; and (c) the respect of citizens and the state for the institutions that govern economic and social interactions among them.” *Id.* Governance then has six dimensions that the World Bank measures, including “Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption.” *Id.* For purposes of this article, I will only address the rule of law as an indicator of a country’s governance.

officials, the police and the courts in protecting people and property.\textsuperscript{52} In other words, to what extent are the laws and the enforcement mechanism for those laws effective in promoting human rights and property rights?

Not surprisingly, the United States and China are significantly different in their WGI rule of law percentile rankings. In 2009, the United States ranked in the ninety-second percentile while China ranked near the forty-fifth percentile.\textsuperscript{53} In the case of China, that means only forty-five percent of the rest of the nations had a ranking for the rule of law worse than China’s. Accounting for the margin of error, China’s rank in 2009 ranged from about the thirty-third percentile to just over the fiftieth percentile.\textsuperscript{54} Finland and Sweden were tied for the top mark in 2009, while Somalia ranked last.\textsuperscript{55} Since 1996, both China and the United States’ rule of law rankings increased. In 1996, China’s ranking was just under the fortieth percentile and the United States ranked just under the ninety first percentile.\textsuperscript{56}

\textsuperscript{52} Over seventy—sometimes overlapping—concepts are measured for the Rule of Law indicator, so this statement is made based on the recurrence of themes of enforcement by the authority of the rule of law. \textit{Id.}

\textsuperscript{53} \textsc{World Bank, Country Data Report for United States 1996-2010} 6 (2010); \textsc{World Bank, Country Data Report for China1996-2010} 6 (2010). The WGI ranks a country according to the degree to which people perceive that the country adheres to the rule of law. By giving each country an aggregate score, the WGI project ranks countries on a percentile basis—a higher percentile indicating a stronger rule of law. The WGI also reports a margin of error based on a ninety percent confidence interval. Kaufman et al., \textit{supra} note 47, at 12-13. Statistically significant comparisons of two countries are thereby easier to identify so long as the confidence intervals for two countries do not overlap. \textit{Id.} at 13.

\textsuperscript{54} \textsc{World Bank, Country Data Report for China1996-2010} 6 (2010).


\textsuperscript{56} \textit{Id.}
The WGI project has been criticized on the grounds that such measures are (1) not useful for comparing countries over time, (2) bias exists in the indicators, and (3) the data sources used for the assessments are not independent, as well as other related criticisms.\(^{57}\) Despite the criticism, the WGI project is—according to the World Bank—“the most widely-used indicators of governance by policymakers and academics.”\(^{58}\) Needless to say, it is difficult to capture the complexity of any given governance system with one number, and we should be cautious when drawing normative conclusions based on an imperfect ranking. The usefulness of the WGI is that it covers so many countries, draws upon several sources for data, and provides estimates that have a wide margin of error.\(^{59}\) Consequently, the accuracy of the WGI should not be in dispute when broad comparisons are made between countries where there is no overlapping margin of error.

In the specific areas of accounting and auditing, China and the United States are slightly closer in their rule of law rankings. In the World Economic Forum’s *Global Competitiveness Report*—a study that the WGI uses to compile its summary figures\(^{60}\)—China was in the fifty seventh percentile while the United States was only in the seventy second percen-

\(^{57}\) Daniel Kaufmann, Aart Kraay & Massimo Mastruzzi, *The Worldwide Governance Indicators Project: Answering the Critics* 2 (World Bank Policy Research, Working Paper No. 4149, 2007). The World Bank uses 31 different sources to compile its rule of law indicator including surveys and assessments from government agencies, non-governmental organizations ("NGO") and commercial business information providers. *Id.* at 1. Over 25 different organizations provide the data; consequently, the results are necessarily “a synthesis of the views of a very large and diverse group of stakeholders regarding the quality of governance across countries.” *Id.*

\(^{58}\) *Id.*

\(^{59}\) *Id.*

In the same study, investor protection in China is perceived as below the worldwide norm with a ranking in the forty-sixth percentile, while the United States ranked in the ninety-sixth percentile. While comparative empirical work provides interesting insights, a fuller understanding of the rule of law also requires studying institutionalism and comparative political economy.

B. Institutionalism & the Development of Rules

The theory of institutionalism helps explain how rules develop and the degree to which a particular political economy has the incentive and ability to change its rules. Douglas North, largely considered one of the principal founders of institutionalism, defined an institution “as a set of rules, formal or informal, that actors generally follow, whether for normative, cognitive, or material reasons.” Organizations are distinguished from institutions and are defined as “durable entities with formally recognized members, whose rules also contribute to the institutions of the political economy.” Characterizing rules as institutions will become important later.

61 See KLAUS SCHWAB, WORLD ECONOMIC FORUM, GLOBAL COMPETITIVENESS REPORT 2011-2012 407 (2011), available at http://www3.weforum.org/docs/WEF_GCR_Report_2011-12.pdf. These percentile ranking are derived from the Global Competitive Report figures, which reported that China’s accounting and reporting regime was ranked 61st among 142 countries; the U.S. ranked 40th in the same report. Id. 62 See id. at 410. China was reported as being 77th among 142 countries, while the U.S. was ranked fifth. Id. 63 Hall & Soskice, supra note 46, at 9. 64 Id. Much has been written by economists on how to define “institution.” Aoki defined institution to be a “rule of the game” with exogenously and endogenously-generated formal and informal rules such that the rules embody “shared beliefs about the ways how the game is to be played.” Masahiko Aoki, Endogenizing Institutions and Institutional Changes, 3 J. INST. ECON. 1, 6-7 (2007), available at http://www.stanford.edu/~aoki/papers/JOIE(Final).pdf.
in this article when discussing how political economies change the established rules by which it operates.\textsuperscript{65}

Institutions are thought to constrain behavior such that actors are bound to follow the institution or risk a sanction. Despite some debate on the definition of institution, there is general agreement that institutions consist of both formalized laws (such as constitutions, regulations, judicial opinions) and informal norms. Actors must follow the formal laws or risk a legal penalty—either civil or criminal. In contrast, the punishment for failing to follow informal norms is an unofficial penalty. For example, actors within the political economy may choose not to engage with another actor who does not follow the informal rules of the game.\textsuperscript{66}

Studies in the rule of law benefit from an institutional analysis, since the concept of the rule of law encompasses legislative and judicial rules (the laws on the books) and the cultural norms in whether such rules are enforced. Under this approach, a distinction is sometimes made between institutions that constrain market actors—i.e. laws and informal norms—and the rule of law as an enforcement mechanism of those institutions.\textsuperscript{67}

A nation’s degree of acceptance of the rule of law, however, can also be considered as an institution in itself. If corruption and a weak rule of law is embedded in a society and its culture and political structures, then it becomes a rule of the game. Moreover, to the degree that a country has a weak rule of law in its accounting regime, generally, the country’s formal institutions will reflect laws on the books that are not rigorous and which allow companies to hide the truth in financial reporting. Thus,

