

Supervisor: Professor W. E. Butler

Securities Regulation in China During an Era of Change

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San-Zhu Zhu

Faculty of Laws
University College London

University of London

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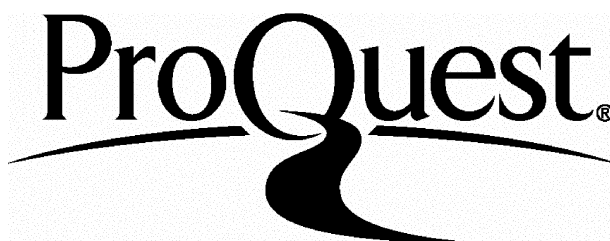
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Abstract

In the 1990s the world witnessed the collapse of communism in the former Soviet Union and Eastern Europe, economic reforms in India, Southeast Asia, and Latin America, and liberalization and deregulation in many developing countries. The past two decades have been an era of worldwide reform and change. China's economic reform process, which started in the late 1970s, is part of this worldwide reform and change. An entirely new securities market has emerged in China, and it has become one of the most important securities markets in the developing countries. A securities regulatory framework has been established in China to oversee the market and to protect investors. This thesis addresses the principal regulatory issues which have arisen in course of developing China's law of securities regulation.

Following Chapter I, which provides a general background to China's emerging securities regulatory framework, Chapter II and Chapter III examine the scope of regulation and the institutional structure respectively. Chapters IV and V look at basic regulatory frameworks for public offerings of securities and the secondary trading market. Chapter VI considers the basic regulatory framework for foreign participation in China's securities market. Chapter VII and Chapter VIII examine two facets of China's securities regulatory regime: internationalization and the adoption of foreign securities laws on the one hand, and maintaining socialist characteristics on the other. These two facets reflect generally the uncertainty which China is facing in its transformation from a socialist society to an economically and ideologically mixed society. Chapter IX examines certain issues from the point of view of investor protection. The concluding chapter summarises the arguments presented in previous chapters and offers some reflections on the development of China's securities regulation in an era of change. Following the concluding chapter a brief account is given of the 1998 Securities Law of the People's Republic of China.

The main findings of this study and the significance of these findings can be summarised as follows. The development of the law of securities regulation in China in the past years shows that China can not transcend the limitations of its past as a socialist country and as a socialist legal system in its effort to build a securities market and a corresponding system of securities law. It inevitably has distinctive Chinese own characteristics, although there are common characteristics shared with the securities legislation of other countries. The future development of this area of law in China could be slow or could be rapid, and its direction could differ, depending directly upon China's overall economic reforms and indirectly upon China's political and social reforms.

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(adopted at the ninth session of the Standing Committee of the Sixth National People's Congress on 21 January 1985, and amended at the fifth session of the Standing Committee of the Eighth National People's Congress on 29 December 1993)

Administrative Penalty Law of the People's Republic of China

(adopted at the fourth session of the Eighth National People's Congress on 17 May 1996 and effective from 1 October 1996)

Commercial Bank Law of the People's Republic of China

(adopted at the thirteenth meeting of the Standing Committee of the Eighth National People's Congress on 19 May 1995 and effective from 1 July 1995)

Company Law of the People's Republic of China

(adopted at the fifth session of the Standing Committee of the Eighth National People's Congress on 29 December 1993, and effective from 1 July 1994)

Criminal Law of the People's Republic of China

(amended and promulgated by the Eighth National People's Congress on 14 March 1997 and effective from 1 October 1997)

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State Compensation Law of the People's Republic of China

(adopted at the seventh meeting of the Standing Committee of the Eighth National People's Congress on 12 May 1994 and effective from 1 January 1995)

The State Council and its Ministries and Commissions

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(promulgated by the State Council on 25 December 1995)

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(promulgated by the State Council on 24 July 1994)

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(promulgated by the State Council on 4 August 1994)

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(adopted by the Shanghai Municipal People's Government on 18 May 1992, and effective from 1st June 1992)

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Abbreviations

China Reference

A-share	Share for domestic investors
B-share	Rmb special share for foreign investors
CIETAC	Chinese International Economic and Trade Arbitration Commission
CSA	China Securities Association
CSRC	China Securities Regulatory Commission
NPC	The National People's Congress
PBOC	The People's Bank of China
PRC	The People's Republic of China
Rmb	Renminbi (Chinese currency)
SAFE	State Administration of Foreign Exchange
SCSC	The State Council Securities Committee
SSE	The Shanghai Stock Exchange
SZSE	The Shenzhen Stock Exchange

Hong Kong Reference

HKSE	The Hong Kong Stock Exchange
SARHK	Special Administrative Region of Hong Kong
SFC	Securities and Futures Commission

References from Other Jurisdictions

IOSCO	International Organization of Securities Commissions
MJDS	Multi-Jurisdictional Disclosure Systems
SEC	Securities Exchange Commission (U.S.A.)
SIB	The Securities and Investments Board (U.K.)
SROs	Self Regulatory Organisations

INTRODUCTION

In recent decades the world has witnessed the collapse of communism in the former Soviet Union and Eastern Europe, the economic reforms in India, Southeast Asia, and Latin America, and the liberalization and deregulation in many developing countries.¹ It has been an age of worldwide reforms and changes. One of the outcomes of these reforms and changes is the emerging of new capital markets in some of these countries.² Around the world new regional stock exchanges have emerged;³ new securities commissions have been established, some of which have become new members of the

¹ See generally the World Bank's reports and studies, to name only a few: *"Mass Privatization in Central and Eastern Europe and the Former Soviet Union: A Comparative Analysis"*, 1995; *"India: Recent Economic Developments and Prospects"*, 1995; *"Financial Sector Reforms, Economic Growth, and Stability: Experiences in Selected Asian and Latin American Countries"*, 1994; *"Adjustment in Africa: Reforms, Results and the Road Ahead"*, 1994.

² See generally, *"Trends in Developing Economies 1994 Extracts: Vol. 2. Emerging Capital Markets"*, the World Bank, 1994; *"Creating Capital Markets in Central and Eastern Europe"*, the World Bank Technical Paper No. 295, 1995.

³ As an outcome of its economic reform and open-door policy adopted in 1979, China established two stock exchanges in the country: the Shanghai Stock Exchange was established in 1990 and the Shenzhen Stock Exchange in 1991.

International Organisation of Securities Commissions (IOSCO).⁴ In recent years there has been a surge of capital flows in the form of debt and equity investments to these emerging markets, and the trend is expected to continue.⁵ During the Industrial Revolution more than a century ago, the world witnessed a wave of capital markets⁶ and now history seems to be repeating itself with another similar, though not identical, wave.

China is part of this wave. The economic reform and open-door policies adopted in the late 1970s led to an entirely new securities market emerging in China⁷ by the middle of the 1980s. It has undergone sustained development since then. A legal and regulatory framework has in the meantime been established to oversee the market and to protect investors. In 1993 the China Securities Regulatory Commission was formally set up, marking a new stage in the development of China's securities regulation. This Thesis will address the principal regulatory issues which have risen in this connection.

Chapter I, as an introductory chapter, sets out the regulatory background of China's emerging securities market. Section A describes the relationship between China's economic reform and its emerging securities market, whereas Section B discusses the

⁴ In 1995 IOSCO, a multinational securities supervisory organization established in 1983, accepted four new voting members and three associate and affiliate members, including among others the China Securities Regulatory Commission, the Russian Federation Commission on Securities and the Capital Market. As a result, the membership of IOSCO increased to 121. See, *Annual Conference Release*, IOSCO, 1995.

⁵ World Economic Outlook: A Survey by the Staff of the International Monetary Fund, Chapter IV "The recent surge in capital flows to developing countries", *World Economic Outlook*, October 1994, pp. 48-64.

⁶ Take the United Kingdom as an example: during the 19th and early 20th centuries more than 20 stock exchanges were set up in towns ranging from Aberdeen to Cardiff in the wave of establishing the capital market. See, *A History of the London Stock Exchange*, p. 6, (London Stock Exchange, 1993)

⁷ The broad term "securities market" encompasses both the markets for the distribution of securities into public hands and the markets for continuous trading in outstanding securities.

development of China's securities regulatory framework. The schemes for foreign participation in China's securities market and the co-operation between China's securities authorities and foreign securities authorities are two important aspects of China's emerging securities market. The background of their developments was introduced in section C and section E respectively. Section D highlights some of the controversial issues which China's securities regulation is confronting in the transition to a socialist market economy, introducing among others the issue of socialist public ownership and the role of the government in regulating the securities market. These issues will be further discussed in the following chapters.

