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SECURITIES SUPERVISION AND JUDICIAL REVIEW [IN CHINA]*

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Translator's Note: Since its founding in 1992, the China Securities Regulatory Commission ("CSRC") has, by the design of the central government of China, become the primary regulator of the Chinese securities market. The CSRC has, however, made some controversial decisions in enforcing its securities regulations. In particular, this article addresses the legal implications of the CSRC's failure to comply with controlling securities regulations in rejecting the Hainan Kaili Central Construction Company's listing application and the ramifications of such selective regulatory enforcement. The article provides an analysis of the current relationship between Chinese administrative and securities law.

I. INTRODUCTION

The Beijing Higher People's Court delivered its final judgment on July 5, 2001 in Hainan Kaili Central Construction Co. Ltd. v. China Securities Regulatory Commission. The case had been closely followed by both the securities and legal scholar communities, and after this judgment, the accompanying controversy temporarily subsided. But this does not mean that the case and its ensuing debate have come to a close. In this article, the authors analyze the process of determining what constitutes internal and external administrative actions, and analyze administrative and judicial discretionary authority as addressed in Kaili v. CSRC.

II. FACTUAL BACKGROUND OF KAILI v. CSRC

In December 1994, six major shareholders, including the Yantze River Tour Company, jointly established Hainan Kaili Central Construction Company Ltd.
Pursuant to the recommendation of the National Ethnic Group Committee, Kaili submitted A-share application documents and related materials to the Chinese Securities Regulatory Commission ("CSRC") in June 1998. In September 1999, Kaili received a CSRC report entitled Document Number 39 ("Doc. 39") which was turned over to the CSRC by one of the State Council's offices. The document addressed Kaili's listing application. According to Doc. 39, 97% of the profits Kaili had reported were fabricated. The fabrication was a serious violation of the Company Law, causing Kaili to fail to meet the listing requirements. The CSRC invalidated Kaili's qualification for listing. In April 2000, the Administrative Office of the CSRC issued a document entitled Document Number 50 ("Doc. 50"). Document 50 addressed the return of documents and materials submitted by Kaili for its preliminary review of the A-share issuance. The document further confirmed that Kaili's financial and accounting information for the three years prior to its listing application was untruthful, and thus Kaili failed to meet the listing requirement. The CSRC decided to return Kaili's A-share issuance-related application materials that had been submitted for preliminary review.

During the intervening period between the issuance of Doc. 39 and Doc. 50, Kaili brought an administrative action against the CSRC in the Beijing City First Intermediate People's Court. The Beijing City First Intermediate People's Court declined to accept the case, reasoning that the issuance of Doc. 39 was an "internal administrative action." Kaili appealed

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2 [Translator's note] According to the Company Law of China, there are three company forms. Previous to the implementation of the Company Law, there was no such distinction among companies because most of them were merely traditional state-owned enterprises. After the passage of the Company Law, the conversion of these traditional state-owned enterprises produces three main company forms: (a) limited liability shareholding companies (youxian gufen gongsi) (the approximate equivalent of the large stock corporation in Western countries belongs in this category), (b) limited liability companies (youxian zeren gongsi), and (c) wholly state-owned limited liability companies, a special type of limited liability company that may be wholly owned by a state agency.

3 [Translator's note] Shares were initially classified as "internal employee shares" (neibu zhigong gu), issued only internally to enterprise employees, and as "public shares" (gong zhong gu), available to the general public. Subsequently, with more foreign investment in the Chinese economic system, a separate category of shares was created and issued exclusively for foreign investors. Shares are now divided into those for domestic investors (neitigu), commonly known as A-share, and for foreign investors (waizigu), commonly known as the B-share, denominated in Renminbi and offered exclusively for purchase and sale for foreign currencies by foreign investors. In the early 1990s, Chinese state-owned enterprises began to list their shares abroad, and as a result, special classes of foreign investment shares labeled as "overseas-listed foreign investment shares" were created. These shares are issued by Chinese companies listed on foreign stock exchanges, such as H-shares in the companies listed on the Hong Kong Stock Exchange.

4 According to the CSRC's first reply, Kail's fabricated accounting information was found in four areas: (1) contributed capital; (2) proceeds of business; (3) cost expenses; and (4) profits. See BEIJINGSHI DIYI ZHONGJHONG RENMIN FAYUAN XINGZHENG PANJUESHU-ZHONG XING CHUZI DI 118 HAO [BEIJING CITY FIRST INTERMEDIATE PEOPLE'S COURT JUDGMENT BOOK] (2000).
the court’s decision, but withdrew its appeal after the CSRC issued Doc. 50, because the issuance of Doc. 50 was a new administrative action. In July 2000, Kaili filed a new consolidated administrative suit with the Beijing City First Intermediate People’s Court based on the CSRC’s issuance of both Doc. 39 and Doc. 50.\(^5\)

On December 18, 2000, the Beijing City Intermediate First People’s Court decided that: (1) the CSRC’s return of Kaili company’s A-Share application materials was in violation of law, (2) the CSRC should commence a review and re-evaluation of Kaili’s listing application and make a new determination within two months from the effective date of the court’s judgment, and (3) Kaili’s other claims were dismissed.\(^6\)

Kaili’s requests in this suit are: (1) that the CSRC repeal its conclusions that Kaili provided false financial statements for the three years prior to its listing application and that 97% of the company profits were not truthful, (2) that the CSRC rescind its decision to cancel the company’s eligibility for the issuance of A-shares and to return the materials for preliminary examination, and (3) that the CSRC renew its review and evaluation of Kaili’s listing application.