\textsuperscript{65} See infra Part IV.
\textsuperscript{66} See Hall & Soskice, supra note 46, at 12-14.
informal rules may actually institutionalize corruption and result in a lack of enforcement for those laws that are on the books.68

C. Political Economy and the Rule of Law

One field where institutionalism theory flourishes is comparative capitalism studies. Comparative capitalism makes use of institutional analysis in trying to understand and document the transition of formerly communist regimes—e.g. the Soviet Union and China—into market economies. For purposes of this article, I contrast two approaches to comparative capitalism. The first approach, termed “varieties of capitalism,” divides market economies into two general types—liberal market economies and coordinated market economies.69 In either type, the rule of law might be strong or weak. The second approach, from William Baumol, Robert Litan, and Carl Schramm’s book Good Capitalism, Bad Capitalism and the Economics of Growth and Prosperity, classifies market economies into four types—entrepreneurial capitalism, big firm capitalism, oligarchic capitalism, and state capitalism.70 This approach makes a normative judgment that entrepreneurial capitalism results in a more just society with an inherently stronger rule of law, whereas, state capitalism has a weak rule of law and is susceptible to corruption.

1. Varieties of Capitalism

Peter Hall and David Soskice’s varieties of capitalism model emerged as an important model for comparative capitalism studies—one which offered a different point of view from the American centric approach.71 Varieties of capitalism

69 See Hall & Soskice, supra note 46, at 8.
70 See William J. Baumol et al., Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity 60-61 (2007).
uses new institutionalism studies to identify rules that characterize certain types of economies. Hall and Soskice broke developed economies into two classifications—liberal market economies (“LMEs”) and coordinated market economies (“CMEs”). Hall and Soskice maintain that a particular type of economy—LME or CME—emerges in a region as a result of its history, culture and informal norms. Examples of LMEs include the United States and the United Kingdom, whereas Germany and Japan are examples of CMEs. Scholar’s applying Hall and Soskice’s approach have classified China as a CME, though not all scholars agree. Michael Witt suggests “China has the formal trappings of a CME paired with actual practices that are more reminiscent of an LME.”

Competitive markets are the hallmark of LMEs, and the institutions that govern such an economy include formal contracting, arm’s-length negotiations and open competition for transactions. LMEs are characterized by fluid and flexible labor markets; consequently, labor unions are weaker in an LME than in CMEs. Ownership of any given firm is dispersed and a liquid securities market allows for diversification. As a result, corporate governance of the firm is classified as an “outsider” system where there is a separation

72 See CROUCH, supra note 45, at 2.
73 Hall & Soskice, supra note 46, at 12-14.
74 Id. at 19-20. Hall & Soskice identified five spheres—industrial relations, education, corporate governance, inter-firm relationships and employee relations—in which firms operate and studied how a firm develops core competencies within these spheres. Id. at 7. Hall & Soskice applied a business studies approach to comparative capitalism studies by combining macroeconomics with microeconomic game theory. Id. at 5.
75 Jay Tate, National Varieties of Standardization, in VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE 469 (Peter A. Hall & David Soskice eds., 2001).
77 Hall & Soskice, supra note 46, at 8.
78 See id. at 29-30.
between ownership and control. One consequence of this liquidity structure and diversification is that LMEs develop financial systems where shareholders are more willing to finance entrepreneurial companies that take more risk. This, in turn, leads to a much higher level of innovation especially in areas such as technology and financial services.

In contrast, the economic relationships in CMEs are not subject to competition but are coordinated by actors who have developed relationships. The key dynamic in a CME is collaboration rather than competition. In corporate governance, CMEs are classified as “insider” systems and “are characterized by the significance of the state, families, non-financial corporations, employees and banks as a source of funding and/or control.” The profit motive in a CME gives way to an approach that takes into account the various stakeholders involved in a firm. Managers in the firm collaborate with labor unions and the government in order to try to benefit all of the actors. These institutions typically result in an economy with capital-intensive industries. CMEs are thought to have less innovation than LMEs.

Hall and Soskice were not the first to adopt a dualist approach to capitalism studies; however, they are careful not to draw normative conclusions on whether a particular type is better in producing high growth rates, low unemployment, or a

81 Hall & Soskice, supra note 46, at 8.
82 See id.
83 Dignam & Galanis, supra note 80, at 202.
84 Id.
85 Ahlering & Deakin, supra note 79, at 874.
86 Dignam & Galanis, supra note 80, at 203-04.
reasonable inflation rate.\textsuperscript{87} Hall and Soskice maintain that LMEs and CMEs each produce a comparative institutional advantage in producing different types of goods and in managing certain types of industries. In each type of political economy, the institutional make-up is geared “to produce some kinds of goods more efficiently than others because of the institutional support they receive for those activities in the political economy.”\textsuperscript{88}

The varieties of capitalism model does not differentiate political economies as being susceptible to corruption or having a strong or weak rule of law. Some CMEs have a weak rule of law, and are prone to corruption. Other CMEs, such as Finland and Sweden, have an extraordinarily strong rule of law.\textsuperscript{89} Under this view, China’s political economy would not—by itself—explain a weak rule of law as to accounting. According to a varieties of capitalism approach, different political economies have different types of rules, but it does not necessarily explain differences in the degree to which the rule of law enforces institutions.

The dualistic approach of the varieties of capitalism school has been criticized for being too deterministic, rigid, and simple.\textsuperscript{90} Some theorists maintain that a strong rule of law is a

\textsuperscript{87} Hall & Soskice, supra note 46, at 20-21. Hall & Soskice contend that LMEs have a higher income disparity and a longer work week than CMEs. \textit{Id.} at 21.

\textsuperscript{88} \textit{Id.} at 37. Interestingly, this observation has important implications for the assumptions of convergence to the liberal economic model that are put forward by advocates of opening markets and globalization. Given that CMEs operate well with open markets, it does not necessarily follow that all markets will converge to become liberal market economies. \textit{CROUCH}, supra note 45, at 25-26.

\textsuperscript{89} World Bank, \textit{One Indicator for Selected Countries}, \texttt{WORLDWIDE GOVERNANCE INDICATORS}, \url{http://info.worldbank.org/governance/wgi/mc_countries.asp} (follow “click here” hyperlink at bottom of page to access full dataset) (last visited Feb. 11, 2012).

\textsuperscript{90} \textit{CROUCH}, supra note 45, at 22-23.
core characteristic that helps differentiate free market capitalistic economies from other political economies. This next section provides a more multifaceted approach, where the type of political economy may determine the degree to which the rule of law is implemented.