Chapter II deals with the scope of securities regulation. Section A examines the legal definition of securities in current national and local regulations. It starts with definitions of bond and share, then with the definition of "securities", followed by a brief discussion of commodity and financial futures products which have emerged in the past few years in China, that are not defined by current national and local regulations as "securities", but are considered to be within the scope of securities regulation. Section B examines the activities which are defined as securities business and thus fall under securities regulation. Section C considers the geographical scope of securities regulation. In section D a comparison is made with certain other jurisdictions to determine whether China could learn something useful for the future development of securities regulation.

Chapter III deals with the institutional structure of the securities regulatory system. Section A examines the function of the Securities Committee of the State Council (SCSC) and the China Securities Regulatory Commission (CSRC), including the relationship between them and the relationship between them and the local securities commissions in

provinces and municipalities. The advantages and disadvantages of the central securities commission proposed by the draft Securities Law of the PRC to replace the SCSC and the CSRC are discussed. Section B examines the functions of the departments of central and local governments which share responsibilities for securities regulation, and their relationships with securities commissions. Section C explores the role of the People's Bank of China (PBOC), China's central bank, in securities regulation both before and after creation of the SCSC and the CSRC. Self-regulatory organisations and their role in securities regulation are discussed in Section D. Finally, Section E raises the question: "who will regulate the regulators?", and examines possible control mechanisms under China's legal system.

Chapter IV and Chapter V provide a basic account of the regulatory aspects of primary and secondary securities markets in China. Chapter IV begins with the issue of incorporation in section A which examines the process of incorporation of joint stock companies under China's company regulations, in particular, through the public issue of shares. Public offerings of shares and the listing of shares on stock exchanges and their conditions and procedures are discussed in Section B and Section C, whereas Section D discusses the issue of dispute resolution, which looks at available forums for the resolution of disputes arising in the course of securities transactions in primary and secondary securities markets. It specifically looks at certain problems concerning the resolution of disputes involving foreign parties which affect foreign investor confidence in the securities market.

Chapter V continues with regulatory issues in the secondary securities market in China. Section A commences with a discussion of the disclosure regime for listed

companies, including interim and annual reports of listed companies, price sensitive information, and enforcement of disclosure requirements. Section B addresses some continuing obligations, including the obligations imposed on directors, supervisors, managers, and senior personnel of a listed company. Section C provides a basic account of the regulatory framework for takeovers of listed companies, including a few cases dealt with by the CSRC which involved violations of takeover rules. Finally, Section D considers the regulatory measures to prevent securities frauds.

Chapter VI deals with the issue of foreign participation in China's securities market. Section A discusses the regulatory framework for the B-share scheme, including a discussion of the legal nature of B-shares, the regulatory authorities responsible for B-shares, and requirements in relation to articles of association of B-share companies. Section B discusses the regulatory framework for the overseas listing of Chinese companies, including the legal nature of foreign investment shares in overseas listed Chinese companies, the co-operation of the Chinese securities regulator with foreign securities regulators, and special disclosure requirements. Section C looks at the process of opening up China's securities market to foreign securities firms and investment banks, and Section D examines the prospects for the future liberalization of China's securities market. Attention is given to the conditions under which foreign securities firms are allowed to carry on foreign investment share business, the scope of business they are allowed to carry on in China, the progress made towards the convertibility of Chinese currency, and its impact on the future liberalization of China's securities market to foreign securities firms.

Chapter VII and Chapter VIII deal with two facets of China's securities regulatory

regime, namely, China's efforts to move towards a more open and liberated securities regulatory regime and to bring China's securities regulatory regime close to international standards through the adoption of foreign securities laws, and the limitations that China's securities regulatory regime is facing in its development of a regime with Chinese socialist characteristics. Chapter VII reviews the experience of listing Chinese state-owned companies on the Hong Kong Stock Exchange in Section A and explores the relationship between China's securities regime and that of Hong Kong with a view to the future prospects for regulatory harmonisation in Section B. Section C discusses the adaptation of foreign securities laws in China, including the process of adaptation and certain problems arising from a comparative law point of view.

Chapter VIII considers the influence of socialist ideologies in the development of China's securities law. Section A examines the issue of socialist public ownership and its influence on the regulation of the securities market, one of the most controversial issues in China's economic reform, as well as in the development of China's securities law. Section B addresses the influence of central economic planning practice under the old centrally planned system on the regulation of the securities market, such as the quota system used in the regulation of the securities market. Section C examines the role of government regulatory authorities in the regulation of the securities market, with particular attention to excessive administrative involvement in the regulation of the securities market under the influence of the old pattern of government administration. Section D explores the relationship between government policy and securities law, including general jurisprudential concerns about the relationship between policy and law in China.

Chapter IX deals with the protection of investors in the securities market. Section

A highlights the fact that legislation is falling behind the pace of development of the securities market in China and analyses the efforts made to build a unified regulatory regime. Section B examines the implementation and enforcement of securities law under China's legal system, emphasizing their importance for the adequate protection of investors. Section C discusses the differences between a heavily regulated securities market and a completely free market, pointing out the tendency to over-regulate the market in China and the need for securities regulation to strike a balance between a heavily regulated securities market and a free market. Section D discusses the need for a strong and efficient regulator in China and in this context compares the latest regulatory reform plan proposed by the Government of the United Kingdom for reforming the City of London regulatory regime with a view to seeing what China could learn in the development of its securities regulatory regime.

Chapter X, as a concluding chapter, summarises the arguments presented in previous chapters and puts forward the concluding views of the Thesis on the development of China's law of securities regulation in an era of change.

Chapter XI briefly evaluates the Securities Law of the PRC formally adopted on 29 December 1998. It focuses on the scope of the law, the securities commissions and self-regulatory bodies, and the provisions regarding the regulation of primary and secondary securities markets.

China's securities market has just emerged. It has a short history as does the securities regulatory regime. Regulatory changes and improvements are taking place in line with the economic reform which has accelerated the development of the securities market since 1993, when it entered a new stage. The Thesis, as the title "China's

Introduction

"Securities Regulation in an Era of Change" suggests, sets its discussion against the background of our changing era in general and China's changes in particular. Throughout the Thesis approaches certain issues from a comparative perspective to determine whether China could draw useful experience from other securities regulatory regimes in developing its own law of securities regulation.

Chapter I

China's Emerging Securities Market and Regulatory System

After the founding of the People's Republic of China in 1949, China followed the socialist model of the former Soviet Union and began to shape itself along the lines of the people's democracies. Its legal system developed from the early socialist embryonic form introduced in the communist controlled areas in the 1930s¹ and was later regarded as a member of the socialist legal family.² In 1966, when the so-called "Ten-year Cultural Revolution" (1966-76) broke out, China entered into a period in which extreme political and ideological campaigns left a chaotic society isolated from outside world.³ During these chaotic ten years, the economy came to the edge of collapse and the legal system was

¹ See, Butler, W. E. (ed.), *The Legal System of the Chinese Soviet Republic 1931-1934* (Dobbs Ferry: Transnational Publishers Inc., 1983).

² Zweigert, Konrad, *Introduction to Comparative Law* (2nd ed. rev.), Chapter V: "The socialist legal family," pp. 296-358, (Oxford: Clarendon, 1987).

³ See generally, Oksenberg, Michael, et al., *The Cultural Revolution: 1967 in Review* (Ann Arbor: University of Michigan, Centre for Chinese Studies, 1968); Meyer, Milton Walter, *China: A Concise History* (2nd ed. rev.), Chapter 22, pp. 297-311, (Lanham: Rowman & Littlefield, 1994).

virtually destroyed.⁴ In the aftermath of the Cultural Revolution and after two years of hesitation, China began to follow the worldwide trend of reforms and changes and embarked on a successful economic reform and open-door policy. The economic reform has brought about radical changes to the economic system, and the open-door policy has opened up China to the outside world in an unprecedented way. As a result, the country witnessed a breath-taking surge of foreign investments into China. The legal system has also undergone substantial reforms to adapt itself to the changing environment. A comprehensive body of laws and regulations began to emerge in different areas while in fundamental and theoretical terms, the direction of the development of China's legal system began to depart from the socialist legal family on the world legal map towards its own destination with so-called "China's own characteristics". It is against this general background that conditions have been created which led to the emergence of a securities market and a corresponding regulatory system in China.