The court of first instance pointed out:

\[^{5}\] Although Document No. 39 was a report submitted by the CSRC for review by its superior authorities, this administrative action was definitive, concrete, and unequivocal, because the document declared the company’s profits to be false and in violation of law, hence its failure to meet the requirement for listing, resulting in a decision to enforce the cancellation of Kaili’s qualifications for stock issuance. According to Article 12 of the “Interpretation” regarding enforcement of the Administrative Procedure Law issued by the Supreme People’s Court, if an agency’s action affects the interest of a claimant, and the claimant can prove the existence of the agency’s action, the claimant may bring an administrative suit based upon such action. This court is of the opinion that such cases are within the scope of judicial review....

\[^{6}\] In accordance with the verification procedure (shenhe chengxu) issued by the CSRC, effective on March 16, 2000, the procedures for approval and examination of share issuance are as follows: acceptance of the application, preliminary examination and approval, evaluation by the Evaluation and Approval Committee for Share Issuance (faxing shenhe weiyuanghe), verification and approval, and reconsideration. The Committee, in the course of review of share issuance, will determine the eligibility of an applicant to issue stock. In its approval, the agency issues public documents concerning procedural outcomes of review. In its disapproval, the agency also issues its written opinions that explain the reasons for its denial. In receiving applications, the Committee changed the review procedure, and instead applied the verification procedure to those companies that had been subject to the 1997 quotas. This new procedure does not provide for whether the Committee may return the submitted materials if the approval to evaluate the applicant company is not granted. The CSRC’s act of returning Kaili’s application documents lacks legal basis. The CSRC’s action took place after the above verification procedure took effect. Given the retroactive application of this new procedure, the defendant’s review action should have adopted the new procedure that just aptly took effect. The defendant argued that the decision of the CSRC to return Kaili’s application was made in accordance with the old review procedure, thus it was deficient in both factual and legal basis. Notwithstanding this, the court should find that the return action contravened the procedure, and that the CSRC should reevaluate the company’s application material... concerning the plaintiff Kaili company’s request to cancel the CSRC’s decision affirmed in Doc. 50... again in Doc. 39, this court should confirm that the CSRC’s return action violated the procedure and...
The CSRC appealed to the Beijing City Higher People’s Court, claiming the First People’s Court made erroneous factual findings and misapplied the law. The Higher People’s Court dismissed the appeal on July 5, 2001.

III. THE LEGAL NATURE OF DOC. 39 AND THE JUSTICIABILITY ISSUE

The source of debate in this case is whether the issuance of Doc. 39 was an internal administrative action and thus not “within the scope of court’s judicial review” (xinzheng susong de shouan fanwei).

Administrative actions refer to acts or omissions by administrative agencies, organizations, and their personnel in the course of managing activities and enforcing power and function. Administrative actions can be divided into two categories based upon their application and scope: internal

order reevaluation of the company’s eligibility. This court should hold that the agency’s review action was not triggered yet. Thus, after consideration of both parties’ disputed claims, the court finds that the agency’s action had not reached a point of producing direct legal effect, nor were the disputed claims held to be within the court’s scope of review. As a result, this court cannot make a judgment in this case.

The court of second instance pointed out:

Whether or not Kaili’s financial information was objectively true depends on whether or not the company complied with China’s unified corporate accounting system. In the course of review, if the agency finds some problems, the CSRC should entrust to other relevant departments in charge (youguan zhuguan bumen) or professional agencies (zhuangyejigou) the task of evaluating and approving the financial status of an applicant in accordance with the special provisions on corporate accounting standards. The CSRC did not entrust other professional agencies to evaluate and confirm the financial statements of Kaili. To the contrary, the general office of the CSRC issued Doc.50. Doc. 50 was deficient in factual confirmation . . . . Although Kaili applied for public listing before the review procedure (hezhun chengxu) was promulgated, the CSRC should have protected the interest of Kaili by following the procedural requirements in its decision to permit or decline the share issuance. When Kaili applied for public listing and submitted all the documents and materials, however, the Administrative Office of the CSRC issued Doc. 50 and returned all of the submitted pre-review materials. The CSRC’s decision was not only deficient in its failure to specify on what rules or regulations or statutory provisions the decision was made, but did not follow its own enacted review procedure. The court of first instance’s judgment upholding illegality of CSRC’s action and its order that the agency should reconsider the company’s application within a fixed period of time as dictated by court, were correct . . . . The CSRC’s Doc. 39 (1999) is also within the purview of an internal action of an administrative agency. The content of Doc. 39 was also included in Doc. 50. This court had specified in its previous rulings, and because the court of first instance’s dismissal to an appeal was correct, . . .

The above description is from the First Intermediate People’s Court Book of Court Judgment (2000), and also from Beijing Higher People’s Court Book of Administrative Law Judgment (2001).

administrative actions and external administrative actions. Internal administrative actions refer to those legally binding and effective actions taken by administrative personnel in the course of managing an administrative agency. In practice, to distinguish internal administrative actions from external administrative actions, one should take into account the following factors: the legal basis of an administrative action, the object and matter of such action, the procedure applied in the implementation of an administrative action, and the legal effect of the action. Although these factors should be considered comprehensively, the most important factor is the legal effect. If an administrative action significantly affects another party’s right or duty, the other factors should be given less significance. This is necessary to protect the affected party’s legal rights and to ensure that the administrative agency exercises its authority lawfully.

Article 5 of the PRC Administrative Procedure Law (xingzhengsusongfa) provides that when the People’s Court adjudicates an administrative action, it will examine whether or not the actual administrative action was lawful. The administrative law does not directly define what constitutes ‘administrative actions,’ but Articles 11 and 12 specify what actions may be subject to judicial review. Article 12 provides that: ‘a People’s Court will not accept those suits brought by private individuals, legal persons or other organizations on the following grounds, . . . (3) Administrative agencies’ decisions to punish, appoint and remove their personnel . . . .”

9 Id. at 115.
10 In an edited book, ADMINISTRATIVE LAW, the author sheds light on the distinction between internal administrative actions and external administrative actions from three angles: (1) From the angle of an “actor,” the actor of an internal administrative action is the administrative agency or administrative organization. The objects of such actions are state officials, other administrative agencies, organizations, and other administrative actors. In contrast, external administrative actions’ actors refer to all administrative organizations that may meet the administrative qualifications. The objects of such administrative actions are rule-abiding people, legal persons or other organizations. (2) From the angle of the nature of “matter” (shixiang) and “its legal basis,” the matters of internal administrative actions occur internally within an administrative agency, and their legal bases are internal organizational laws. In contrast, the matters of external administrative actions address social matters, and their legal bases are laws and regulations that are applied for the operation of society. (3) From the perspective of “contents of administrative actions and the legal effects,” contents of internal administrative actions are concerned with intra-organizational relationships, relationships of subjugation and jurisdiction, and personnel relationships. The legal effects usually influence the duties and responsibilities of the objects to which the administrative actions apply. The contents of external administrative actions are related to some aspects of operation of society. The legal effects usually influence the privilege and duties of law-abiding people, legal persons and social organizations. Id. at 116.
This list does not exclude all internal actions, nor does it even use the term “internal administrative action.”

