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A Big Gap between ‘law in books’ and ‘law in action’ and "A New Taxonomy of Enforcement Strategies"

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Conclusion

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1 A Big Gap between 'law in books' and 'law in action'

Any attempt to comprehensively analyse the enforcement of corporate law and securities regulation is difficult, not only because there are so many distinct national systems in play, but also because, we need to examine both formal enforcement mechanisms and the way in which such mechanisms are applied in practice. If nothing else, the expert analyses presented in the foregoing chapters of this book confirm that with respect to enforcement issues a rather large gap does exist between what Roscoe Pound memorably called 'law in books' and 'law in action'.[1]

Across the globe, there certainly appears to be a discernible trend toward encouraging private enforcement in recent years. As this collection demonstrates: the PRC formally allowed private claims against securities misrepresentation in 2002;[2] after the Parmalat case of 2003, Italian courts have adjudicated several very significant civil cases concerning securities misrepresentation;[3] Germany introduced a model case mechanism to provide collective redress for securities investors in 2005;[4] in 2004 Japan introduced a special provision enabling investors to pursue liability of securities issuers for misrepresentation in disclosure documents;[5] Korea passed a law in 2003 (effective from 2007) to introduce a class action mechanism designed to enhance protection for small investors in the Korean securities markets;[6] in 2003, Taiwan established a non-profit organisation successor to a similar body created in the late 1990s, the Securities and Futures Investors Protection Center, which can by itself bring a representative action with respect to an alleged securities

[1] Roscoe Pound, *Law in Books and Law in Action*, 44 AMER. L. REV. 12 (1910). See John Armour, Bernard S. Black, Brian R. Cheffins and Richard Nolan, Chapter 13.
[2] See Liming Wang, Chapter 6.
[3] See Guido Ferrarini and Paolo Giudici, Chapter 19.
[4] See Rainer Kulms, Chapter 18.
[5] See Gen Goto, Chapter 20.
[6] See Hwa-Jin Kim, Chapter 21.

or futures-related breach which has harmed multiple securities investors or futures traders;[7] and India reformed its company law statute to allow for class action in 2013.[8] Of course, the trajectory in the US, the motherland of private enforcement of corporate and securities law in a decidedly common law context, has been in the opposite direction as a result of both statutory amendment and jurisprudential developments, and notwithstanding the scandals that gave rise to Sarbanes-Oxley and then the Global Financial Crisis.[9]

However, it is one thing to stipulate a private right of action in statute or regulation, and it is quite another to see it implemented or pursued in practice. In all countries and legal systems, the successful implementation of a private enforcement scheme depends on various procedural, institutional, political and cultural factors.[10] In some jurisdictions that have actually gone as far as introducing a class action mechanism, such as Korea and India, its effectiveness has been severely curtailed by the lack of rules allowing or governing contingency fee arrangements. In emerging economies such as the PRC, India and Brazil, private enforcement has in many ways been frustrated by the judiciary. For instance, the PRC had long provided a regulatory-statutory 'legal basis' for civil liability for false and misleading disclosure in its securities markets, but this could not even begin to be implemented until 2002–2003 when the PRC Supreme People's Court (SPC) reversed its initial ban on acceptance of such cases and started to allow Chinese courts to take such cases under intense public pressure. And even after the SPC's switch in 2002–2003, the Chinese judicial bureaucracy has continued to use all manner of tricks to stymie the handling of civil compensation claims for misrepresentation in the securities markets, which at least one of the authors in this collection sees as the reason for the lower-than-expected number of securities civil claims to date.[11] Similarly, in India and Brazil, limitations

[7] See Wen-Yeu Wang, Chapter 22. [8] See Vikramaditya Khanna, Chapter 16.

[9] See Judge Jed Rakoff, Chapter 1; James D. Cox and Randall S. Thomas, Chapter 12; and John Armour, Bernard S. Black, Brian R. Cheffins and Richard Nolan, Chapter 13.

[10] See Judge Jed Rakoff, Chapter 1; Mathias Reimann, Chapter 2; and Xianchu Zhang, Chapter 7.