A. Economic Reform and Emergence of Securities Market

In the early 1950s there were some funding activities carried out in China during which the government issued debt securities to finance the economy.⁵ Such activities also

⁴ During the Cultural Revolution, courts were "smashed"; lawyers changed their profession; legal educational institutions were shut down. See generally, Chen, Albert H.Y., *An Introduction to the Legal System of the People's Republic of China*, chapter 3 "The Legal History of Modern China", pp. 29-33, (Singapore: Butterworths (Asia), 1992).

⁵ Soon after the founding of the P.R.C., the Chinese government issued treasury bonds to finance the economy and by the 1960s they had all been paid off.

occurred in other socialist countries.⁶ But a proper securities market and a corresponding regulatory system never existed prior to the 1979 economic reform in China. The reason was simple: there were no conditions for such a market to develop and for such a corresponding regulatory system to exist. Throughout the 1950s-70s, the economy in China was centrally planned; public ownership was dominant form of ownership; the majority of enterprises were state-owned and financed from the state budget. It was impossible for a proper securities market to exist under these conditions. All this has been changed by the economic reform. The centrally planned economy has been moving towards a market economy; public ownership has been supplemented with private ownership, as well as with the separation of ownership from management;⁷ state-owned enterprises have been given greater financial autonomy and have been undergoing a process of restructuring into either joint stock companies or limited liability companies since 1993, when the Company Law of the PRC was adopted. The emergence of the securities market in China is a natural outcome of these and other conditions created as a result of the economic reform and open-door policy.⁸ When one looks back at the stages of development of China's emerging securities market, one can find that such development stages are closely corresponding to the development stages of China's

⁶ For example, the former Soviet Union regularly issued bonds for public subscription. See, Butler, W. E., *Securities and Banking Law of the Republic Kazakhstan*, p.1, (London: Simmonds & Hill Publishing Ltd, 1995).

⁷ This was formally stated in the Decision of the Chinese Communist Party Central Committee on Reform of the Economic Structure, adopted by the Third Plenary Session of the 12th Chinese Communist Party Central Committee on Oct. 20, 1984. The separation of ownership and management means that the state's right to own and to run business "may be appropriately separated" in order to expand enterprise autonomy.

⁸ For a full account of the background under which China's securities market emerged, see further Mei Xia, et al., *The Re-emerging Securities Market in China*, Chapter 2 "Economic Reforms and their Impact on the Emergence of the Securities Market", pp. 19-34, (Westpoint: Quorum Books, 1992).

economic reform and open-door policy.

Generally speaking, securities gradually became an integral part of the economic system in the 1980s. The principal forms of securities were bonds (*zaiquan*) and shares (*gupiao*). Bonds were classified into four main types according to their purposes and issuing bodies, namely, the treasury bond (*guokuquan*), construction bond (*jianshe zaiquan*), enterprise bond (*qiye zaiquan*), and financial bond (*jinrong zaiquan*).⁹ Shares were classified into the "internal employee share" (*neibu zhigong gu*), only issued internally to enterprise employees, and the "public share" (*gong zhong gu*), issued to the general public. Later on, with the emergence of a separate category of share issued exclusively to foreign investors, shares were further divided into those for domestic investors (*neizigu*), commonly known as the A-share, and those for foreign investors (*waizigu*), commonly known as the B-share, denominated in Renminbi (Rmb) and offered exclusively for purchase and sale for foreign currencies by foreign investors. Accordingly, two separate share markets have developed. In the early 1990s state-owned enterprises began to issue and list their shares abroad and, as a result, special classes of foreign investment share were created in these enterprises, such as the "H-share" created in the companies listed on the Hong Kong Stock Exchange.

The Chinese Government began to issue treasury bonds in 1981 and every year since various kinds of treasury bond with maturities ranging from three to ten years have been offered. In addition to treasury bonds, other kinds of government bonds have been

⁹ Treasury bonds are issued by the Ministry of Finance to cover budget deficits and to raise funds for large investment projects; construction bonds are issued by central and local governments or enterprises to finance major construction projects; enterprise bonds and financial bonds are issued by enterprises and financial institutions respectively.

created and issued, including major project bonds, construction bonds, and index-linked bonds.¹⁰ In the early 1990s, when the market economy reform was gradually deepening, more enterprises began to raise funds through the issue of bonds and shares. Consequently, the government and enterprises were effectively competing with each other for funds from the general public. In order to realise the issue plans for treasury bonds set out by the central government, regulatory measures were adopted which created a tension between the government and the enterprises because enterprises were not allowed to issue their own bonds and shares until the treasury bonds had been sold out.¹¹ On a more general level these measures were introduced in order to control the speed and direction of the economic reform by the government in the transition from a centrally planned economy to a market economy.

Enterprises (*qiye*)¹² began to issue bonds and shares in the mid-1980s in some parts of China on an experimental basis first to their own employees and later on to the general public. In September 1984 the Tian Qiao Department Store Ltd., the country's first joint stock company since 1949, was set up in Beijing and issued shares to the public. Afterwards the country witnessed a wave of enterprise bond or share issues, although they

¹⁰ For a general introduction to these government bonds and their respective features, see "Guozai Zhishi" (Facts about Government Bonds), *Fazhi Ribao* (*Legal Daily*), 8 April 1994, p.2.

¹¹ See the Circular of the State Council on Stopping Chaotic Fund-raising Activities and Strengthening the Regulation of Bond Issues (Guowuyuan guanyu jianjue zhizhi luan jizi he jiaqiang zhaiquan faxing guanli de tongzhi), issued by the State Council on 11 April 1993.

¹² "Enterprise", a generic term in China, encompasses state-owned enterprises, collectively-owned enterprises, privately-owned enterprises, and in a loose sense, companies. For a description of the different forms of enterprises in the mid 1980s, see, Zheng, Henry R., "Business Organization and Securities Laws of the People's Republic of China", *The Business Lawyer*, 1988, Vol. 43, No. 2, pp. 549-619.

were at a primitive stage and on an experimental basis.¹³ In 1986 some state-owned enterprises were restructured into joint stock companies and that year saw the first major share issue to the public by such a reorganised state-owned enterprise.¹⁴ With the transformation of state-owned enterprises gathering pace and expanding to most parts of China, more large and medium sized state-owned enterprises began to issue shares and list them on stock exchanges. Reforms of enterprises, especially state-owned enterprises, are at the heart of the economic reform, and this is where socialist ideologies have been challenged and capitalist practices adopted. It is therefore not surprising that there have been ups and downs in the enterprise reform, which in turn influenced greatly the development of the regulatory framework for enterprise securities.

Beginning in 1986, certain major cities began to set up trading centres to facilitate securities transactions and to place the securities businesses under regulatory control by the authorities.¹⁵ Trading in bonds and shares started in these cities through those trading centres. A nationwide trading system, the Securities Trading Automated Quotations System, was established in December 1990 and linked initially about eighty trading centres throughout China. On 19 December 1990 the Shanghai Stock Exchange was established, followed by the Shenzhen Stock Exchange in July 1991. The establishment

¹³ Shenyang, an industrial city in north China, carried out such experiments extensively and was in the forefront at that time. See "Qiye Yu Zhigong Gongmingyun" (Enterprises and Employees Share the Same Fate), *Renmin Ribao*, (*People's Daily*), 4 February 1987, p. 3.

¹⁴ It was the Shenyang Jinbei Auto Industrial Corporation, which consisted of more than fifty auto-related manufacturers around Shenyang province in north China.

¹⁵ The first trading centre was established in Shenyang City on Aug 5, 1986. By the end of 1986, the cities of Shanghai, Beijing, Wuhan, and Guangdong had all set up their securities trading centres. For a survey of these trading centres and their activities up to early 1990s, see, Mei Xia, et al., *The Re-emerging Securities Market in China*, pp.104-112, (Westpoint: Quorum Books, 1992).

of these two national stock exchanges marked a new phase of development of China's emerging securities market. Although regulatory efforts were made to ensure a fair and open market in accordance with the general principles governing civil transactions established under the 1986 General Principles of the Civil Law, frauds of various kinds occurred and the integrity of the market was under threat from time to time. Serious questions were raised about the inadequacy of the regulations and their enforcement.

Along with the emergence of the securities market, securities firms appeared all over China to carry on securities business; lawyers, accountants, asset valuers and their firms were authorised to provide professional services in relation to securities; financial analysts and consultants were trained to provide financial consultancy in securities activities. Terms such as "intermediaries" (*zhongjie jigou*) and "brokers" (*jingjiren*) have come into daily usage; financial services and brokerage have become a newly established service industry. Litigation, particularly between securities firms and their clients, overwhelmed the people's courts. For the first time in their history since 1949 the people's courts have faced the difficulties and challenges presented by those cases involving securities and securities transactions.