The Supreme People’s Court issued an Opinion concerning a consistent and thorough implementation of the Administrative Procedure Law, which went into effect on July 11, 1991, thus making progress in delineating the scope of administrative judicial review. Most noticeably, the court outlined the boundary of “specific administrative action (juti xingzheng xingwei).” Article 1 of the Opinion provides that specific administrative actions are unilateral actions of national administrative agencies, personnel of administrative agencies, or organizations vested with power by laws or regulations. They also include those administrative actions by organizations entrusted by administrative agencies to individuals when unilateral action is taken for individuals, legal persons or organizational duties in the exercise of administrative functions and powers. This definition appears to imply that internal administrative actions are not within the scope of the Administrative Procedure Law.

The above Opinion, however, was effectively superseded on March 10, 2000, when the Supreme People’s Court replaced it with an Interpretation on the implementation of the PRC Administrative Procedure Law.11 The Interpretation differs from the Opinion in terms of the scope of judicial review it authorizes for specific administrative actions. The Interpretation still fails to define the boundary of “specific administrative actions.” The first clause of Article 1 clearly provides that when individuals, legal persons or other organizations disagree with the administrative actions of national agencies, they can file a suit, and the administrative action will be subject to judicial review. The Interpretation uses the term “administrative action,” but it does not specify what constitutes “administrative action,” nor does it distinguish “internal administrative action” from “external administrative action.” The second clause of Article 1 identifies administrative actions not subject to judicial review, but it also does not use the term “internal administrative actions.”

With respect to Kaili’s action against the CSRC, in order to determine whether Doc. 39 is an internal administrative action, and whether it is within the scope of authorized judicial review, we need to approach and analyze the matter in terms of many aspects of the action, including the legal basis, the object and matter of the action, the applicable procedure, and the legal effect.

11 The “Interpretation” of the Supreme People’s Court was adopted in the 1088th Conference of Judges of the Court. It was promulgated on March 8, 2000 and went into effect beginning March 10, 2000.
The first clause of Article 7 of the PRC’s Securities Law (zhengquanfa)\textsuperscript{12} provides: "the State Council’s Securities Regulatory Commission will manage a unified operation and supervision over all securities markets." In April 1998, according to the State Council’s organizational reform plan, the Securities Commission and the Securities Regulatory Commission were incorporated to become a unified, single administrative agency under the State Council’s direct control. In its ratified regulation for deployment of the CSRC’s functions, internal organization, and personnel mappings adopted in September 1998, the State Council made a clear announcement that the CSRC was now the principal organization to handle securities and futures markets.\textsuperscript{13} The CSRC is an agency under the State Council’s control, and is required to submit its own report to its superior authorities concerning issues that are deemed worthy of reporting.

Doc. 39 by the CSRC was not earmarked for Kaili. Rather, it was designed as a report concerning some detailed information about Kaili to be submitted to the State Council. In light of this, the question becomes, is Doc. 39 an “internal administrative action?”

Doc. 39 was not addressed to Kaili directly, but it was transferred to the company through the General Office of the Hainan Administration, to whom it was originally sent by the State Council’s secretarial office on September 1, 1999. Undoubtedly, Doc. 39 had a significant effect on Kaili’s ability to list on the market, and the certainty and foreseeability of Kaili’s receiving an unfavorable decision from the regulatory body. Hence, in view of the nature of the matter and the legal effect of the document, Doc. 39 contained the attributes of an external administrative action.

Naturally, one issue persists: Doc. 39 was never addressed to Kaili in the first place. In addition, in April 2000, the CSRC also issued Doc. 50 to the general office of the Hainan Provincial Government (a copied version of this document was sent to Kaili), stating that Kaili’s financial and accounting data for the three years prior to the listing application were not truthful and failed to meet relevant listing requirements. Later, the CSRC decided to return all of the materials submitted for A-Share issuance review.\textsuperscript{14} Considering the procedure of the case, isn’t Doc. 39 a full-fledged administrative action? Or, was it not proper to bring an action against the CSRC before the CSRC issued Doc. 50? Perhaps, as legal scholars maintain,

\textsuperscript{12} The Securities Law was adopted by the 6th plenary meeting of the 9th Standing Committee Conference of National People’s Congress on December 29, 1998. It went into effect on July 1, 1999.

\textsuperscript{13} For more detailed information, visit CSRC's website at http://www.csrc.gov.cn.

\textsuperscript{14} Id.
the CRSC’s administrative action should be viewed as a unified whole that should not be subdivided.15

Within the Chinese legal system, there has been no direct attempt to define and utilize the ripeness doctrine.16 In the promulgated legal Interpretation by the Supreme People’s Court concerning administrative litigation, however, the Court imposed a key standard of the ripeness doctrine—the “adversely affected” factor.17 Considering this, the authors believe that, according to the Interpretation, the court of first instance’s ruling that Doc. 39 could be subject to judicial review was correct. In its judgment, the court of first instance clearly pointed out that Doc. 39 had a dispositive influence on Kaili; it was specific, clear, and had a legal interest related to Kaili. Further, Doc. 39 can be used as evidence that an administrative action occurred, hence, the plaintiff could bring an action against the CSRC and the court should find the case to be within the scope its powers of judicial review. Although the court of second instance dismissed the appeal and upheld the final judgment of the court of first instance, the court of second instance expressed a differing opinion on the issue of judicial reviewability of Doc. 39. The court of second instance stated that because Doc. 39 was an internal action of the CSRC, and the content of Doc. 39 was included in Doc. 50, the court could dismiss Kaili’s request that these two documents were mutually interrelated. The rationale for the court of second instance’s judgment implies that its opinion differs from that of the court of first instance. The court of second instance appears to disagree with the court of first instance’s opinion that Doc. 39 is within the scope of judicial review.18

The authors think that because there is no such term as “internal administrative action,” the proposition that courts in the current legal system may not review internal administrative actions is questionable. Further, the

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15 For detailed information, see FAZHI REBAO [LEGAL SYSTEM DAILY], July 25, 2001, Section 8. In the article, it was stated that the CSRC’s administrative action was a unified action. The administrative action included CSRC’s evaluation of Kaili’s application materials, the CSRC’s negative evaluation of Kaili’s submitted data, the CSRC’s negative determination to not to permit the company to be listed, and the CSRC’s return of submitted materials and documents.