2. Good Capitalism, Bad Capitalism

Baumol, Litan & Schramm take a more nuanced approach and describe a typology of capitalism that breaks into four categories. Like the varieties of capitalism model, each of the four archetypes (entrepreneurial capitalism, big firm capitalism, oligarchic capitalism, and state capitalism) is characterized by certain rules of the game (i.e., institutions) by which the economy operates. Political economies evolve over time. Any given state might have the general characteristics of one of the categories during a different stage of development, but the political economy evolves over time, and some states exhibit characteristics of more than one of the archetypes.

Unlike the varieties of capitalism model, this approach identifies some archetypes as having a strong rule of law and others as weak. Of the four archetypes, Baumol, Litan & Schramm isolate entrepreneurial capitalism as the linchpin that fosters both innovation and strong economic growth.

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92 *BAUMOL ET AL.*, supra note 70, at 11.
93 *Id* at 11.
94 *Id*. at 85-86. The authors argue that because technology advances the standard of living, the standard of living rises in a society geared towards entrepreneurial capitalism. *Id.* Recently, a movement is afoot to challenge the premise that strong economic growth is desirable as a goal within a political economy. *See, e.g.*, BILL MCKIBBEN, DEEP ECONOMY: THE WEALTH OF COMMUNITIES AND THE DURABLE FUTURE 1-2 (2007). When a society focuses on economic growth as the main goal of an economy, inevitably, harm happens to some market actors; for example, workers are displaced, inefficient businesses go bankrupt and the environment suffers.
Litan & Schramm describe four institutions or rules of the game that make up an economy based on entrepreneurial capitalism. First, it must be simple, efficient and cheap to both create and dissolve a business. Government should not hamper the process by adopting strict regulations governing the creation and dissolution of business. Additionally, there must be fluid and flexible capital and labor markets, so that entrepreneurs can find financing and operate efficiently by firing and hiring employees at will. Second, the property and contract rights must be supported by the formal laws, regulations and judicial system. Entrepreneurs must be confident that their hard work will not be taken away through nationalization, otherwise, they will not take on the risk of starting new companies. Third, the institutional rules of the game should advance policies that result in a Pareto improvement, as opposed to rent-seeking behavior. The society should not allow “political lobbying or the filing of frivolous lawsuits designed to transfer wealth from one pocket to another.” Fourth, rules should be adopted that provide incentives to both small and large firms to “innovate and grow, or else economies will sink into stagnation.” Entrepreneurial capitalism is characterized by smaller firms that are innovative.

In contrast, the second archetype of big firm capitalism consists of large, traditional firms that engage in mass production. While an economy consisting of large firms can

from pollution. Id. A group of reform-minded academics, government officials, and analysts have developed measures of societal development different from GDP in order to gauge prosperity. See Jon Gertner, The Rise and Fall of the G.D.P., N.Y. TIMES, May 13, 2010, http://www.nytimes.com/2010/05/16/magazine/16GDP-t.html.

95 BAUMOL ET AL., supra note 70, at 7.
96 Id.
97 Id.
98 Id. at 8.
99 Id.
100 Id. at 61.
101 Id. at 79.
result in a powerful economic engine, the companies usually operate in established industries. Such an economy can produce a corporate bureaucracy that makes it difficult to innovate. In such an economy, entrepreneurism and innovation is not rewarded.\textsuperscript{102}

Baumol, Litan & Schramm, however, conclude normatively that the best economy is one which blends big firm capitalism with entrepreneurial capitalism.\textsuperscript{103} The U.S. economy, according to Baumol, Litan & Schramm, has both innovation and a prominent role in international trade; therefore, it exists as a hybrid of archetypes—combining some of the characteristics of entrepreneurial capitalism with big firm capitalism.\textsuperscript{104} U.S. economic institutions reflect government regulations that allow for fluid, flexible capital and labor markets, while strongly enforcing property and contract rights.

The third archetype—oligarchic capitalism—is characterized by an economy where “the bulk of the power and wealth is held by a small group of individuals and families.”\textsuperscript{105} Oligarchic capitalism exists in some areas of the former Soviet Union as well as Africa and many of the Arab states in the Middle East.\textsuperscript{106} Since those regions are not within the scope of this article, I will concentrate the rest of this section on the last form of capitalism.

Baumol, Litan & Schramm’s fourth archetype, state directed capitalism, or state capitalism, is characterized by a centrally-controlled economy. The government, rather than entrepreneurs and private investors, make decisions about the winners and losers in the economy—i.e. the firms that will be given capital in order to pursue development in a given

\textsuperscript{102} Id. at 80-81.
\textsuperscript{103} Id. at ix.
\textsuperscript{104} Id. at viii-ix.
\textsuperscript{105} Id. at 60.
\textsuperscript{106} Id. at 71.
economic sector.\textsuperscript{107} In Baumol, Litan & Schramm’s view, communism and socialism are an archetype that disappeared by the time the Cold War ended.\textsuperscript{108} All remaining economies, in their view, fit within one of the four archetypes. It should be noted that while the government may designate which firms get capital, this does not mean that such firms are necessarily successful. In fact, in some cases, such firms are inefficient and become too big to fail, thus resulting in bailouts from the government.\textsuperscript{109}

China has an extraordinarily successful state-guided capitalism economy. What was once a third world country is now the world’s second largest economy.\textsuperscript{110} According to Baumol, Litan & Schramm, the downside to state-guided capitalism is innovation may be stifled since the government, rather than the market, chooses winners and losers.\textsuperscript{111} State capitalism is characterized by rent-seeking behavior—such as insider dealings.\textsuperscript{112} Consequently, innovators are not necessarily rewarded, while business people with connections inside the government do receive rewards. China’s economic success is based, in large part, on manufacturing products with cheap labor, while technological innovation lags when compared with the United States.

In the Baumol, Litan & Schramm approach, the rule of law is likely much weaker in a state capitalism economy. In

\begin{itemize}
\item \textsuperscript{107} Id. at 62-63.
\item \textsuperscript{108} Id. at 7.
\item \textsuperscript{111} See \textit{BAUMOL ET AL.}, supra note 70, at 68-70.
\item \textsuperscript{112} See \textit{id.}, at 63-64, 70 (discussing state guided capitalism and susceptibility to corruption).
\end{itemize}
their view, the state-guided capitalism model is inherently susceptible to corruption.\textsuperscript{113} Even if China could be considered to be transitioning from state capitalism to some other form, the empirical evidence of corporate fraud is extensive.\textsuperscript{114} In economies transitioning from state capitalism to a more market-centric model, controlling shareholders and managers are faced with opportunities and pressures to increase wealth after being “freed from the constraints imposed by central planning.”\textsuperscript{115}

The scandals surrounding CRMs, as well as other evidence of corruption surrounding accounting standards in China, validate the Baumol, Litan & Schramm model. With this framework in mind, I will now discuss the particular characteristics of the Chinese accounting regime and the reasons behind the collapse of the CRMs.