[11] Robin Hui Huang, Chapter 8. We should note that in some cases the PRC judiciary acts creatively when faced with doctrinal and institutional constraints. For instance, in the distinct area of private enforcement of corporate law fiduciary duties, one of our authors theorises that PRC judges have enforced basically common law transplanted fiduciary duty doctrines using the traditional civil law analytical framework for tort liability. See Jiangyu Wang, Chapter 10. Similarly, the spirit of judicial innovation has been demonstrated in the enforcement of China's statutory corporate veil piercing regime. See

associated with the functioning of the courts are identified as one of the central challenges facing private enforcement.[12]

However, if something is not 'in the books' or is subject to some level of regulatory or institutional constraints, one need not jump to the conclusion that there results a complete vacuum, as there may be in operation effective functional substitutes for what appears to be missing. This volume reveals that phenomenon in spades. For instance, China does not have class action and severely restricts both 'group' actions and contingency fee arrangements,[13] but the Chinese People's Courts have come up with a procedural innovation – something with a function similar to the German model case regime – which allows the PRC People's Courts to efficiently hear multiple cases arising from the same securities misrepresentation.[14] In Japan and Italy, the lack of a class action has not proven a fatal problem either.[15] Likewise, while Australia does not formally allow the kind of contingency fee arrangements which are considered crucial for private enforcement, in practice a third party litigation funding mechanism has served as a functional substitute for contingency fee arrangements.[16]

While it is hard to determine the relative significance of public and private enforcement in quantitative terms, from the chapters in this book it would seem that across the globe – with the notable exception of the US[17] – private enforcement is far less important than public enforcement. In Hong Kong, for example, while a private right of action is available, it has not really been used to date, partly due to the lack of class action, partly because of the effectiveness of public enforcement in protecting investors. The Hong Kong securities regulator, for example, has instead ordered issuers to repurchase from aggrieved investors the

Robin Hui Huang, 'Piercing the Corporate Veil in China: Where Is It Now and Where Is It Heading?', 60 *American Journal of Comparative Law* 743 (2012).

[12] John Armour and Caroline Schmidt, Chapter 23 (stating that 'Brazilian judges are overworked, with a long case backlog. They are also under-trained in business matters . . . '); Vikramaditya Khanna, Chapter 16 (noting 'the glacial speed of the Indian courts').

[13] See Liming Wang, Chapter 6.

[14] See Robin Hui Huang, Chapter 8.

[15] Guido Ferrarini and Paolo Giudici, Chapter 19 (contending that 'the poor state of Italian private enforcement did not depend on substantive rules or the simple absence of class actions'); Gen Goto, Chapter 20 (opining that 'US-style class action is not a prerequisite for securities litigation').

[16] Michael Legg, Chapter 15 (stating 'litigation funding addresses the cost disincentives to the commencement of class action litigation . . . ').

[17] Even in the US, it is claimed that ' . . . [as] representative shareholder litigation comes under increasing attack . . . attention has shifted to governance and market mechanisms to address managerial agency costs'. James D. Cox and Randall S. Thomas, Chapter 12.

shares sold to them at inflated prices caused by misrepresentation in public issuance documents, and ordered insiders to pay money to their trading counterparties to restore such counterparties to the same position, in financial terms, they were in before the insider trading prohibition-breaching trades.[18] We may conclude therefore that public enforcement in Hong Kong – rapidly becoming one of the world's most important securities markets – has been very effective in protecting investors, largely obviating the need for private enforcement. Further, in many jurisdictions where there is some allowance for private enforcement in varying degrees, such as the PRC, Taiwan, Japan and Korea, a 'piggyback' can be employed, whereby private enforcement always follows after or operates in parallel with public enforcement. As many of the authors in this collection note, this kind of piggybacking helps private claimants overcome the evidentiary difficulties caused by the lack of discovery rules in those jurisdictions and allows private enforcement to benignly free ride on public enforcement.