China's emerging securities market is still relatively small and limited in terms of international standards, though it has undergone a sustained development since the 1980s. Yet its emergence has had a tremendous impact upon Chinese society, where socialist ideologies have dominated the way of life in past decades. It is no exaggeration to say that most of the population has been involved in "share frenzy" in one way or another.¹⁶

¹⁶ The opening of the Shanghai and Shenzhen stock exchanges was, for example, met with great enthusiasm by thousands of people who rushed to the scene to enjoy themselves as well as to purchase securities. See "Stocks: New Experiments in China's Economic Life", *Beijing Review*, 10-16 August 1992, pp. 14-17.

More importantly, the emergence of the securities market has created a dilemma which has fundamentally affected China's basic political, social, and legal system, as well as its ideological and theoretical foundations. Around the world new securities markets in developing countries and in former socialist countries have come into being as a natural result of economic reforms and changes. This is true in China too. However, China's economic reform has been directed by the Communist Party and the government along the line of China's own political, economic, legal, and social environment rather than the experiences of the former socialist countries. The result is that China has had to face the dilemma of, on one hand, promoting a free market economy and, on the other hand, maintaining its political system and socialist ideologies without fundamental change. Securities and the securities market, a typical capitalist institution, has developed in China as a natural result of its economic reform, but controversies regarding securities and the securities market have led to heated debates among officials, academics, practitioners, and ordinary citizens that have left profound traces on the development of China's law of securities regulation.

B. Development of Regulatory Framework

The development of a securities regulatory framework in China, broadly speaking, has passed through two stages distinguished by the creation of the national securities commission in 1992. In the early stage the People's Bank of China (PBOC), was designated as a watchdog to oversee the securities market in conjunction with various bodies of the central and local governments. In that stage securities regulations issued by certain local authorities were the main form of regulation. In October 1992 the Securities

Committee of the State Council (SCSC) and the China Securities Regulatory Commission (CSRC) were established, and the development of a securities regulatory framework entered a new stage during which there has been a steady increase in the number of national securities regulations, coupled with an emphasis on unified regulatory control. The 1993 Company Law, the first company legislation of the PRC since 1949, came into force in July 1994, whereas the Securities Law of the PRC was listed on the legislative agenda of the Standing Committee of the National People's Congress in July 1992.

The PBOC was initially given powers to regulate bonds and shares under banking regulations in the mid-1980s as part of its responsibilities for financial activities.¹⁷ Its local branches, particularly the branches in Shanghai and Shenzhen cities¹⁸ where securities experiments were allowed to proceed ahead of other parts of China, were responsible for the day-to-day regulation of the local securities markets. The responsibilities of the PBOC and its branches included, among others, to approve applications for issues of bonds and shares, to licence securities firms, and to monitor the securities markets generally. The reason why the PBOC rather than an independent regulatory agency was designated with the regulatory power at that time was mainly because the government wanted the Central Bank to control the overall flow of investment funds raised through issuing securities and hence retain a control over the economy.¹⁹ One consequence of this arrangement was excessive intervention from the PBOC to control the Shanghai and Shenzhen stock

¹⁷ The Interim Regulations of the People's Bank of China on the Administration of Banks, promulgated by the State Council on 7 January 1986.

¹⁸ Shenzhen, a city next to Hong Kong, is one of the first four cities which were granted the status of Special Economic Zones in the early 1980s.

¹⁹ For an explanation of this and other reasons, see Mei Xia et al, *The Re-emerging Securities Market in China*, p. 66, (Westpoint: Quorum Books, 1992).

exchanges in their day-to-day management of the market.²⁰

In addition to the PBOC, the responsibility of regulating securities was also distributed among a number of bodies of the central government, including the State Planning Commission, the State Commission for Restructuring the Economic System, and the Ministry of Finance. Because of the experimental nature of securities in the early period, the State Commission for Restructuring the Economic System, the government's designer of the economic reforms, was playing a central role in formulating securities policies and directing the experiments, whereas the State Planning Commission, the government's central economic planner, was exercising overall planning control over the securities issues. An ad hoc regulatory office was set up within the State Council to liaise between the State Council and other bodies of the central government in implementing securities policies and regulatory controls. The responsibilities under these arrangements did to a certain degree overlap among these bodies, which in turn resulted in bureaucratic inefficiency.

Local governments in Shanghai and Shenzhen and some other parts of China played a supplementary role in the regulation of the securities market. They, in conjunction with the branches of the PBOC, participated in approving applications by local companies for bond and share issues, supervising local stock exchanges, and formulating local securities regulations. By late 1986 some provinces and cities had

²⁰ See Potter, Pitman B. "The Legal Framework for Securities Markets in China: the Challenge of Maintaining State Control and Inducing Investor Confidence", *China Law Reporter*, 1992, Vol. 7, No. 2, pp. 61-94.

promulgated local regulations to control securities experiments in their local regions.²¹ These early regulations were basically concerned with the definitions of shares and bonds, the qualifications of the issuers, the conditions and procedures under which securities could be issued, the purchase and transfer of securities, and the distributions of dividends and the payment of interest. The regulatory patterns were similar among these provinces and cities, and they represented China's developing securities law at its early stage.

At the national level a number of circulars and regulations were issued during this period either by the State Council itself or by the PBOC and other bodies of the central government. Among them the 1987 Regulations on the Issuance of Bonds by State-owned Enterprises²² demonstrated a more conservative approach with regard to the issuance of enterprise securities than that of the local regulations, and they effectively tightened control over the issues of bonds by state-owned enterprises. In May 1992 the State Commission for Restructuring the Economic System, jointly with several other bodies of the central government, issued an interim set of regulations known as the Standard Opinion on Joint Stock Companies and Standard Opinion on Limited Companies. These regulations for the first time set out a framework for setting up or otherwise transforming existing enterprises into joint stock companies or limited companies and a framework for issuing securities by companies and enterprises both to their employees and to the general public.

²¹ The provinces of Guangdong and Xiamen and the cities of Shenyang, Beijing, Shanghai and Shenzhen were those first provinces and cities to have their local securities regulations promulgated. For a detailed introduction to these early regulations, in particular, those of Guangdong and Xiamen, see, Zheng, Henry R. "Business Organization and Securities Laws of the People's Republic of China", *The Business Lawyer*, 1988, Vol. 43, No. 2, pp. 549-619.

²² It was issued by the State Council on, and effective from, 27 March 1987.

The establishment of the SCSC and the CSRC was a significant step towards the development of the national regulatory framework in China. The SCSC was designated to be responsible for formulating overall securities policies, whereas the CSRC, as an executive arm of the SCSC, was responsible for regulating securities markets on a day-to-day basis.²³ One problem this two-tier structure created was that of dividing the regulatory responsibilities between them. Another problem concerned their status because their creation had no statutory basis, and they were not given a status equivalent to that of the ministerial departments of the State Council. It was therefore argued that their powers were inconsistent with the current laws provided for in the 1982 Constitution of the PRC and several other statutes in respect of the powers of ministerial departments of the State Council.²⁴

At the time of the creation of the SCSC and the CSRC, the regulatory responsibilities undertaken previously by the PBOC and other bodies of the central government were reiterated and redefined in a circular issued by the State Council.²⁵ Under this Circular the PBOC was designated to be responsible for regulating securities firms; the State Planning Commission for formulating securities planning; the State Commission for Restructuring the Economic System for coordinating shareholding reforms; and the Ministry of Finance for regulating accounting firms involved in the

²³ See the Circular of the Administrative Office of the State Council on the Establishment of the Securities Committee of the State Council (Guowuyuan bangongting guanyu chengli guowuyuan zhengquan weiyuanhui de tongzhi), issued on 12 October 1992.

²⁴ See "Explanations to the Securities Law of the PRC (Draft)", by Liu Suinian, Chairman of the Financial and Economic Committee of the National People's Congress, on 18 August 1993, pp. 2-3.