III. CHINESE ACCOUNTING REGIME AND THE COLLAPSE OF CRMS

The premise that corruption is an institutional characteristic of China’s political economy leading a weak rule of law is supported by the evidence surrounding the CRM scandal and the general accounting regime. This section examines five factors that contributed to the CRM accounting fraud scandal: (1) Chinese insularity, (2) poor implementation of accounting standards by Chinese regulators, (3) shortages in skilled accountants/auditors and a lack of quality in the accounting profession, (4) lack of enforcement of accounting standards because of a weak regulator and a weak judiciary, and (5) lack of jurisdiction by U.S. enforcement officials.\textsuperscript{116}

\textsuperscript{113} Id. at 70.
\textsuperscript{114} E.g., Gongmeng Chen et al., Ownership Structure, Corporate Governance, and Fraud: Evidence from China, 12 J. CORPORATE FINANCE 424, 424-448 (2006).
\textsuperscript{115} Id. at 445.
\textsuperscript{116} Robert Holmes, Loopholes From Here to China, THE STREET (Dec. 22, 2010, 8:56 AM), http://www.thestreet.com/story/10953616/1/china-rto-
First, Chinese business culture is highly insular and resists the sort of disclosure and openness that is the hallmark of U.S. securities laws. Much has been written about Chinese insularity, and this particular characteristic can be thought of as a strong institutional norm in China. U.S. attorneys working with Chinese companies on reverse mergers have found that language difficulties, as well as cultural limitations, result in a due diligence process where the Chinese company is slow to respond and provides incomplete information. The insular regulatory environment also prevents the PCAOB from inspecting the work of firms auditing the financial statements of Chinese firms that list on U.S. exchanges. PCAOB has a mandate from Congress to audit the auditors, and therefore cannot carry out its role of oversight on auditors of Chinese firms. Such oversight is important, given that Chinese auditors have not fully adopted American accounting standards. In an effort to inform the market, the PCAOB published a list of the companies and auditors with operations in China where the PCAOB was unable to conduct inspections.

Interestingly, breaking down insularity with the presence of outside directors on the board of Chinese companies seems to be an important way to combat corporate fraud. Chen, Firth, Gao, and Rui found that “[i]ncreasing the proportion of

regulation-shows-cracks.html.

117 Feldman, supra note 21, at 203.
118 Id.
119 Id. at 202-05.
121 Id.
122 See Holmes, supra note 116.
123 Issuer Audit Clients of Non-United States Registered Firms in Jurisdictions where the PCAOB is Denied Access to Conduct Inspections, supra note 120.
outsiders on the board is one way to reduce fraud.”

In sharp contrast, using a prestigious auditing firm over a smaller firm had no effect on the incidence of fraud. Additionally, the presence of foreign investors as shareholders also had no effect in deterring fraud. Because outside directors penetrate insular firms in order to monitor management, the incidence of fraud decreases.

Second, Chinese regulators have not uniformly adopted western accounting standards. In 2007, Chinese regulators adopted accounting standards that were purported to converge Chinese rules with the International Financial Reporting Standards (“IFRS”). Companies that list on U.S. capital markets must either report financial information according to either the U.S. standard of Generally Accepted Accounting Principles (“GAAP”) or IFRS. In reality, however, there is substantial divergence between IFRS and the Chinese implementation on the important issue of fair value accounting (“FVA”). Before 1997, Chinese accounting rules required a historical-cost basis accounting, which skewed the financial picture of a company by over-valuing some assets, such as out-of-date inventory, and under-valuing other assets that have appreciated in value. Reforms were made in the following ten years, but were largely considered to be ineffective.

124 Gongmeng Chen et al., supra note 114, at 446 (reporting results using a multivariate analysis).
125 Id.
126 Id.
127 Id.
128 Holmes, supra note 116.
131 Id. at 10-11.
The 2007 reforms were said to have led to convergence, but the Chinese rules are actually a “made-for-China version of FVA that differs from IFRS.”132 Songlan Peng and Kathryn Bewley identified nine divergences between the IFRS standard and the Chinese 2007 reforms in the area of FVA.133 For example, under the IFRS rules, accountants must estimate the “market value for all assets, but under [the Chinese 2007 reforms] this is optional for investment and biological assets, while it is prohibited for properties, plants, and equipment (PP&E) and intangible assets.”134 Chinese officials explain that market value may not be an appropriate measurement because underdeveloped capital markets in China135 make it difficult to obtain “reliable fair price inputs” for some assets.136 The Chinese perspective is not to conform identically to international standards, but to consider convergence as “a multilateral or bilateral interaction among countries involved, not a one-way exercise.”137 In essence, the Chinese are telling the International Accounting Standards Board that IFRS needs to adapt to the realities of the existing accounting standards found in emerging countries rather than just imposing standards.138

Third, the Chinese accounting profession is experiencing shortage and quality problems.139 In 2007, it was estimated China needed an additional 300,000 qualified accountants, and, given its economic growth, as many as 3 million new accountants needed to be trained.140 China recognizes the shortages and has a goal to create 10 large and 200 medium-sized Chinese accounting firms by 2015.141 Even if these goals

132 Id. at 31.
133 Id. at 40.
134 Id. at 15.
135 Id. at 41.
136 Id. at 15.
137 Id. at 18.
138 Id.
139 Id. at 22-25.
140 Id. at 23.
141 Press Release, Hong Kong Institute of Certified Public Accountants,
are met, quality problems are pervasive in audits of publicly listed firms by Chinese accountants. Of the smaller accounting firms doing audits, only 16% were rated as thorough and 73% were “rough” in a CFO China survey.\textsuperscript{142} Even the big four accounting firms operating in China were not well regarded—with over half being rated as “rough” in their auditing practices.\textsuperscript{143} These discrepancies can be explained, in part, by a lack of experience and skill; however, a lack of ethics is also pervasive.\textsuperscript{144}

Fourth, there is a lack of enforcement of accounting standards because of a weak regulator and a weak judiciary. Moreover, the Chinese accounting profession is marred by accusations of corruption and a lack of ethics.\textsuperscript{145} In 2000, after the first series of accounting reforms were introduced, two-thirds of the largest state-owned enterprises in China had released falsified financial statements in order to transfer wealth to managers who had political connections.\textsuperscript{146} The Far East Economic Review reported that an investigation of 192 firms showed that over half falsely reported profits in their 2001 annual reports.\textsuperscript{147}

The Chinese Securities Regulatory Commission ("CSRC") promulgates regulations for firms listed on Chinese stock exchanges, including corporate governance standards, such as requirements for outside directors and audit committees for listed firms.\textsuperscript{148} The CSRC also requires auditing firms to

\textsuperscript{142} Peng & Bewley, supra note 130, at 24.
\textsuperscript{143} Id.
\textsuperscript{144} Id. at 22-24.
\textsuperscript{145} Holmes, supra note 116.
\textsuperscript{146} Peng & Bewley, supra note 130, at 11.
\textsuperscript{147} Id. at 12.
\textsuperscript{148} Id. at 21. The Chinese Institute of Certified Public Accountants
comply with strict requirements in order to be able to audit companies listed on Chinese stock exchanges. Since Chinese regulators focus on companies that list on Chinese exchanges and are not incentivized to investigate companies that only list on U.S. exchanges, this has resulted in a “regulatory hole” where no oversight is provided for some CRMs.