Hence, although private enforcement seems to have become increasingly important and popular amongst the national jurisdictions examined in this book, it has not yet played a very significant role in enforcing corporate and securities laws, at least judging from the number of cases observed to date. Of course, we recognise that it may not be appropriate to measure the significance of private enforcement simply by reference to the private cases which are actually brought. In Korea, for instance, the introduction of class action is said to have generated strong deterrence so that many Korean listed companies rushed to improve their disclosure practices before the law took effect three years after its enactment.[19]

The above observations divined from the chapters presented in this book have important implications for a more critical understanding of the widely-accepted 'law and finance' literature.[20] On the one hand, methodologically, it is simply not adequate to solely identify formal rules for investor protection on the books, both substantive and procedural, and

[18] See Alexa Lam, Chapter 17. [19] See Hwa-Jin Kim, Chapter 21.

[20] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Law and Finance', 106 *Journal of Financial Economics* 1113 (1998) (reporting that the common law outperforms the civil law in encouraging financial development); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, 'What Works in Securities Laws?', 61 *Journal of Finance* 20 (2006) (arguing that compared with private enforcement, the importance of public enforcement is at best modest); Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, 'The Law and Economics of Self-dealing', 88 *Journal of Financial Economics* 430 (2008) (conducting a cross-country empirical study of law and finance).

then assign value to them as independent variables in cross-country and allegedly empirical studies of 'law and finance'. This book reveals that although many jurisdictions have had the same or similar formal rules on the books, the enforcement of such norms and implementation of such procedures in practice vary greatly, always depending on the respective institutional, political, cultural and economic environments in which they operate. Moreover, the simple valuing of such norms or formal practices as independent variables so characteristic of this literature completely ignores the possibility that a given jurisdiction might use equally or more effective substitute mechanisms, the implementation of which is invisible in these tabulations.

On the other hand, the robust 'legal origins' conclusions drawn by the 'law and finance' studies, seem rather weak in the face of the material presented in this book. Under the 'legal origins' argument, common law jurisdictions make more use of private enforcement which correlates to deep and more liquid securities markets. However, this book suggests that the initial premise upon which the 'legal origins' edifice is built is overly simplistic: indeed, apart from the US, all other common law jurisdictions discussed in this book, including the UK, Australia, Canada, India and Hong Kong, clearly put more reliance on public enforcement than private enforcement.[21] At present, these non-US common law jurisdictions seem to rely on private enforcement at a level comparable to that in civil law jurisdictions, both in terms of the availability of the class action regime and the actual cases produced to date. In fact, one of the chapters in this book demonstrates that historically the level of investor protection in the UK and Germany was actually similar over the nineteenth century.[22]

In short, what seems apparent from the discussion in this book and the conference in which it is rooted is the divergence in the approaches to enforcement of corporate and securities laws – certainly across national jurisdictions, but more importantly even among jurisdictions sharing the same 'legal origins', within the same geographical locations, or tagged into the same developmental categories. Accordingly, rather than celebrating the perhaps false dream of convergence in what all admit are increasingly globalised capital markets, this book hopes to contribute to

[21] See John Armour, Bernard S. Black, Brian R. Cheffins, and Richard Nolan, Chapter 13 (empirically examining the role of private enforcement in the two leading common law jurisdictions, namely the US and the UK, and finding there is divergence).

[22] See Carsten Gerner-Beuerle, Chapter 3.

a deeper and less synthesising understanding of persistent divergence, and the reasons for it.[23]

2 A New Taxonomy of Enforcement Strategies

Enforcement strategies of corporate and securities law have traditionally been divided into two broad categories, namely public enforcement and private enforcement. In general, public enforcement is initiated by a state official such as a regulator or a prosecutor, while private enforcement is by a private party in the form of civil actions for compensation or rescission. The public vs. private enforcement divide is based on two general criteria: first, public and private enforcers may have differing incentives: the former is usually paid a public servant's salary regardless of case outcomes, whereas the latter is primarily motivated by the prospect of financial gain contingent upon success in litigation; second, public enforcers are relatively centralised and subject to explicit political control, whereas private claimants are not.[24] Both enforcement strategies, however, take the form of court proceedings.