²⁵ See the Circular of the State Council on the Further Strengthening of Macro-regulation of the Securities Market (Guowuyuan guanyu jinyibu jiaqiang zhengquan shichang hongguan guanli de tongzhi), issued on 17 December 1992.

securities business. After the creation of the SCSC and the CSRC, local securities authorities were set up one after another in line with the central SCSC and CSRC to exercise the regulatory role of local governments. Although one of the stated aims of creating the SCSC and the CSRC was to solve the problem of overlapping responsibilities and inefficiency which existed in the previous regulatory arrangements, this aim was not achieved. In fact, as was argued by the draftsmen of the 1993 draft Securities Law, the newly created regulatory structure, with the SCSC and the CSRC at the centre and supplemented by various bodies of the central government and local governments, consisted of too many tiers and bodies and was detrimental to a unified and efficient regulation of the securities market.²⁶

After the establishment of the SCSC and the CSRC, a considerable number of national securities regulations were promulgated within a short time. They covered the areas of share issuing and trading,²⁷ disclosure requirements,²⁸ fraud prevention,²⁹ and the administration of stock exchanges.³⁰ Among them, the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares was a major piece of legislation. It was the first national regulation which provided a comprehensive framework for share

²⁶ See "Explanations to the Securities Law of the PRC (Draft)", by Liu Suinian, chairman of the Financial and Economic Committee of the National People's Congress, on 18 August 1993, p. 3.

²⁷ The 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares, promulgated by the State Council on 22 April 1993.

²⁸ The Standards for Disclosure by Companies Issuing Shares to the General Public (No. 1, Prospectus) and (No. 2, Annual Report), issued by the CSRC on 8 July 1993 and 25 January 1994 respectively.

²⁹ The 1993 Provisional Measures on the Prevention of Securities Frauds, issued by the SCSC on 2 September 1993.

³⁰ The 1993 Provisional Measures on the Administration of Stock Exchanges, issued by the SCSC on 7 July 1993.

issuing and trading, and by extension of its application,³¹ for the issuing and trading of other types of securities. From a quantitative point of view, these regulations covered wide areas of the securities market, and indeed it was regarded as an achievement to have produced these regulations within a short time. But, on the other hand, most of these regulations were provisional and, moreover, important areas were not covered by them even on a provisional basis.

What was lacking, most of all, was the Securities Law of the PRC. The drafting work was begun in 1992, when a group had been set up by the Standing Committee of the National People's Congress. It has been an unusually lengthy and difficult drafting process, with more than ten drafts being produced in the past seven years that diverged over various fundamental issues.³² It was viewed from one standpoint as a process revealing the fundamental differences between those who advocated a more radical approach with an emphasis on adapting certain foreign securities legislative experience and those who preferred a more conservative approach and an emphasis on China's own situation.³³

In addition to the securities regulations themselves, developments in some other areas of law helped to promote a comprehensive securities regulatory system. The 1993 Company Law laid down the foundations for corporate and securities law. Following its adoption, a number of implementing regulations were promulgated in accordance with its

³¹ Article 2 states that the regulations are equally applicable to other types of securities apart from shares.

³² The scope of the law, the role of the securities authority and off-floor trading were among those issues. For a brief comment, see *China Economic Review*, April 1996, p. 12.

³³ This was the view expressed by some of the people to whom I talked during my study trip in China from July to August in 1995, including the people from the CSRC and the Shenzhen Stock Exchange.

general provisions, including among others the regulations governing joint stock companies seeking overseas listing.³⁴ The Accounting Law of the PRC, adopted in January 1985 and amended in December 1993, sets out the basic legal framework for accounting practice and standards. This law, together with two subordinate accounting regulations,³⁵ has brought China's accounting practice and standards close to international standards. In 1995 two decisions were adopted by the Standing Committee of the National People's Congress which updated the criminal law and provided legal weapons to fight against corporate and securities crimes.³⁶ The Criminal Law of the PRC has been amended to become a comprehensive criminal code which contains a group of offenses against crimes violating financial and securities laws.³⁷ With all these developments new concepts have come into China's legal system, such as insider dealing, fiduciary duty, and disclosure rules, to name only a few. The legal system will need to settle and fully assimilate these concepts. Compared with those mature regulatory systems in western countries, needless to say, there is still a long distance for China to go in developing its system of securities regulation into a comprehensive system.

³⁴ The 1994 Special Provisions by the State Council on Share Issuing and Listing Abroad by Companies Limited by Shares, issued by the State Council on, and effective from, 4 August 1994.

³⁵ The 1993 Standard Rules for Enterprise Accounting, issued by the Ministry of Finance on 30 December 1993, and its sister rules, the 1993 General Rules for Enterprise Financial Affairs, issued by the Ministry of Finance at the same time.

³⁶ The 1995 Decision on the Punishment of Crimes Violating Financial Orders, and the 1995 Decision on the Punishment of Crimes Violating the Company Law, adopted by the Standing Committee of the National People's Congress on 28 February 1995.

³⁷ Section 4 of Chapter 3 of the 1997 Criminal Law, including Articles 170-191, deals with crimes violating financial regulation and it creates eleven new offenses relating to violations of securities regulation.

C. Opening Up of China's Securities Market

The opening up of China's securities market started in the early 1990s through, first, creating a domestic B-share market and, second, sending Chinese companies to overseas stock markets for listing. Separate regulations were set out in accordance with the general regulatory principles to facilitate these developments and, in the case of overseas listing, cooperative efforts were made between Chinese and overseas securities authorities to ensure that Chinese companies would satisfy foreign regulatory requirements and the interests of foreign investors would be protected.

The B-share scheme was launched in 1991 when the companies listed on the Shanghai and Shenzhen stock exchanges were allowed to issue a special B class share exclusively to foreign investors. The first B-share issue was by Shanghai Vacuum Electronic Devices Ltd., a Shanghai based joint venture company, in January 1992. The event attracted great attention. The "foreign investors" for the purpose of B-share regulation were initially defined to include institutional and individual investors from foreign countries, including Hong Kong, Macao and Taiwan. The scope has now been extended to include Chinese citizens who reside permanently in foreign countries. At the beginning the experimental B-share scheme was limited to Shanghai and Shenzhen, this limitation was later relaxed to extend the B-share scheme to other parts of China.

In the early stages of the B-share experiment the PBOC and the governments of Shanghai and Shenzhen jointly issued a set of B-share regulations with detailed provisions on various aspects of the B-share scheme. Under the Shanghai regulations, the Shanghai branch of the PBOC, in conjunction with the Shanghai branch of the State Administrative Bureau of Exchange Control, was responsible for the day-to-day administration of the B-

share market. These functions included to approve B-share issues, to authorise securities firms to engage in B-share business, and to supervise B-share market operations. A similar arrangement was set out under the Shenzhen regulations. In December 1995 a national B-share regulation was promulgated and replaced the Shanghai and Shenzhen B-share regulations.³⁸ There has been a shift towards more tightened central control over B-shares under the national regulations and indeed the theme running through the regulations is that of central control of the market.³⁹

Following the launch of the B-share scheme, a further step was taken to open up China's securities market when nine Chinese state-owned companies were sent to Hong Kong for listing on the Hong Kong Stock Exchange (HKSE) in 1993.⁴⁰ This was followed by several companies to the U.S and U.K. markets, and more companies to the HKSE. Around the world there is a tendency for more companies from developing countries to bring their equity offerings to the international markets.⁴¹ By listing state-owned companies abroad, China has followed the trend to create another forum for foreign investors to participate in China's securities market and economic development.

To facilitate the listing of nine state-owned companies on the HKSE a provisional regulation was issued to set out the conditions, approval procedures and the authorities in

³⁸ The 1995 Regulations of the State Council on Listing of Foreign-invested Shares by Joint Stock Companies inside China, promulgated by the State Council on, and effective from, 25 December 1995.

³⁹ For a review of the regulations, see "B-share Legislation", by Freshfields in *China Economic Review*, February 1996, p. 21.

⁴⁰ Among them, Qingdao Brewery was the first of nine companies brought to the Hong Kong Stock Exchange in 1993, the shares of which started trading on July 15.

⁴¹ See, World Economic Outlook: A Survey by the Staff of the International Monetary Fund, chapter IV "The Recent Surge in Capital Flows to Developing Countries", *World Economic Outlook*, October 1994, pp. 48-64.

charge of those matters.⁴² In 1994 a formal regulation to govern overseas listing was promulgated by the State Council in accordance with the relevant provisions of the 1993 Company Law,⁴³ which set out detailed requirements for all companies seeking an overseas listing, including those which had been listed or were seeking a listing on the HKSE. The regulation tried to standardize the approval procedure and documentation requirements regarding overseas listing. It was emphasised that any company seeking an overseas listing must from then on be approved by the SCSC and the CSRC.