16 BERNARD SCHWARTZ, ADMINISTRATIVE LAW 478-79 (Xu Bing trans., 1986). The basic rationale of the doctrine of ripeness is to prevent the courts, through avoidance of premature adjudication, from entangling themselves in abstract disagreements, over administrative policies, and also to protect the agencies from judicial interference until an administrative decision has been formalized and its effects felt in a concrete way by challenging parties.

17 In the Court’s Interpretation, the First Article, Section 2 provides that it is impermissible to bring an action if there is no actual influence on law-abiding people, legal persons, or other organizations’ privilege and duty.

18 See Beijingshi Diyi Zhongji Renmin Fayuan Xingzheng Panjueshu-gaoxingzonzi di qi hao [Beijing Intermediate People’s Court Judgment Yearbook (2000)].
proposition that courts should not review Doc. 39 because it is an internal administrative action is also questionable. The question of whether Doc. 39 is an internal administrative action has generated controversy. Undeniably, the consequence of Doc. 39 was Kaili's failure to meet the listing qualifications. Pursuant to Article 12 of the Supreme People's Court's Interpretation, "if there is a specific administrative action and this action engages individuals, legal persons or other organizations into a legally binding relationship, and they disagree with such action, they can challenge on the basis of such an administrative action."19

Whether or not Doc. 39 is replaceable by Doc. 50, thus decreasing Doc. 39's susceptibility to judicial review, the authors think that because these documents are closely related, one cannot deny the legal efficacy of Doc. 39. Doc. 39 specifically and distinctively adversely affected the rights, privileges, and duties of Kaili, and had an undeniable legally binding effect on Kaili. Because both Doc. 39 and Doc. 50 were decisions made by the CSRC for Kaili's application for listing and were temporally proximate to each other, if Doc. 39 was not a ripe administrative action, should Kaili have waited to bring an action against the CSRC until the agency issued a new administrative decision (like Doc. 50)? In the authors' view, Doc. 39 was first sent down by the Secretarial Office of the State Council on September 1, 1999 to the General Office of Hainan Provincial Government, which in turn forwarded it to Kaili. This should confirm the dispositive efficacy of Doc. 39. In other words, because Kaili was applying for listing, at the time the company was adversely affected by the decision, Kaili's action against the CSRC was ripe. In addition, Article 40 of the Interpretation provides that:

When an administrative agency takes an actual administrative action, and fails to enact provisions or provide for legal documents, those law-abiding common people, legal persons or other organizations objecting to such action, may bring an action with the People's Court only if they distinctively provide that there exists a specific administrative action, and the Court should review the cases.

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19 Within our current legal regulations, there is no clear definition of what constitutes a "specific administrative action." It has been customary to categorize administrative actions according to their objects; abstract administrative actions and specific administrative actions. Specific administrative actions refer to those specific actions taken toward certain individuals or matters in the process of agency management. The contents and consequences of these actions directly affect other persons' rights and other agencies' powers. The most noticeable features of these actions are their specificity. See Luo, supra note 8, at 116-17.
On its face, this Article is significantly advantageous for the company. To summarize, the appropriateness of the rationale for the court of second instance’s judgment—that Doc. 39 was an internal administrative action, simply because its contents were demonstrated to be implied and incorporated into subsequent Doc. 50—is questionable. The CSRC’s action adversely affected Kaili. Thus, judging from the goal of administrative law in ensuring the protection of legal privilege of the regulated party and in supervising whether an administrative body implements its powers lawfully, Doc. 39 should be deemed to be within scope of judicial review by the court.

IV. THE ADMINISTRATIVE DISCRETION ISSUE

Administrative discretion refers to the power delegated to the administrative agency in conformity with administrative statutes and rules to ensure the unbiased rule-making and reasonable exercise of privilege in the agency’s normal scope of operation. It is designed to give the agency freedom of self-determination, or the power to make its own administrative decisions. In practice, administrative discretionary power refers to the power of choice by an administrative body under certain conditions. The power is granted by law and regulation, and the way it is exercised should be based on the principle of unbiased rationality and preservation of legislative intent. In large part, the content of this discretionary power includes the agency’s decisions against its target entities, the method of deployment of this power, and the frequency with which it is exercised. When an administrative agency exercises this discretion, it should be done in conformity with principles of lawfulness and reasonableness. This means that an administrative agency should not go beyond its vested power and original legislative purpose. It should take into consideration many related factors, conducting and implementing the discretion reasonably and without bias while ensuring the establishment of corresponding legal supervision and relief mechanisms.

In Kaili’s case, the administrative discretionary power centers on the CSRC’s review of the company’s submitted materials. This includes the prescribed time limit in which the CSRC is expected to evaluate Kaili’s listing application and the question of whether the CSRC is actually vested with the power to review Kaili’s submitted materials for listing. If the

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CSRC is so empowered, the final issue is how the CSRC should exercise that power.

As explained in the Part II, Kaili submitted the requisite materials to the CSRC for A-Share issuance eligibility selection in June 1998. In September 1999, Kaili received Doc. 39 which had been issued by the CSRC on August 20, 1999, and then mediated and transmitted through one of the offices of the State Council. In April 2000, the company received Doc. 50. Kaili experienced a long waiting period. Is this long waiting process prescribed by law or regulation?