Even if the CSRC’s strict laws were applied to Chinese auditors of U.S.-listed companies, it is not perceived as being an effective enforcement agency. There is little independence, and the Chinese government agency does not have enough resources to investigate the large number of businesses that have come into existence as China’s economy has grown. Political influence also prevents some enforcement measures, and managers—especially at large companies—who have ties to politicians can avoid penalties. Given the nature of the legal environment, “the risk that an accounting firm will receive administrative punishment notices or be required to pay out civil damages is close to zero.”

The problem with lax enforcement of accounting and corporate laws in China is systemic—reaching beyond publicly listed companies. Even potential criminal liability for corporations does not seem to deter corruption. Corporate criminal laws in China establish 142 types of crimes for the corporate

149 Id. at 24.
151 Peng & Bewley, supra note 130, at 28-29.
152 Id. at 29.
153 Id.
entity, including such financial disclosure crimes as: “illegally disclosing or concealing critical information” and “concealing or intentionally destroying financial vouchers, financial account books or financial statements.” Yet, the threat of punishment on the books is hardly a deterrent. After discovering tax evasion by real estate firms in one province, Chinese officials investigated 100 additional companies and discovered that nearly every company had illegally evaded taxes.

Rule of law problems in China are often blamed not on the lack of laws on the books, but on the lack of enforcement and a weak judiciary. In some respects, this is not surprising, given that the judiciary (as well as the profession of law) is a relatively new part of the society. The legal system began to develop in 1978 as part of the reform movement led by Deng Xiaoping. While there are rule of law concepts embodied in the Chinese constitution, such as protection of private property, the courts have no power of judicial review of legislation; consequently, there is no way for citizens to enforce these constitutional rights through the courts.

Additionally, there is little judicial independence—at least as Westerners conceive of it. The judiciary as a whole might be seen as independent, but judges are not. Judges are more like bureaucrats who have to follow the orders of their superiors. Sometimes cases are decided by a higher court without hearing the evidence or consulting with counsel of either side. Although political interference from the Communist

155 Id. at 100-02.
156 Id. at 91.
157 Id.
158 Id. at 15.
159 Dam, supra note 67, at 14-15, 18.
160 Id.
161 Id.
162 Id. at 15-16.
163 Id. at 16.
Party is more likely to occur in administrative bureaucracies, it does occur in the judiciary, as well.\textsuperscript{164}

Fifth, the SEC, PCAOB and other government agencies have no jurisdiction to enforce U.S. laws on Chinese auditors.\textsuperscript{165} Moreover, U.S. regulatory agencies are understaffed, and therefore use only the occasional prosecution to create fear and deter bad actors.\textsuperscript{166} Since U.S. regulators have no jurisdiction in China, such fear has no effect on Chinese entrepreneurs.\textsuperscript{167} As the accounting scandal unfolded, it became apparent that some CRMs filed more accurate financial statements with Chinese regulators and then significantly inflated the figures when filing disclosure statements with the SEC.\textsuperscript{168}

Like U.S. regulatory agencies, the U.S. firms that have to sign off on financial statements have trouble inspecting Chinese counterparts. Some commentators point out that the task of inspecting Chinese accounting firms is difficult even for big four accounting firms with operations in China.\textsuperscript{169} All of the big four accounting firms have used “the joint venture model to do business in China since foreign ownership of private firms is not permitted.”\textsuperscript{170} As a result, the big four share their internal company oversight with Chinese counterparts over whom they have no control.

\textsuperscript{164} Id. at 17.
\textsuperscript{165} Holmes, supra note 116.
\textsuperscript{166} Id.
\textsuperscript{167} Id.
\textsuperscript{168} Id.
\textsuperscript{169} Lawrence, supra note 17.
\textsuperscript{170} Id.
Given the evidence from the CRM scandal, it is clear China continues to struggle with institutionalized corruption and a weak rule of law as to the accounting regime. The remaining sections will explore the degree to which China might change given the U.S. regulatory and market responses to the CRM problem.

IV. CATALYSTS FOR RULE OF LAW CHANGES IN CHINA’S ACCOUNTING REGIME

Much has been written by Western scholars indicating China’s economy will improve if it adopts the laws of a liberal market economy and strengthens its rule of law as to the enforcement of those institutions.\textsuperscript{171} Assuming for the moment that Baumol, Litan & Schramm are correct and state capitalism is susceptible to a weak rule of law, to what degree can China change the institutions surrounding its accounting regime to result in a stronger rule of law?

A. Institutional Change, Path Dependence and Exogenous Forces

Institutional change has been the subject of much debate among comparative capitalism scholars. One important inquiry in institutionalism is the degree to which a political economy has the capacity to change a rule of the game once it becomes embedded as an institution. Many scholars contend that once an economy has developed and adopted an institution, there is built-in resistance to change the rule even if there is a better, more rational approach.\textsuperscript{172}

Path dependence theory suggests the ability for an economy to change its institutions may be a factor in the degree to which that institution is embedded within the economy.\textsuperscript{173}

\textsuperscript{171} See, e.g., Dam, supra note 67, at 9-11.
\textsuperscript{172} CROUCH, supra note 45, at 10.
\textsuperscript{173} Hall & Soskice, supra note 46, at 12.
The dominance of an institution can be understood through path dependence, which suggests that as a political economy develops, certain choices are made by the economic actors—i.e., they go down a certain path. In a society’s development, there may have been choices between types of rules—all of which were equally valid at the time and each of which would produce useful outcomes. By adopting one of the rules instead of another, however, the actors increased the likelihood that they would make the same choice again.\footnote{CROUCH, supra note 45, at 75-76.} All institutions—whether formal laws or informal norms—arise through bargaining between groups, each of whom have a certain amount of power which they attempt to use to benefit their own group.\footnote{Id. at 7, 80.} Consequently, a group that benefits from the use of a rule will attempt to make that rule permanent in order to continue to receive the benefits.\footnote{Id. at 80.} Additionally, it becomes inefficient to take another path because there is a learning curve associated with adopting new rules.\footnote{Id. at 78-80.}