At the time when the nine state-owned companies were brought to Hong Kong, a team from the HKSE and the Securities and Futures Commission (SFC), the Hong Kong securities authority, worked for nearly a year with their Chinese counterparts on the terms under which the HKSE would accept these companies.⁴⁴ The HKSE and the SFC were concerned to ensure that minority shareholders in Chinese companies should have a level of investor protection comparable with that of shareholders in companies registered in Hong Kong. In order to achieve this aim, arrangements were then made which modified the Listing Rules of HKSE to accommodate these nine companies.⁴⁵ The experience of Hong Kong listing encouraged a further overseas listing of Chinese companies and

⁴² The Supplementary Provisions on Implementation by Companies Listing in Hong Kong of the Standard Opinion on Joint Stock Companies and Limited Companies, issued by the State Commission for Restructuring Economic System on 24 May 1993.

⁴³ They are Articles 85 and 155, which provide a statutory confirmation that companies would be allowed to go abroad to issue and list their securities.

⁴⁴ For a detailed report on the background of the negotiations between the Chinese and Hong Kong securities authorities, see Holberton, Simon. "Solutions to Chinese Puzzle," *Financial Times*, 13 July 1993, p. 12.

⁴⁵ New rules governing the mainland companies listing were created by HKSE, inserted as Chapter 19A at the end of Chapter 19 of HKSE Listing Rules. For the full text of Chapter 19A in English, see *South China Morning Post*, 20 June 1993.

required close co-operation with the foreign securities authorities. In April 1994 the CSRC and the United States Securities and Exchange Commission (SEC) signed a memorandum of understanding which established a framework for providing technical assistance to the CSRC, sharing information with each other, and enforcing American and Chinese securities laws cooperatively. This kind of bilateral regulatory framework was later established between the CSRC and the securities authorities of some other countries.⁴⁶

The opening up of China's securities market has led to the improvement of regulation of the domestic market in China by adapting foreign regulatory practices. In the areas of company and securities laws, such as the articles of association of companies, company director duties, information disclosure requirements, the functions of securities commissions, certain foreign statutory and regulatory practices have been introduced into China's legislation. In the process of drafting the Securities Law, the drafting team went to Hong Kong to see how the law of securities regulation was operating in Hong Kong. Foreign experts were frequently invited to China to share information about the experience of securities regulation in their countries.⁴⁷ These were things which could hardly have happened if the attitude of the legislative authorities had not been changed towards "capitalist laws". However, although the present legislative climate in China encourages learning from foreign laws, especially from foreign commercial laws, the approach of "using capitalism for socialism" and the emphasis on "China's own conditions" may nevertheless have a negative effect on the efforts to bring China's regulatory practices

⁴⁶ The CSRC has signed a memorandum of understanding with, for example, Singapore, United Kingdom, and Australia securities authorities in past few years.

⁴⁷ John J. Phelan, Jr., Chairman of the New York Stock Exchange, was, for example, invited to China.

close to international practices.

D. China's Securities Regulation in Transition

China is in transition to market economy, driven by its domestic economic reform and by world reforms and changes. The economic reform carried out in China has taken a different route from those of the former socialist countries in East Europe and the Soviet Union in that it is to build the country into a "socialist market economy" and a "socialism with Chinese characteristics". There have been attempts to maintain socialist ideologies while adopting capitalist practices, and to promote a free market economy while keeping the political system without change. Such reconciliation has inevitably led to a battle between socialist ideologies and capitalist practices together with a cycle of uncertainty as to which way to turn. The emergence of securities in China, regarded as an unexpected development,⁴⁸ is a controversy of great concern and past decades have seen a continuous battle between socialist ideologies and capitalist practices in this area, in particular, the issue of public ownership, economic planning, delegated power of local regulators, self-regulation, and the difficulties of applying principles of fairness, equality, and good faith in China's context.

The abolition of private ownership of the instruments and means of production is, in the Marxian view, an absolute condition precedent to the construction of a socialist

⁴⁸ See Stamos, Nikosa, "China's Nascent Securities Market: Some Observations", in R. H. Folsom and J. H. Minan (eds.) *Law in the People's Republic of China*, (Dordrecht: Kluwer Academic Publishers, 1989) pp. 639-642 at p. 639.

order.⁴⁹ In accordance with this Marxian agenda, China confiscated and nationalized privately owned instruments and means of production in early 1950s soon after the Communist Party took power. For many years in China, state ownership on behalf of the "whole people" was taught to be the most ideal form of ownership. Stocks and shares were condemned as a means of exploiting the working class by which a capitalist may hold ownership of a business and receive profits. When other former socialist countries embarked on mass privatisation, China began to transform its State-owned enterprises into stock companies.⁵⁰ One important precondition for the development of stock companies in China is that the dominant control of public ownership be ensured and not be undermined by the private ownership of stocks.⁵¹ Hence, shares are classified into state-owned shares (*guoyougu*), legal person-owned shares (*farengu*), individual-owned shares (*gerengu*), and foreign-owned shares (*waizigu*), and regulatory measures have been adopted to ensure that public ownership remains in control both in the given State-owned entity and in the entire economy. On the other hand, the 1993 Company Law confers various rights on shareholders, similar to those rights granted to shareholders by company legislation in some western countries, but how to exercise these rights, especially by minority shareholders against majority state shareholders, remains uncertain and many questions have to be answered in practice.

⁴⁹ Butler, W. E., "Marxian Concepts of Ownership in Soviet Law", 1985, 23 *Columbia Journal of Transnational Law*, p. 281.

⁵⁰ For a comparison between China and Eastern Europe on enterprise reform, see Cao, Lan, "The Cat That Catches Mice: China's Challenge to the Dominant Privatization Model", *Brooklyn Journal of International Law*, 1995, Vol. 21, No. 1, pp. 97-178.

⁵¹ For further analysis of this fundamental concern, see Chen, Jianfu, "Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC", *Sydney Law Review*, 1993, Vol. 15, No. 1, pp. 59-85.

The role of the State in economic planning has diminished as a result of the economic reform as China moves towards a market economy, but the state still is in a position to use central planning to control and influence the economy. The securities industry, being a sensitive industry in the sense that it may affect economic as well as political and social stability, is largely a centrally planned sector in nature, though it is also regulated by market factors. A substantial part of the provisions in various securities regulations are actually dealing with matters concerning planning control of the securities sector by central and local governments. In the early 1980s, when the securities market first emerged in China, enterprises rushed to raise funds by issuing bonds and shares because they had suffered a shortage of funds from the state which had led to an erosion of the state's overall control over national finance and investment.⁵² Regulatory measures were taken whereby the government tried to strike a balance between the financial freedom of enterprises and the need for state planning and overall control. It is no surprise in this context that the State Planning Commission and the State Commission for Restructuring the Economic System, two powerful bodies of the central government, were given important powers in securities regulation both before and after the creation of the SCSC and the CSRC.

A decentralizing and re-centralizing circle also is evident in the regulation of the securities market in recent years. In the early period experiments with the securities market were carried out only in certain parts of the country; some areas were given more preferential treatment than others in carrying out such experiments. On one hand, this was

⁵² For example, savings deposited to state banks were sharply decreased. For other examples of such erosion, see Zheng, Henry R., "Business Organization and Securities Laws of the People's Republic of China", *The Business Lawyer*, 1988, Vol. 43, No. 2, pp. 549-619 at p. 606.

necessary to ensure a successful experiment by "feeling the stones to cross the rivers", as was called, but on the other hand, it contributed to unbalanced development among local regions. A regionalism in respect of securities policies and regulations was growing as a result of such preferential policies. Different attitudes, for example, were evidenced between Shanghai and Shenzhen towards foreign participation in China's securities market.⁵³ Regulatory powers and responsibilities were decentralized at an early stage to local regulators, but after the establishment of the SCSC and the CSRC, there has been a shift to re-centralizing the regulatory powers and responsibilities away from local regulators. Some of the important and direct regulatory roles which used to be undertaken by local regulators have been centralised back to the SCSC and the CSRC, such as regulatory roles in relation to the B-share market.

Self-regulatory organisations (*ziluxing zuzhi*) have in recent years become part of the institutional framework for the regulation of the securities market. In the meantime, the concept of self-regulation has been introduced into China's securities regulation. The China Securities Association (CSA), a self-regulatory organization for securities firms and dealers throughout the country, was formally established in August 1991.⁵⁴ The concept of a self-regulatory organisation was introduced in the 1993 Provisional Regulations on the Administration of Issuing and Trading Shares and later confirmed in the drafts of the Securities Law of the PRC. Although the establishment of the CSA was encouraged by the government and the concept of self-regulatory organisation was introduced into

⁵³ For a detailed description and analysis of such different attitudes, see Potter, Pitman B., "Securities Markets Opening to Foreign Participation", *East Asian Executive Reports*, April 1992, pp. 7-9.