The CSRC’s review procedure for stock issuance, promulgated on May 29, 1998, includes A-share issuance guidelines, and operates as follows:

1. Pre-Selection Stage (yuxuan jieduan): (3) the CSRC Share-Issuance department evaluates the submitted materials... receiving data, documents, registering the time it have received the requisite application... (5) the CSRC shall submit its own opinion in determining whether the applicant company shall be permitted to issue shares within 25 days of its receipt of submitted materials... For those applicant companies that satisfy requisite eligibility standard, it will issue an agreement with submitted materials... with regard to those companies that do not satisfy the requisite eligibility standard, it will not issue an agreement with submitted materials.

2. Evaluation and Approval Stage (shenpi jieduan): (1) provincial government or local government and the State Council’s related industrial bureaus complete the first stage of evaluation and send their own opinions to the CSRC and then hand over the requisite documents and materials to the agency within 30 days from the receipt of requisite materials by the applicant company. (2) the CSRC share-issuance department shall receive materials from those companies that satisfy the eligibility standard, and shall register the time of receipt... (4) when requisite materials meet the standard of share-issuance department, within 7 days, the materials will be turned over to the Evaluation and Approval Committee (shenhe weiyuanhui) ...
As demonstrated above, the review procedure for share issuance contains several regulations that bind the CSRC in the exercise of its powers and functions, including the imposition of time limits for completing each stage of review. But the provision has some drawbacks, such as the absence of administrative relief provisions, and lack of specificity and certainty for some time limits. For example, although one provision states that for standard-clearing companies, the CSRC’s department of stock issuance shall receive the requisite application materials, it does not specify the time frames in which the department will determine whether it has received all such materials. Similar problems exist in other review stages. The stock-issuing department receives the submitted materials from an applicant company once the applicant meets the standard, but there are no specific provisions concerning the prescribed time limits for the stock-issuing department’s notification to the applicant company of receipt of the requisite materials. From the applicant company’s perspective, it is reasonable to assume that if the CSRC does not request additional materials, it met the CSRC’s eligibility standard and the application will be evaluated in due course. To summarize, the lack of provisions for time limits for each stage’s review process greatly impacts the length of the applicant’s waiting time.

In Kaili’s case, although there are no provisions that set time limits, one should note CSRC’s action. In accordance with CSRC’s prescribed procedure, in June 1998, Kaili submitted the requisite pre-selection materials. Although the procedures do not provide for the time limits on the share-issuing department’s decision concerning notification of receipt of submission, the CSRC specifically provides time limits for those cases that pass the pre-selection standard. In our case, the Doc. 39 decision did not concern “whether the agency had received the requisite materials.” Once the CSRC had received requisite materials and Kaili satisfied the eligibility stage, the CSRC should have observed the time limit as provided in the “review procedure” (shenhe chengxu). Likewise, the CSRC did not observe the time limits when issuing Doc. 50. In Doc. 50, what the CSRC issued did not concern whether “the agency had received the requisite materials.” Hence, the CSRC should have observed the time limits, but it did not.

Aside from this, Doc. 50 was a decision to return all the materials that had been submitted for pre-review. According to review standards, the CSRC at the pre-review stage should not have made a decision to return the submitted materials. Rather, it should have decided to accept or reject the submitted materials, or to issue a report to superior authorities. In conformity with the CSRC’s regulations on reviewing listing applications, only at the stage of review, and only after the share-issuing Evaluation and
Approval Committee’s rejection of the application, may the submitted materials be returned to a local government or to one of the offices of the State Council. Kaili’s listing application did not enter into the stage of review. It remained at the pre-review stage. In view of this, the CSRC’s issuance of Doc. 50 which mandated the return of the requisite submitted materials, violated the procedure.

On July 1, 1999, the Securities Law implemented a new procedure for review for share-issuing. Among the provisions, the sixteenth provision provides that: “the State Council’s securities supervisory agency or State Council-vested department should make a decision within three months after its receipt of requisite application materials, and provide an explanation when an applicant company’s application fails.”

In a concerted effort to prevent confusion, the CSRC promulgated a new verification procedure (hezhun chengxu) on March 16, 2000, removing the pre-review stage. This new procedure provides for: how the agency should exercise its power and function; the pace and the prescribed time limits of review; and the administrative relief mechanism. In accordance with the Securities Law and the new verification procedure, the drawbacks of the CSRC’s administrative examination and approval action in large part lie with its lack of provisions concerning the prescribed time limits on each stage of the process. This is the most profound lesson CSRC should learn from this case.

V. THE JUDICIAL DISCRETION ISSUE

Judicial discretion refers to a judge’s power to make a judgment with vigilant circumspection to the circumstances of the case. The exercise of this power should be just, fair, accurate, and reasonable in its application. Law normally empowers judges with duties and privileges and allows the exercise of a degree of freedom to make a judgment under the particular circumstances. Judges should exercise this power as the circumstances dictate—sometimes they have to exercise this privilege within the constraints set by statutes.

The application of judicial discretion permeates various aspects of a court’s review, including principles of administrative discretion, legal foundation, content, and procedure. In the course of administrative litigation, judges in reasonable exercise of their judicial discretion should take into account the following factors: (1) the significance of the decision or indeterminacy of the legal rule; (2) the intent of express statutory provisions or indeterminate, implied statutory provisions; (3) the purpose and principle
of the law and policy; (4) values of social equality and justice; and (5) the reasonable relationship between judicial power and administrative power, among others. In Kaili's case, the issue of judicial discretion is mainly reflected in the application of law and the CSRC's review power.

A. Application of Law

In the middle of the CSRC's review of Kaili's listing application, the Securities Law was promulgated and entered into effect. In accordance with the new Securities Law, the CSRC enacted a verification procedure, removing the pre-review stage, and adding time limits and administrative relief provisions. Accordingly, the disputed claims should center on the following issue: should the CSRC adopt the old standard of review or the new standard?