Although it may be economically rational for a society to change its rules of the game, the institutions are so engrained in the society, culture and political structures that change is nearly impossible.\footnote{Id. at 1-2.} Once an institution becomes dominant, actors may continue to use the rule even when the process is no longer effective (i.e., no longer producing optimum results) because they just do not know how to do things any other way.\footnote{Id at 79.} This theory of path dependence has been advanced to suggest it is difficult, if not impossible, to change an embedded rule within a political economy—a rather pessimistic outlook if the hope is to improve the rule of law in China.\footnote{Id. at 74.}

\begin{itemize}
\item \footnote{CROUCH, supra note 45, at 75-76.}
\item \footnote{Id. at 7, 80.}
\item \footnote{Id. at 80.}
\item \footnote{Id. at 78-80.}
\item \footnote{Id. at 1-2.}
\item \footnote{Id at 79.}
\item \footnote{Id. at 74.}
\end{itemize}
Path dependence theorists, however, have been criticized for being too simplistic, deterministic, and pessimistic on the ability of a political economy to evolve. 181 In reality, institutions do change. Rapid change might occur as a matter of crisis 182 or there may be incremental evolution of an institution over long periods of time. 183 Such changes may be the result of endogenous or exogenous forces. 184 A typical example of an exogenous shock that leads to institutional change is a change in technology that “renders existing institutions inefficient,” thereby leading to new intuitional rules. 185

A more relevant example of exogenous change was the influence of a financial crisis that served as a catalyst for Russia to institute changes in its tax code. 186 Prior to its 1998 financial crisis, the Russian tax regime had been in a “vicious cycle of exorbitant tax rates and widespread evasion.” 187 The Russian Oil Companies (“ROCs”) and the government had been unable

181 Id. at 22-23.
182 Id. at 3. Significant changes that occur in short periods of time are typically followed by long periods where subsequent change is limited to a “closely bounded” range. Id. at 74-75. An example of crisis-driven change occurred in the U.S. during the financial crisis of 2007-2009 when the Department of the Treasury bought stock in banks and financial institutions. See generally Benjamin A. Templin, The Government Shareholder: Regulating Public Ownership of Private Enterprise, 62 ADMIN. L. REV. 1127 (2010). Before the financial crisis, a proposal of widespread government ownership of bank stock would have been vilified as socialism. The purchase of stock by the government, however, was justified in order to stabilize and add liquidity to the credit markets in a time of crisis. Id.
183 CROUCH, supra note 45, at 75.
185 Id. at 161.
187 Id. at 145.
to agree upon reform in the past, but “the 1998 financial crisis exposed the government’s susceptibility to fluctuations in the global marketplace because of its dependence on the oil sector for budgetary revenue.”\(^{188}\) In response, the government agreed to respect private ownership and establish a tax code not subject to unilateral change, and the ROCs adopted international accounting standards and corporate governance.\(^{189}\)

Although the impact of the CRM scandal is not nearly as great as the 1998 Russian financial crisis (at least to date), there are some parallels in that outside forces from U.S. regulators and the market will likely make it more difficult for Chinese companies to raise capital in the U.S. markets until there is reform in China’s accounting regime. CRMs are being delisted from stock exchanges, and the market has discounted the value of Chinese firms, given the impression that accounting fraud is an investment risk. While it is still too early to say whether China will strengthen its rule of law as to accounting disclosure in response to these exogenous forces, it is clear that far fewer CRM deals are occurring as a result of the U.S. regulatory and market response. The remainder of this section will examine what external forces may drive change in China.

**B. U.S. Regulatory and Market Responses to the CRM Scandal**

In what ways will external forces help change institutionalized corruption in accounting practices in China? The PCAOB has made cross-border regulatory oversight of Chinese auditors a priority, but many hurdles remain before that becomes a reality. To the extent exogenous forces contribute to institutional change, regulatory and market responses within the United States that restrict CRMs may create indirect pressure for accounting reform in China. If U.S. regulators expect change in China, they will need to require that Chinese companies provide additional proof of the accuracy of their audits.

\(^{188}\) *Id.* at 145–46.

\(^{189}\) *Id.* at 147.
Such domestic measures by regulators will likely need to come in the form of strengthening reverse merger regulations, alerting investors to the risks associated with Chinese companies and holding U.S. accounting firms accountable for the practices of Chinese auditors. Investors can spur change by factoring the risk of accounting scandals into the purchase of CRM securities. If CRMs have a lower valuation because of perceived risk, these companies will likely take more steps to provide accurate disclosure to the market. The remaining sections will discuss these regulatory and market responses to the CRM auditing problems.

1. **Cross-Border Regulatory Oversight**

In late 2011, PCAOB Chairman James R. Doty stated that one principal goal of the agency was to get agreement with Chinese regulators to allow cross-border inspections of Chinese accounting firms that audit U.S.-listed companies. As this article was published, the PCAOB expected an agreement to be in place by February 2012. It is uncertain, however, whether China will ultimately agree. China has resisted foreign oversight as a matter of sovereignty and because of “secrecy laws” that cover data used in inspections.

Cooperation between U.S. and Chinese regulators in cross-border oversight authority is—at best—in the preliminary stages. The ultimate goal is to sign a bilateral agreement that

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193 Chi, *supra* note 150.
allows for the PCAOB to jointly inspect the 110 Chinese auditors who have registered with the PCAOB. At a July 2011 meeting, officials from the PCAOB and SEC met with their counterparts at the China Securities Regulatory Commission (“CSRC”) and the Chinese Ministry of Finance (“MOF”) in Beijing, and the only substantive agreement was to continue talks.

On a positive note, the PCAOB has entered into bilateral agreements with 30 other foreign accounting regulators to perform cross-border audit oversight, including Switzerland, the United Kingdom, and Norway. Bilateral agreements on cross-border audit oversight, however, typically take time, even between Western developed nations. The PCAOB had an agreement with Norway’s Financial Supervisory Authority in 2008, but inspections were delayed, in part because approval was still forthcoming from the European Union (“EU”) Commission. EU concerns over the PCAOB’s inspection methods have since been resolved and the PCAOB expects to sign additional bilateral agreements with other European nations.

196 Baldwin, supra note 191.
197 Lamoreaux, supra note 190.
200 Lamoreaux, supra note 190.
2. Domestic Political and Regulatory Actions

At the urging of Congress, the SEC and the PCAOB stepped up oversight of Chinese companies, especially CRMs, in 2010. In September 2010, the House Financial Services Committee complained about “a lack of rigor in the auditing of Chinese companies.” Subsequently, the SEC launched a task force in 2011 to investigate “how networks of U.S. accountants, lawyers and bankers have helped bring scores of Chinese companies onto the U.S. stock markets.” Shortly thereafter, the FBI opened an investigation into CRM fraud, and the Justice Department began investigating the possibility of bringing criminal charges against companies and auditors involved in the CRM scandals.