As this book makes clear, the simplistic dichotomy between public and private enforcement may not fully capture the complexity and diversity of how corporate and securities laws are enforced in practice. For instance, how do we understand efforts made to enforce the law but without recourse to court proceedings? Professor John Armour of Oxford University, one of the contributors to this book, has come up with a new taxonomy of enforcement strategies, introducing a formal vs. informal divide according to whether the law is enforced through state judicial institutions. Under this two-dimensional taxonomy, there are four types of enforcement strategies, including: formal public enforcement, informal public enforcement, formal private enforcement and informal private enforcement.[25]

[23] See Donald Clarke, Chapter 5 (arguing that the purported 'bonding' effects of cross-listings by PRC issuers might be illusory).

[24] The Securities and Futures Investors Protection Center in Taiwan shows the blurring of boundaries between public and private enforcement mechanisms: The Center can bring private litigation for compensation on behalf of aggrieved investors but has close ties to the government which render it 'dangerously akin to a typical governmental administrative branch'. Wen-Yeu Wang, Chapter 22.

[25] John Amour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment', (April 2008) *ECGI Working Paper Series in Law* (No 106/2008). And see Nicholas Calcina Howson, 'Enforcement Without Foundation? – Insider Trading and China's Administrative Law Crisis', 60 AM. J. COMP. L. 955 (2012)

This categorisation of enforcement strategies represents a significant improvement over the simple public-private dichotomy, but still has inadequacies. To start with, the criterion used for the formal vs. informal divide may need refinement. As noted above, the formal vs. informal dimension is introduced to take account of those enforcement activities which are not affected through state judicial institutions. This informal type of enforcement activity has the advantage of economising on the considerable costs of judicial or quasi-judicial proceedings. These advantages, however, cannot be taken as absolute, because enforcement by regulators may be subject to judicial review, and thus state judicial institutions may ultimately be involved.

Importantly, the scope of enforcement activities a public regulator is able to carry out without seeking judicial orders is a 'rule of law' issue.[26] For instance, in the PRC the securities regulator has a wide range of powers to freeze or seal up assets, restrict securities transactions, and impose administrative penalties such as warnings, fines and revocation of licences, as well as orders prohibiting the subjects of enforcement from certain activities.[27] It would be inappropriate to refer to those enforcement activities as 'informal'. The reputational sanction imposed by stock exchanges in the form of public censure is commonly understood as a mode of informal enforcement, but in fact, when stock exchanges impose public censure, they need to go through the same procedure as other disciplinary measures such as fine, suspension or delisting of securities. Again, it would be remarkable to understand delisting decisions as 'informal enforcement' as well. The same could be said of the enforcement activities carried out by public regulators or stock exchanges in many other jurisdictions such as Hong Kong, where the regulator has power to impose public censure, fine licensed persons, and suspend or revoke business licenses.

Under the new taxonomy, another example of informal enforcement by regulators is a private conversation between the regulator and the firm or securities trading party in question. This can occur in the context of either an investigation after an alleged violation, or during an application

(demonstrating how China Securities Regulatory Commission civil enforcement of the PRC's insider trading prohibition is *ultra vires* and a breach of 'administration according to law' [*yifa xingzheng*]).

[26] See Jeffrey G. MacIntosh, Chapter 14 (discussing enforcement modalities from a rule of law perspective).

[27] Robin Hui Huang, *Securities and Capital Markets Law in China* (Oxford University Press, 2014), Chapter 2.

for enforcement action in the future. In the former case, private conversations can be seen as 'informal' to the extent that they are not done through any formal proceedings. It seems doubtful, however, that private conversations regulator to regulate should be treated as a form of enforcement in some cases. Private conversation is something like the threat of sanctions, rather than actual sanctions, and in such cases sanctions are not imposed presumably because the alleged violation is deemed too minor to warrant enforcement. Under these circumstances, private conversation is more like education than enforcement in the strict sense. In the latter case, the regulator provides guidance or even approval to market participants in relation to matters which have captured regulatory attention. This might be more properly labelled a kind of '*ex ante* enforcement', a regulatory technique which has been used extensively in the PRC of course where the government had maintained a tight grip on the securities market via a host of approval requirements. For instance, up until now, China has used a merit review regime for public markets' fundraising transactions, notably initial public offerings. The non-action letter mechanism used in many jurisdictions such as the US might be another example.