The new standard of review requires the applicant to prepare the requisite materials and, with authorization from either the provincial government or the State Council's related bureau, apply to the CSRC for listing and include a recommendation from one of its primary underwriters. Prior to submission of the requisite information and materials to the CSRC, the lead underwriter (zhucheng xiaoshang) should guide the applicant for one year. In this one year guidance period (fudaoqi), the primary underwriter should test the applicant company's board of directors, supervisory body members, and management members' legal knowledge relating to the Securities Law and the Company Law. For those companies belonging to the 1997 share-issuing standard, the CSRC must test the degree of knowledge of Securities Law and Company Law held by the company's board of directors, supervisory body members, and management members.

The court of first instance recognized in its judgment that the review standard was in transition. The court of second instance recognized this again in its judgment and gave more specific analysis and comments on this, explaining that:

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22 [Translator's note] The purpose of this guidance period is to ensure that the company proposed for listing has the relevant legal knowledge about listing and an appropriate procedure for disclosing information. Securities firms are designated as "coaches" to provide the company with such help. As most of China's listed companies lack such knowledge and experience, it is a desirable procedure to improve the overall quality of listed companies on China's stock market. A problem, however, may arise regarding the quality of the "coaches" themselves, since some of the securities firms, especially those newly set up, lack legal knowledge about listing and information disclosure. See ZHU SANZHU, SECURITIES REGULATION IN CHINA 97-98 (2000)
[A]fter the CSRC’s receipt of Kaili’s requisite materials for share-issuing, the agency should have adopted the existing standard of review. Through the review process, it also should have issued its own decision as to which companies were held to comply with the requisite standard. Shortly after the CSRC initiated its investigation of Kaili company’s listing application, the Securities Law was promulgated, enacting a new procedure for the selection of appropriate companies for issue-sharing and listing. In March 2000, in accordance with the Securities Law, the CSRC formulated a new verification procedure, which replaced the old standard by providing a supplementary provision designed for those companies that applied under the 1997 share-issuing standard. For example, for those companies that applied to the CSRC for listing under the 1997 standard, prior to the Evaluation and Approval Committee for Issue-sharing’s (faxing shenhe weiyuanhui) examination and verification, the CSRC should conduct a legal knowledge test of the Securities Law and the Company Law (gongsifa) for members of the board of directors, supervisory bodies, and management. This would remove the applicant company’s requirement for one year of the lead underwriter’s guidance. In the intervening period between promulgation of the new standard and replacement of the former standard, under the operative premise of protecting the rights of original applicants, the CSRC chose to use the new procedure. The CSRC also explained that the new procedure of verification (hezhun chengxu) had already been adopted for evaluating applicant companies for listing. Thus, although Kaili applied to the CSRC prior to the adoption of the new procedure, in order to protect the applicant’s rights, the CSRC made its decision in accordance with the new procedure in allocating acceptance or rejection decisions among applicant companies. But, the CSRC issued Doc. No. 50 under the title of its office and returned all the pre-review materials. The decision to return the application materials was not based on then available enacted law, statutes and regulations, nor did the CSRC rely on its own enacted procedure of verification. Therefore, the court of first instance’s judgment that the CSRC’s decision was a mistake and should be reconsidered within a certain period of time to be dictated by the court proves to be correct . . .
The court of second instance held that a company applying for issuing of shares should be subjected to the new procedure of verification because the new standard specified the knowledge test for the applicant company's members. However, isn't the ground for the new standard related to the applicant company's listing application materials? Further, except for the knowledge test for the applicant company's executives, for all other aspects of the listing application, shouldn't the old standard apply?

Although the new standard of verification does not expressly address those companies that applied under the 1997 standard, it should be applicable retroactively, and a court relying on this should adopt the new standard. Such an approach is quite convincing. In addition, from the vantage point of the purpose of the law, it is reasonable to adopt the new procedure. The Securities Law prompted the transition from the old standard to a new one (from shenpizhi to hezhunzhi), and this transition was designed to diminish administrative intervention, thoroughly carrying out "three principles:" the procedure for stock issuance and eventual public listing will be conducted lawfully, reasonably, and highly effectively. The new standard of verification was enacted by the CSRC in accordance with the newly enacted Securities Law; thus, the authors believe that adoption of the new procedure in CSRS'c listing decisions fulfills its original legislative purpose. However, the authors take note of the PRC Legislative Law (lifafa), which went into effect on July 1, 2000. Article 84 of the PRC Legislative law provides that law, administrative rule, local rule, self-government provisions, direct-controlled city clauses, and regulations do not apply retroactively. They may be applied retroactively only to protect the rights and interests of law-abiding common people, legal persons and other groups.

B. Substantive Review Power

The most controversial aspect of the Kaili decision is the court's determination of the CSRC's substantive review power (shizhi shenchaquan). Namely, the decision addresses whether the CSRC is vested with substantive review power to approve or disapprove of Kaili's submitted listing application materials. If the CSRC is vested with substantive review power, the focus of this question shifts to how the CSRC should exercise its power in review of an applicant company.

23 Lifafa (PRC legislative Law) is a basic law that defines the boundary of legislative activities. The National People's Congress ratified this law on March 15, 2000. The Legislative Law shall define the boundary of laws, regulations and rules and respective procedures.
Pursuant to Article 14 of the Securities Law, the State Council's Securities Supervision and Management Organization is required to install an Evaluation and Approval Committee for Share Issuance (faxing shenhe weiyuanhui). The Committee members are professionals selected either from the State Council's Securities Supervision and Management Organization or outsiders invited from different organizations. The Committee uses a voting system as a means of approving an application for the issuance of shares and gives its own opinion on evaluation and approval. The State Council Securities Supervision and Management Organization (guowuyuan zhengquan jiandu guanli jigou) formulates the organizational structure, office tenure, and operational procedure of the Evaluation and Approval Committee for Share Issuance. The State Council's Securities Supervision and Management Organization reports to the State Council, which in turn ratifies the organization's formulation. The first clause of Article 15 of the Securities Law provides that "the State Council Securities Supervision and Management Organization bears full responsibility for evaluating and approving applications for share issuance within legal constraints. The review procedure must be open and be subject to supervision as dictated by law."