In late December 2010, the SEC settled a case against the U.S. auditing firm Moore Stephens Wurth Frazer & Torbet LLP (“Moore Stephens”) for overstating financial results of China Energy Savings Technology. The firm was barred from accepting new clients from China, Hong Kong or Taiwan for a period of time and was assessed a penalty of $129,500. In a related action, the PCAOB banned two firms from public

201 Holmes, supra note 34.
205 Holmes, supra note 34.
206 Id.
company auditing because the firms did not verify the work of local Chinese auditors.\footnote{Michael Rapport, \textit{SEC Probes China Auditors}, \textit{WALL ST. J.} (June 3, 2011), http://online.wsj.com/article/SB1000142405270230456310457636142237212124.html.}

The SEC also issued a bulletin in June 2011 warning investors about the risks associated with reverse mergers in general and reporting actions it had taken against CRMs in particular.\footnote{OFFICE OF INVESTOR EDUC. \& ADVOCACY, SEC. EXCH. COMM’N, INVESTOR BULLETIN: REVERSE MERGERS (2011), available at http://www.sec.gov/investor/alerts/reversemergers.pdf.} Among the actions taken against some CRMs, the SEC halted trading in the stocks when questions arose over accounting irregularities.\footnote{\textit{Id.} at 4.} Some high-profile companies, once touted as profitable investments, have had to restate earnings and some have been delisted.\footnote{RINO International Corp. and Fuqi International Inc. were listed as “top investments” by Investor’s Business Daily. Ackerman, \textit{supra} note 202. RINO is now delisted as is China Changjiang Mining & New Energy Co. OFFICE OF INVESTOR EDUC. \& ADVOCACY, \textit{supra} note 208.} In other cases, the SEC revoked the registration of securities for companies that have not met filing requirements, thereby requiring the companies to go through the registration process again before any trades can be executed by a U.S. broker or dealer.\footnote{\textit{Id.} at 3-4.}

\section*{3. Stock Exchange Rule-Making Responses}

U.S. stock exchanges may also suspend trading in a company’s securities to the extent the company no longer meets listing requirements.\footnote{17 C.F.R. § 240.12d2-1 (2011). Stock exchanges are self-regulatory entities and have rulemaking authority. 15 U.S.C. § 78f (2006). Any rules, however, must go through a notice and comment period with the S.E.C. \textit{Id.}} The more liquid and prestigious exchanges—the New York Stock Exchange, the NASDAQ and the American Exchange—have begun to suspend trading in
some CRMs, relegating those companies to the over-the-counter market and sending a signal to the market that the companies are not to be trusted. Having a major exchange suspend trading has the effect of further depressing a stock’s value. By mid-2011, an estimated 29 CRMs were either delisted entirely or at least had trading of shares suspended or halted by the SEC, NASDAQ or the NYSE. Halts in trading often result in the eventual delisting of a stock.

As a result of the CRM scandal, both the NASDAQ and the NYSE proposed more stringent listing requirements for companies that go public through reverse merger. Both plans required reverse merger companies to trade on the over-the-counter market or a national exchange for either one year (under the proposed NYSE rule) or six months, (for the proposed NASDAQ rule) as well as meet minimum share price requirements for a period of time. The SEC called for the exchanges to propose rules that were consistent. As a result, the two exchanges agreed for a more stringent one-year waiting period, which the SEC approved in November 2011.

4. Market Responses: Discounting Based on Risk

One market response has been widespread discounting of Chinese based upon perceived risk. No commentators—except for hardened cynics—maintain that all CRMs are reporting false data. One factor that may have affected the loss

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213 CORNERSTONE RESEARCH, INVESTIGATIONS AND LITIGATION RELATED TO CHINESE REVERSE MERGER COMPANIES 2 (2011).
214 Id.
216 Id.
217 Id.
in value is not necessarily fraud, but misunderstanding. Investors may disfavor an otherwise sound company just because there is a “lack of transparency and full disclosure—along with the formidable barriers of language, distance and culture.”

When the market rallied behind IPOs in the first quarter of 2011, however, only one company going public was Chinese given the “declining quality and increasing skepticism” about Chinese firms.

Sometimes the market overreacts to bad news, and some smaller capitalization Chinese companies saw a price drop despite strong earnings. For example, in March 2011, SinoHub, a reputable electronics manufacturer in China, posted strong 2010 year-end net earnings that were 54% over the previous year.221 Although the stock price initially rose to $3.15 per share on the good news, the negative sentiment on Chinese stocks in general drove the price down 21% to $2.50.222 By late 2011, the stock was trading below $0.50.223 Although part of the decline can be explained by a decline in earnings,224 there appears to be a serious mis-valuation in the market given that the company’s enterprise value (or takeover value) is around $104 million.

219 Holmes, supra note 34.
220 Amy Reeves, Big Money Coming Back Into IPOs, INVESTOR’S BUS. DAILY, Apr. 18, 2011, at A5.
222 Id.
225 Some analysts consider enterprise value to be a more accurate valuation than market capitalization since it represents the price that “would need to be paid by the buyer when taking over a company.” Definition of ‘Enterprise
while the market capitalization hovers below $16 million. Even well-regarded Chinese companies, where no one suspects fraud, saw a selloff in shares because of a taint associated with CRMs. Given the discounting of their shares, it is possible these blue chip Chinese companies will exert pressure for Chinese regulators to allow the PCAOB to conduct cross border inspections.

5. Short Sellers: Exposing Fraud while Making a Profit

Short sellers also played an important role in revealing the CRM misconduct. Short selling is a practice where private investors borrow and then sell shares—in effect, placing a bet that the company’s share price will go down so that the investors will make a profit when they buy back the shares at a lower price. Motivated by the prospect of making money by betting against companies with inflated stock prices, short sellers began to make bets against CRMs as early as 2009. After placing their bets, some short sellers posted research reports criticizing the companies, and, in some cases, informed the SEC asking that the agency begin an investigation.

Short selling is controversial. Critics contend short selling manipulates the market and abnormally depresses the value of a company’s stock. Short selling has also been blamed for increasing market volatility. During the September 2008 fi-

228 Lawrence, supra note 17.
229 Id.
231 Id.
nancial crisis, the SEC banned short selling on the shares of 799 financial companies in an attempt to stabilize the markets.\(^{232}\)

Short sellers, however, play an important role in detecting accounting fraud early. In studying the market as a whole, Karpoff and Lou found that nineteen months before misrepresentations become publicly known, the short interest in a company’s shares steadily increases.\(^{233}\) Short selling sometimes helps to inform the market and protect other investors before the misconduct is officially revealed in two ways. First, short selling “increases the speed with which financial misrepresentation is detected.”\(^{234}\) Second, short selling drives down the company’s price, which helps to “mitigate the mispricing that occurs when firms misrepresent their financial statements.”\(^{235}\)

During the CRM crisis, short sellers were credited with exposing financial misdeeds before the SEC took notice.\(^{236}\) Interestingly, it was reports from a Chinese government agency that provided short sellers with some of the evidence of the accounting misdeeds.\(^{237}\) By comparing a CRM’s reports to the SEC with the reports the company made to the Chinese State Administration for Industry & Commerce (“SAIC”), short sellers were able to identify significant discrepancies.\(^{238}\) In some respects, the short sellers did a better job of due diligence than the auditors. Some investors are suing U.S. auditors for


\(^{233}\) Karpoff & Lou, supra note 230.