⁵⁴ "Zhongguo Zhengquanye Xiehui Zai Jing Chengli" (The China Securities Association is established in Beijing), in *Shanghai Zhengquan* (*Shanghai Securities Weekly*), 2 September 1991, p. 1.

China's securities regulation, the role of self-regulatory organisations has so far been limited. This is not surprising as the concept of "self" or "independent" regulatory organisations raises a challenge to a traditional system under which the Communist Party, the government, and their affiliated organisations have dominated almost all aspects of social activities.

Around the world, the concept of self-regulation was chiefly adopted in United Kingdom financial regulatory system, which in turn influenced other countries in their securities regulatory systems. The debates about self-regulation and state-regulation has always been a centre of academic concern in the law of securities regulation. The application of the concept of self-regulation and self-regulatory organisations in China's law of securities regulation depends, on one hand, on the general conditions applicable to all other countries where a system of self-regulation has been adopted, such as a highly trained profession engaged in the securities business, and on the other hand, on China's own political, social, legal and historical conditions. The idea of a "socialist market economy" and "socialism with Chinese characteristics" would no doubt influence its application.

The general civil law principles of fairness, equality and good faith which are set out in the 1986 General Principles of Civil Law⁵⁵ have been emphasized to be fundamental principles in the regulation of securities markets. One can find these principles quoted in virtually every securities regulation promulgated at the national and

⁵⁵ Article 4 of the 1986 General Principles of Civil Law of the PRC states "civil law activities must respect the principles of voluntariness, fairness, compensation of equal value and good faith."

local levels.⁵⁶ To apply these principles in practice has, however, proved to be not as easy as to put them on paper. One good example is company listing. The problems revealed in the listing process have shown that listing process is not a fair one, but rather highly politicised, and the companies which have been listed are so not because of their strong balance sheets, but because of their connections and because of the government's attempt to balance competing interest groups. As far as the principle of openness is concerned, its application in practice has proved to be not easy neither. For example, in 1996 rules were introduced to tighten control over the reporting of economic news by foreign news agencies in China, under which Xinhua, China's official news agency, was empowered to monitor the activities of foreign news agency.⁵⁷ Concerns were subsequently raised about the implications of these rules for the transparency of China's financial and securities markets.

E. International Dimension

In past decades the world's securities markets have grown more closely together and this trend of internationalization has brought changes in the field of securities regulation. Regional harmonisation activities have been carried out, in particular, in the European Union where, during the past fifteen years, an increasingly detailed supranational securities regulatory structure has been constructed for its twelve Member

⁵⁶ Article 3 of the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares, for example, states: "the issue and trading of shares shall be conducted in adherence to the principles of oneness, fairness, and good faith."

⁵⁷ The Administrative Measure for the Release of Economic Information Inside China by Foreign News Agencies and their Subordinate Information Organizations.

States. It has become the primary model for multinational regulatory harmonisation.⁵⁸ In the enforcement front, progress has been made in identifying means by which regulators could co-operate and assist one another in detecting and deterring cross-border misconduct.⁵⁹ In the wake of the Barings Bank collapse, securities regulators around the world once again realised the need and importance for cross-jurisdiction cooperation to tackle the ever increasing cases involving a number of jurisdictions and other complex issues. Through the experience of listing its enterprises in Hong Kong and other foreign countries and the experience of co-operation with the foreign securities authorities concerned, China has linked itself with international communities in the field of securities regulation. This has opened up a dimension for China to develop its securities regulation in international contexts.

One potential development for China's securities regulation is harmonisation with the securities regime of Hong Kong, since Hong Kong has been returned to China. Hong Kong has been a primary forum for capital formation for China since the late 1980s.⁶⁰ The listing in 1993 of state-owned companies in Hong Kong brought China into a closer and more direct relationship with Hong Kong in this respect. It was a process which generated an experiment in "marrying China's socialist civil law to Hong Kong's version of the

⁵⁸ See Warren, Manning Gilbert, "The European Union's Investment Services Directive", 1994, 15 *University of Pennsylvania Journal of International Business Law*, p. 181.

⁵⁹ See IOSCO Working Party Report "Addressing Difficulties Encountered While Negotiating and Implementing Memoranda of Understanding" released by the Technical Committee in July 1990, and "IOSCO principles for MOUs" released by the Technical Committee in July 1991.

⁶⁰ Before the nine state-owned companies were brought to Hong Kong in 1993, there existed the so-called "China concept stocks" in Hong Kong. See Nottle, Robert, "The Development of Securities Markets in China in the 1990s", *Company and Securities Law Journal*, 1993, Vol. 11, No. 8, pp. 503-523.

common law of the United Kingdom".⁶¹ There is no doubt that Hong Kong will continue to be a primary forum for China to raise funds in the future. With further integration of the two sides economically, socially, and legally, there are reasons to believe that their securities regulation would gradually move towards a harmonisation similar to that happening in the European Union.

As far as cross-jurisdiction co-operation is concerned, China has in the past few years established frameworks for cross-jurisdiction co-operation with several foreign securities authorities by concluding bilateral memorandums of understanding with them. In 1995 China joined IOSCO, which marked an important step in international cooperation. On a more general level, domestic legal developments since 1979 have brought fundamental changes in those such areas as civil and criminal procedure, arbitration procedure, and practices in relation to international private law. These developments have helped to establish mechanisms for cross-border judicial cooperation and assistance and for recognition and enforcement of foreign judgments. In addition, China has in recent years entered into certain international treaties, as well as bilateral treaties in the area of judicial assistance and enforcement cooperation.⁶² Although these developments have greatly improved the situation, foreign investors still often feel no confidence in China's legal system. They are worried about such problems as uncertainty of laws, interpretation of statutes, and political influence and interference. These are

⁶¹ See Holberton, Simon. "Solutions to Chinese Puzzle," *Financial Times*, 13 July 1993, p. 12. Incorporated in Qingdao's articles of association is an attempt to codify common law on matters such as the roles and responsibilities of directors, protection of minorities and accounting standards.

⁶² In 1986, for example, China acceded to the 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards.

certainly some of the difficulties which need to be addressed in developing China's legal framework for cross-jurisdiction co-operation in the field of securities regulation.

Chapter II

Scope of Regulation

There are two related aspects to the scope of securities regulation: first, to what "securities" should the statutory regulation apply and, second, what activities relating to securities should be regulated?¹ In the United Kingdom, and United States systems of securities regulation, the scope of regulation is regarded as a central and critical issue to the system and has been thoroughly defined through statutory definitions and judicial interpretation.² Indeed, for all systems of securities regulation, there is a need first to define the scope, albeit the way through which the scope is defined as well as the scope may vary with each other.

China's emerging system of securities regulation is not exceptional. Its scope has

¹ These were the two aspects reviewed by Professor Gower of the scope of securities regulation in United Kingdom. See L. B. Gower, *Review of Investor Protection*, a Report presented to Parliament by the Secretary of State for Trade and Industry, part I, chapter 4 (London: H.M.S.O, 1984) (Cmnd 9125).

² In the United Kingdom system, see the definitions of "investment" and "investment business" under the Financial Services Act 1986, s. 1 (1)(2) and Sched. 1 part I, II, III; in the United States system, see the definition of "security" under the Securities Act 1933, s.2(1); and the case law in both the systems interpreting the statutory definitions.

been gradually defined along with the stages of development of the emerging securities market since the 1980s. The securities to which regulation applied were bonds and shares in the early times, and this has been enlarged as new types of securities and other investments emerged; the activities relating to securities were then confined to those of issuing and trading bonds and shares and now there is a wide range of activities subject to securities regulation. The law on the definition of "securities" and "securities business" in China is found in various national and local securities regulations and in the Securities Law of the PRC adopted in 1998.

A. Legal Definition of Securities

The equivalent Chinese term for "securities" is "*zhengquan*". Thus "securities market" is translated as "*zhengquan shichang*", (*shichang* means market) and "securities regulation" as "*zhengquan fagui*" (*fagui* means regulation). The term "*zhengquan*" can be used in a broad sense and in a narrow sense. In the broad sense it could mean any certificate representing proof or evidence of rights and interests, for example, a property certificate (*fangchan zhengming shu*), whereas in the narrow sense, it means "negotiable instruments" (*youjia zhengquan*), including, broadly, bill of lading, bill of exchange, promissory note, cheque, stock, share, bond, debenture, etc.³ "Negotiable instrument" or "*youjia zhengquan*" is further divided into "*piaoju*" and "*ziben zhengquan*". "*Piaoju*", as a collective term, refers to a bill of exchange, promissory note, and cheque which are

³ See *Faxue Da Cidian* (A Comprehensive Law Dictionary) (Beijing: China University of Law and Political Science Press, 1991), p. 804.

regulated by the 1995 Negotiable Instrument Law of the PRC,⁴ whereas "*ziben zhengquan*" refers to stock, share, bond, debenture, and other forms of capital instruments which are regulated by the Securities Law. The term "*zhengquan*", when used in the context of "*securities market*", "*securities regulation*", or "*Securities Law of the PRC*", means "*ziben zhengquan*". Thus, the Securities Law of the PRC is translated as "*zhengquan fa*" (*fa* here means law), and the Negotiable Instrument Law of the PRC as "*piaoju fa*".