From the legal regulations described above, it is apparent that the CSRC has substantive review power over Kaili's submitted listing application materials. Although no regulation directly defines whether the review power is substantive or formal, the authors think that it is substantive. Such an interpretation is consistent with the verification procedure. It is also consistent with the provisional regulations on share issuance and transaction management that contain requirements of substantive conditions earmarked for an applicant company's open share-issuance,24 and actual operational situations.

In Kaili's case, the source of controversy concerning review power stems from the court of second instance's brief description of its judgment rationale. Pursuant to the Company Law and the Securities Law, the CSRC's strict review of whether a listing applicant company satisfies the qualifications for share-issuance is granted by laws and regulations while it is engaged in supervision and management of the securities market. To discharge its legally designated responsibility, the CSRC must accomplish the following: grasp the circumstances firmly, present conclusive evidence, base legal argument on adequate grounds, and standardize the administration and enforcement of law. The court of second instance states that:

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24 See Provisional Regulations on Share Issuance and Transaction Management, arts. 8-11.
Kaili did not accurately report profits for the 3 years prior to the listing application... hence, whether Kaili's financial disclosure reflects the true financial situations of the company wholly depends on its compliance with a national unified accounting system. When the CSRC discovers something questionable in its review of an applicant company, it must entrust other relevant departments or specialized agencies with review and confirmation of the company's financial data because the CSRC did not comply with these special provisions on company accounting appraisal. But, instead it drafted Doc. 50, its confirmation of factual evidence was not satisfactory...

The court of second instance held that the CSRC had review power over submitted materials for listing application. But, to exercise its review authority, the CSRC must grasp the circumstances firmly, it must present conclusive evidence, its legal ground should be convincing, and it should standardize the enforcement and administration of law. The court of second instance further pointed out that when the CSRC found something questionable in submitted financial data—rendering it unable to determine Kaili's true financial status and raising the question of whether Kaili followed the nationally unified accounting system—it should have entrusted other relevant departments in charge or specialized agencies with review and confirmation of the applicant company's financial data. In other words, the CSRC should not have judged Kaili's financial status itself. Undoubtedly, this holding will impose significant limitations on the scope of the CSRC's review authority. The court implies that at least with regard to an applicant company's financial data, the CSRC's review authority is limited to formal review, and substantive judgment rests with other relevant departments or specialized agencies.

Did the judgment of the court of second instance go too far? As described above, according to the official legal regulations, the CSRC is granted substantive review power, and prior to the court of second instance's judgment, there had been no limitation imposed. We think, in this case, the court of second instance exhibited a strong rule-making tendency without a clearly defined legal foundation. The decision is not strongly persuasive, and the court has over-stretched its judicial discretion. Aside from this, in practice, it is indeed difficult to definitively determine whether the judgment

of other departments in charge or other specialized agencies are more objective, fair, and correct than that of the CSRC. In actuality, the Evaluation and Approval Committee for Share Issuance is comprised of the CSRC’s specialized personnel or specialized invitees from other agencies, including socially renowned persons. The Committee’s judgment must epitomize professional standards, and the fact that the CSRC acts as a balancer vis-à-vis the Securities Supervision and Management Organization will justify the classification of the CSRC’s judgment as objective. As demonstrated by the abrupt collapse of Enron, the renowned Arthur Anderson accounting and consulting corporation’s behavior came as a surprise to investors. As a result of the Enron scandal, a great majority of investors lost their confidence in financial markets. Thus, it is not necessarily true that decisions by professional agencies must be always trusted. Potential conflicts of interest lower the degree of objectivity and trustworthiness of professional agencies’ decisions or judgments. Similar events have occurred in China.

With respect to the substantive accuracy of relevant financial data, which agency should be accountable: the CSRC, other relevant departments, or other professional agencies? Under the current system, other relevant departments should be accountable for making substantive assessments of the accuracy of financial data, but the CSRC must participate in the selection of the proper department. Specifically, although the CSRC can make its own substantive assessments concerning financial data, it may also entrust a relevant department or professional agency with making that substantive judgment. If an applicant desires to challenge a judgment, she should be accountable to the relevant department or professional agency.

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26 See regulations on evaluation and approval committee for share issuance under CSRC’s Securities Supervision and Management Committee, Articles 4 and 5.

27 In September 2001, a listed company, Weimaike, sent issued a report that six members of Shengzhen Huafeng accounting office who did not follow the standard in its auditing report were detained for criminal charges and they were released upon bail pending trial. From 2000 to 2001, Hebei Lihua accounting office was found to have made false audit reports without reservation of 28 listed companies such as Kangsai Inc, Xingfa business groups, Huoli corporation. In September 2001, after major discrediting of Yinguangxiahuang newspaper’s huge profits, the Ministry of Finance expressed that it would plan to invalidate licenses of accountant, Liujialong, Xulingwen, and revoke the license of “Zhongtianqin” accounting office. In conjunction with the CSRC, the Ministry of Finance would revoke the accounting office’s licenses for securities and futures-related works, and at the same time seek more responsibilities of that accounting office. On December 25, 2001, the National Auditing Office promulgated that it would investigate the accounting office’s whole year auditing works that included 16 listed companies’ annual accounting reports. It did a sampling of 32 audit reports and reinstated its own auditing works regarding companies in its 21 audit reports. The National Auditing Office found 23 seriously deficient audit reports. This signifies the untruthfulness of financial accounting information, and as a result the total value of the untruthful accounting information amounted to larger than 0.7 billion Yuan (Renminbi). The National Auditing Office found that at least 41 licensed accounting offices were involved in these accounting malpractices. For further detailed information, see Major Incidents of Domestic and International Accounting Jobs, in CAIJING [FINANCE], Vol. 2 (2002).
permitted to argue the case. If the CSRC makes an unfavorable decision on substantive grounds prior to finalizing the decision, the CSRC must permit the applicant to defend itself.\(^2\) After the decision is finalized, the applicant can request another review or reconsideration of the case, or she can appeal the decision. The court of second instance did not need to rely on its own rigid rule-making. There was another established law applicable to resolve the question of which law should be adopted. Pursuant to the verification procedure (*hezhun chengxu*), the CSRC violated the legal procedure. The court should not have overstepped its bounds by issuing a judgment when the legal basis and persuasion were weak. As a result, the way the court of second instance exercised its judicial discretion was unsatisfactory.