\(^{234}\) Id.

\(^{235}\) Id.


\(^{237}\) Lawrence, supra note 17.

\(^{238}\) Id.
failing to compare the SAIC reports with company disclosures.  

Did short sellers get it right in respect to CRMs? As this article went to press, it may be too early to tell. An independent committee of the board of directors of Sino-Forest Corp. found that allegations by short sellers that the company was a “near total fraud” were not backed by the evidence. Commentators, however, were still skeptical of the risks associated with doing business with such a company. Apparently, the variations between SAIC reports and Sino-Forest’s financial statements were explained by the fact that the company and shareholders wanted to hide information from the Chinese government for tax reasons. Such reasoning may help demonstrate the assets of the company are truly represented by the financial statements; however, it still indicated problems with the rule of law as to auditing if a company attempts to hide information from the state.

6. Litigation

Class action securities fraud lawsuits against CRMs are—not surprisingly—on the rise. The number of such lawsuits went from nine in 2010 to 24 in the first half of 2011.

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239 Id.
242 Id.
243 CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2011 MID-YEAR ASSESSMENT 3 Fig. 3 (2011). Lawsuits against CRMs represented over one-fourth of all U.S. securities fraud class action suits in the first six months of 2011. Id. at 1.
The prospect for shareholder recovery is marginal, given that most CRMs have their assets primarily in China, and the U.S. courts have no jurisdiction to compel a damages award. Liability, however, may exist for company service providers—i.e. accountants and lawyers—who committed fraud under the Securities Exchange Act of 1934. Since attorneys, accountants and investment bankers are involved in drafting the various disclosure documents required from publicly traded companies, any intentional act by a service provider to deceive might give rise to a private cause of action in addition to actions by regulatory agencies. In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*, however, the Supreme Court recently held that if the service provider is merely aiding and abetting the fraud, the right of a cause to action rests with the SEC or another oversight agency, not with private individuals. Of course, accountants and lawyers could be held liable in a private cause of action if they violated Section 10(b) of the Securities Exchange Act.

Even if liability isn’t established against the company or its providers, litigation might help drive change in accounting practices. At least one of the companies sued in the scandal appears to be taking action to make sure that future accounting problems do not occur again. After China North East Petroleum Holdings Ltd. had to restate earnings, a class action lawsuit was filed that was later dismissed given that the plaintiffs could not

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247 *Id.*
prove damages.\textsuperscript{248} As a result of the suit, the company incurred millions in litigation costs and fired its CEO and CFO.\textsuperscript{249} In order to prevent future trouble, the company appointed prestigious auditors in an attempt to assure the market that it had learned its lesson.\textsuperscript{250}

7. Auditor Responses

Although \textit{Stoneridge} shields some service providers from litigation, auditors are becoming more cautious about representing Chinese companies given heightened regulatory action. One report stated that U.S. auditors had resigned at over twenty-four CRMs by June 2011, though some companies claim they fired their auditors.\textsuperscript{251} Additionally, the recent problems with CRMs have led to auditors making more disclosures about the risk of accounting mistakes in a company’s filings.

Both attorneys and accountants have an important role in drafting disclosures of the various risks an investor might face by purchasing stock in a particular company. Typical risks might include the risk that a company will be unable to procure a rare ingredient used in the manufacture of its products, given the supply chain.\textsuperscript{252} Initial indications are that U.S. auditors are beginning to offer only qualified opinions when Chinese companies refuse to answer questions.\textsuperscript{253} In October 2011, KMPG

\textsuperscript{249} \textit{Id.}
\textsuperscript{250} \textit{Id.}
\textsuperscript{251} CORNERSTONE RESEARCH, \textit{supra} note 213, at 2 & n.14.
\textsuperscript{252} An example of such a disclosure from a Chinese solar panel company reads: “We may not be able to obtain sufficient silicon raw materials in a timely manner or on commercially reasonable terms, which could have a material adverse effect on our results of operations and financial condition.” JinkoSolar Holding Co., Ltd., (FORM 20-F) (April 25, 2011), available at http://www.secinfo.com/d14D5a.q43zn.htm.
\textsuperscript{253} Isabella Steger, \textit{How Should Auditors Handle China’s State Secrets Law?}, \textit{WALL ST. J. CHINA REAL TIME REPORT} (Nov. 2, 2011, 11:56 PM),
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reported that it could not sign off on China High Precision Automation Group Ltd.’s financial statements when the Chinese company withheld information stating that to do so would violate state secret laws.\textsuperscript{254}

Given the documented problems with the accounting and enforcement regime in China, it may make sense that auditors and lawyers provide a standard disclosure for all companies based in China that financial reports may prove inaccurate due to the weak rule of law as to the accounting regime in China. While such a disclosure is buried deep within a financial statement that few investors will ever read,\textsuperscript{255} the existence of such a universal disclosure—if done with enough publicity—may cause the Chinese government to step up enforcement if for no other reason than as a face-saving measure.

Such a radical universal disclosure of accounting risk in a country is not unprecedented. In 1999, the big four accounting firms required the audits of Japanese companies to include a legend that stated “the statements do not present the financial condition, operating results or cash flows that were prepared in accordance with accounting principles and practice that are generally accepted in countries other than Japan.”\textsuperscript{256} The legend was controversial and was seen as a factor that led to the establishment of the Accounting Standards Board of Japan and attempts to harmonize Japanese principles with international standards.\textsuperscript{257}

\textsuperscript{254} Id.

\textsuperscript{255} See generally MICHELLE LEDER, FINANCIAL FINE PRINT (2003).


V. CONCLUSION: INCENTIVES FOR RULE OF LAW REFORMS IN CHINA

Given the rapid pace of economic growth in China, there may be little incentive in the near term for China to strengthen the rule of law as to its accounting regime. Although some economists contend that a developing country may experience growth in the absence of the rule of law, such growth is not likely to be sustainable. The market, naturally, acts as an informal adjudicator—sending the message that China has to strictly enforce accounting standards if they expect U.S. investors to purchase stock in smaller Chinese companies. Additionally, U.S. lawmakers and regulators should consider passing even stricter laws and regulations that establish additional requirements for countries that have a systemic problem in financial reporting. Stricter requirements would advance the goal of U.S. securities laws to protect investors and would also create incentives for Chinese regulators to start enforcing their own laws in order to open U.S. capital markets to Chinese firms.

258 See generally Dam, supra note 67.
259 Id. at 46-47.