Informal private enforcement refers mainly to the exercise of corporate law-based or securities law-mandated voting rights by shareholders, which for this context we include the 'Wall Street Walk' (voting with their feet by unloading). For many, this so-called informal private action might be more appropriately associated with 'governance' rather than 'enforcement' per se.[28] Even if this can be seen as enforcement in its broad sense, it might be better addressed as 'self-enforcement', which usefully emphasises that corporate and securities law is rather uniquely enforceable by shareholders themselves without recourse to any public institutions such as the judiciary.[29]

There is, however, an urgent need to pay very close attention to private enforcement activity which is not carried out in the courtroom. For

[28] Oliver E William, *The Mechanisms of Governance* (Oxford University Press, 1996), 145–170; see also James D. Cox and Randall S. Thomas, Chapter 12 (referring to institutional shareholder activism and the Say-on-Pay voting mechanism as 'governance developments').

[29] Bernard Black and Reinier Kraakman, 'A Self-Enforcing Model of Corporate Law', 109(8) *Harvard Law Review* 1911 (1996). For the PRC case, see Nicholas Calcina Howson, '"Quack Corporate Governance" as Traditional Chinese Medicine – The Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle Against Party State Political Economic Power', 37(2) SEATTLE U. L. REV. 667 (2014).

instance, securities arbitration has long been an important way to settle securities disputes.[30] Indeed, that mechanism is discussed in several chapters in this book as an alternative to court-based private enforcement.[31] Further, many jurisdictions have special mechanisms for settling securities markets disputes, such as the Financial Services Ombudsman in the UK and Australia, the Financial Dispute Resolution Centre recently established in Hong Kong,[32] and the Shenzhen Securities and Futures Dispute Resolution Centre in the PRC. Although arbitration, mediation, and such special mechanisms can play a role similar to that of court-based private enforcement, they are not currently covered in the taxonomy of enforcement strategies/mechanisms. We submit here that they might be included in the discussion under 'alternative private enforcement'.

In sum, this book and global practice alike teach us that the traditional dichotomy between public and private enforcement is far too crude, and does not adequately reflect how corporate and securities laws are enforced in practice. In the multiplicity of global norms, procedures and practices discussed herein, this book supports the idea that a new, four-way taxonomy of enforcement strategies is a better starting point for understanding – either in isolation or comparatively – the enforcement of corporate law and securities regulation across the globe.

[30] Shahla Ali and Robin Hui Huang, 'Financial Dispute Resolution in China: Arbitration or Court Litigation?', 28(1) *Arbitration International* 77 (2012). Further, China has recently tried to resolve securities disputes through mediation. Robin Hui Huang, 'Securities Dispute Mediation in China', 10(2) *Journal of Comparative Law* 177 (2016).

[31] See Michael Barr, Chapter 4 (stating that 'mandatory pre-dispute arbitration clauses are pervasive in consumer financial and investor contracts'); Xiaochun Liu, Chapter 11 (discussing the newly established Financial Arbitration Centre under China's Free Trade Zone policy); Junhai Liu, Chapter 9 (stating that 'arbitration is faster, cheaper, more confidential, more professional'); Vikramaditya Khanna, Chapter 16 (contending that one potential reform is to 'have shareholders pursue corporate governance claims in arbitral proceedings rather than in judicial or tribunal proceedings'); John Armour and Caroline Schmidt, Chapter 23 (noting the growing role of arbitration in Brazil which is part of 'a mutually reinforcing system of enforcement').

[32] Robin Hui Huang, 'In the Aftermath of the Global Financial Crisis: The Proposed Establishment of a Financial Dispute Resolution Centre in Hong Kong', 85 *Australian Law Journal* 726 (2011).