It is possible, however, to interpret the court of second instance’s strenuous attempt at rule-making in a more favorable light. Under these circumstances, when confronted with overlapping departmental boundaries, duties, and responsibilities among administrative organizations, the court may have been attempting to emphasize mutual respect for each organization’s powers and authority in order to decrease repetitive practices among administrative organizations and increase administrative efficiency. At the same time, one of the rationales for the court of second instance’s rule-making tendency would be to enhance the legal position of professional bodies within intermediary organs, and to emphasize the responsibility of these organs in charge of listing and issuing shares so that their administrative function and efficiency would be fully exercised. If this is the intent of the court of second instance’s rather rigid rule-making, it will serve to stem the abusive use of administrative discretion. If this is the case, there are some positive aspects to this ruling and a wholesale denial of it would be improper.

Aside from this, it is worth noting that if the CSRC in due course of review of Kaili’s submitted materials finds recorded profits untrue and its financial status incapable of passing muster under the CSRC’s standard, it

\(^2\) On December 12, 1999, the CSRC promulgated “A Method on Hearing in China Securities Supervision and Management Committee’s Administrative Penalties.” The Article 2 provides that: before Securities Supervision and Management Organization imposes one of the listed administrative penalties or more than one of administrative penalties, if the claimant requests a hearing, the Organization must hold an appropriate hearing. At the hearing, the following occurs: (1) stoppage of share issuance; (2) revocation of qualifications allowing for securities transactions, due to the seriousness of the wrongful action; (3) closing and reorganization of business; ... (10) pursuant to law, rule, regulation, or provision that merits a hearing, imposition of other penalties.” Article 42 of the Law of Administrative Penalties provides that: “before the administrative organization decides to impose administrative penalties such as closure of business, cancellation of licenses or permits, or large sums of fines, the organization should notify the claimant that she has the right to a hearing, and if a claimant wants a hearing, the organization should hold a hearing. . . .” Given the prevailing law and norm in relation to share issuance and listing, however, no claimant has requested a hearing as yet.
can rely on Article 173 of the Securities Law, which provides that “while performing its assigned legal duty, if the State Council Securities Supervision and Management Organization finds suspicious securities-related illegalities, it must hand over the case to judicial authorities.” Concurrently, Article 202 of the Securities Law provides that:

[S]pecialized bodies who issue reports like appraisal reports, asset appraisals, or legal opinions for the purpose of issuing shares, listing or securities transactions, will be fined in an amount not less than illegal gains but not more than five times illegal gains, if those reports by these bodies prove to be untrue and incorrect, these bodies will be ordered to cease their business by their principal bureaus and those directly responsible for untrue reports will be stripped of their licenses. If there are losses therewith, they are jointly accountable for indemnification. If their actions are subject to criminal charges, criminal penalties will be imposed.

Moreover, the PRC Criminal Law, Article 229 provides that:

[If] those personnel of intermediary organs that assume the responsibility of asset appraisal, asset verification, account, auditing, legal services intentionally provide false certifying documents that are very intentionally fabricated, shall be jointly subject to fixed-term imprisonment or criminal detention or to fines . . . . the first clause also provides that if those personnel subject to the First Section not significantly involved in assuming responsibility make a large mistake in making certifying reports that are not truthful, and the consequence of this mistake is fairly substantive, they will be subject to fixed-term imprisonment of a term of not more than three years or to criminal detention, and will be fined jointly and severally.

Hence, if the CSRC obtains conclusive evidence of illegalities through its own investigation, then it should determine who should bear administrative punishment. If it finds suspicious illegal violations, it should hand the case over to judicial entities for resolution. From this, even though the CSRC came to know Kaili’s fabrication of profits and its financial status not capable of passing the listing standard, and did not take appropriate administrative action to punish those intermediary organs, or if the CSRC
did not turn the case to judicial bodies when it was proper to do so, then it would be held accountable for the failure of action.

In the judgments of both the courts of first instance and second instance, there was no attempt to decide whether Kaili’s submitted financial materials were deficient. In our opinion, both courts seemed to have grasped rather firmly the “degree” of judicial discretion. While they showed deference to administrative discretion enjoyed by administrative bodies, they still proceeded to evaluate administrative actions. For example, the court of second instance recognized in its judgment that the CSRC’s Doc. 50, which was made despite the CSRC’s failure to rely on a specialized agency’s evaluation and confirmation, was not satisfactory. Both courts were at a disadvantage to make a direct and highly professional judgment concerning whether or not submitted financial statements were satisfactory. Under the circumstances, both courts should have turned the case over to the CSRC’s expertise, and the courts should have focused on purpose, legal basis, relevant factual evidence, and procedural aspects of the CSRC’s administrative discretion, and conducted judicial review of CSRC’s reasonable use of this discretionary power. This line of judicial review will not interfere with administrative power while ensuring the restraining role of judicial power over administrative power. Those directly involved will wish to have more of the court’s direct involvement and clear judgment. Theoretically, direct involvement by the court will give rise to encroachment of judicial power into administrative power, while in practice courts are at a disadvantage to make direct judgments that deal with very sophisticated and professional technical issues.

Because this case was brought during the transition period in which the old review procedure was being replaced by the new procedure, the plaintiff and the defendant relied on different procedures. Consequently, Kaili did not receive the treatment required by the new verification procedure for listing. Because it relied on the old procedure of review for listing, the CSRC’s administrative action caused defects in the process. As relevant legal norms improve, those who are affected by administrative actions will receive more assurance and will be taken more seriously. Relevant regulatory procedures, namely administrative legal procedures that warrant protection of privileges of those affected by administrative actions will become more specific and meticulous. More research and discussion will be required to meet the ever-increasing demand for meticulously and specifically crafted regulations and these will improve the legal system.