The legal definition of securities found in various national and local securities regulations in China actually concerns these "*ziben zhengquan*"(capital instruments), defining what they are and what form and function they have. As the majority of national and local securities regulations have been formulated to regulate each type of security, such as share, enterprise bond, or treasury bond, the definition of securities in these regulations is to define what a "share" or a "bond" is rather than to define what a "security" is. There are, however, some regulations which deal with securities as a whole and contain a definition of "securities".

"Bond" (*zaiquan*) was the first type of security to appear in China's emerging securities market. The principal forms were the enterprise bond and government bond. In the 1993 Regulations on the Administration of Enterprise Bonds,⁵ "enterprise bond" (*qiye zaiquan*) is defined as a negotiable instrument issued by an enterprise in accordance with legal procedures which may be transferred, pledged, and inherited, and the holder of

⁴ The full text in Chinese of the Negotiable Instrument Law of the PRC can be found in *the State Council's Gazette*, No. 13, 1995, p. 507.

⁵ It was promulgated by the State Council on 2 August 1993, and repealed the 1987 Provisional Regulations on Enterprise Bonds, a previous provisional regulation on enterprise bonds promulgated by the State Council.

which is entitled to receive repayment of the principal and payment of interest on the bond at a fixed time but has no right to participate in the management of the enterprise.⁶ An almost identical definition of "company bond" (*gongsi zaiquan*) is provided for in the 1993 Company Law of the PRC, which defines the company debenture as a negotiable instrument issued by a company in accordance with legal procedures, and which stipulates the way in which repayment of the principal and payment of interest shall be made.⁷ The company which has issued a company bond may be a joint stock company, a wholly state-owned company,⁸ or a limited company established by two or more state-owned enterprises or state investment entities; the company bond may be transferred at a securities exchange established in accordance with law; there may be registered or bearer company bonds, and a listed company may also issue convertible bonds, the holders of which shall be given an option to convert them into shares.⁹

The government bond takes various forms, the "treasury bond" (*guokuquan*) being the main one. In the 1992 Treasury Bond Regulations of the PRC,¹⁰ it is stipulated that a treasury bond may be pledged and may be transferred.¹¹ The treasury bonds issued before 1988 were not allowed to be traded; this was changed in 1988 when the government decided to set up a market and allow government bonds to be traded. The

⁶ Articles 5, 7, and 9.

⁷ Article 160.

⁸ A wholly state-owned company is defined by Article 64 of the 1993 Company Law of the PRC as a limited company established solely by a state investment entity or an authorised government department.

⁹ Articles 159, 168, 170 (i), 172, and 173 of the Company Law of the PRC 1993.

¹⁰ It was promulgated by the State Council on, and effective from, 18 March 1992.

¹¹ Articles 8 and 9.

decision was regarded as a significant move in establishing a government debt securities market.¹²

"Shares" (*gupiao*) emerged as a result of enterprise reforms and the transformation of state enterprises into companies. In the 1993 Provisional Regulations on Administration of Issuing and Trading of Shares, "share" is defined as an instrument issued by a joint stock company that represents shareholders' rights and interests, as well as obligations they shall undertake in accordance with their holdings.¹³ The definition was later fully presented in the 1993 Company Law of the PRC, which provided that the capital of a joint stock company shall be divided into shares of equal value, represented by the share certificates issued by the company; the shares may be issued at par or at a premium, but not at a discount, and the issues must be in compliance with the principle of equal shares with equal rights and interests; there may be registered and bearer shares, and they may be transferred; the shareholders, by virtue of their shares and in proportion to their holdings, may benefit from their investments, may participate in important decision-making, and may elect senior company personnel.¹⁴

Because of its nature, the definition of share has reflected the government's concern that the dominant control of socialist public ownership should not be undermined by private ownership of shares. Thus, the 1992 Standard Opinion on Joint Stock Companies, an interim set of regulations before the promulgation of the 1993 Company Law, classified shares into "state-owned share" (*guojiagu*), "legal person-owned share"

¹² For background and early government bond issues, see, Mei Xia, et al., *The Re-emerging Securities Market in China*, pp. 56-60 (Westpoint: Quorum Books, 1992).

¹³ Article 81(1).

¹⁴ Articles 4, 129, 130, 131, 133, 143.

(*farengu*), "individual-owned share" (*gerengu*), and "foreign-owned investment share" (*waizigu*), in accordance with the status of the shareholders.¹⁵ State-owned shares are those held by state-owned entities or institutions designated by the government; legal person-owned shares are shares held by a company or legal entity; individual-owned shares are those held by individual investors of the general public or by staff and workers of a company or enterprise; and foreign-owned investment shares are shares held by foreign institutional and individual investors.¹⁶ This classification laid down a theoretical as well as a practical division for the purpose of the protection of state-owned assets and ultimately the purpose of dominant control of socialist public ownership. When these state-owned enterprises are restructured into public companies, their assets are divided into different categories of shares in accordance with this classification. Although the 1993 Company Law of the PRC does not explicitly confirm this classification as a statutory classification, it does not reject its application in practice neither. In fact, this classification has become a basis for later regulations concerning state-owned assets and state-owned enterprise restructuring.¹⁷

"Foreign-owned investment shares" are further classified into "domestically-listed foreign investment shares" (*jingnei shangshi waizigu*), and "overseas-listed foreign investment shares" (*jingwai shangshi waizigu*). The domestically-listed foreign investment shares" are B-shares listed on Shanghai Stock Exchange and Shenzhen Stock Exchange

¹⁵ Article 24.

¹⁶ *Id.*

¹⁷ See, for example, the Provisional Measures on Administration of State-owned Shares in Joint Stock Companies, issued by the State Bureau for Administration of State Assets on, and effective from, 28 June 1994, which adopted the classification.

exclusively for foreign investors and the "overseas-listed foreign investment shares" are those shares issued by Chinese companies listed on foreign stock exchanges, such as H-shares in the companies listed on the HKSE. These two types of foreign investment shares are subject to separate regulation.¹⁸ By definition, "foreign-owned investment shares" are those registered shares denominated in *Renminbi* and offered exclusively for purchase and sale by foreign investors with foreign exchanges; the holders enjoy same rights and interests as the domestic holders with same class of shares; there may be registered foreign investment shares only, and in the case of overseas-listed foreign investment shares the register of foreign shareholders can be placed either in the company in China or with an agent abroad in accordance with the memorandum or agreement reached between Chinese securities authorities and the securities authorities of the foreign country concerned.¹⁹ If the share register is placed abroad, the company concerned is required to keep a copy of the register in China, which should be the same as the original one abroad at all times. This requirement guarantees transparency of the foreign ownership of shares, which helps the government regulator to regulate foreign-owned investment shares.

"Internal employee shares" (*neibu zhigong gu*) are held by employees of a joint stock company which has been placed privately. It is classified as a special category of

¹⁸ The Regulations of the State Council on Listing of Foreign Investment Shares by Joint Stock Companies inside China, promulgated by the State Council on, and effective from, 25 December 1995, which repealed Shanghai and Shenzhen previous B share regulations; the Special Provisions of the State Council on Issuing and Listing of Shares Abroad by Joint Stock Companies, promulgated by the State Council on, and effective from, 4 August 1994. These two pieces of regulations will be considered in detail in Chapter VI.

¹⁹ Article 17 of the 1994 Special Provisions on Issuing and Listing of Shares Abroad by Joint Stock Companies.

shares and is subject to special regulations.²⁰ "Employees" for this purpose are defined to include both existing employees and retired employees of a company.²¹ One of the restrictions imposed on internal employee shares is that they are not allowed to be transferred within three years of issue and even after three years they may only be transferred between employees and not to the general public.²² Quite a number of cases have gone to the people's courts in which holders of internal employee shares illegally transferred their shares in one way or another.²³ Since a large number of shares, especially those of small and medium-size companies, are held internally by company employees, the illegal transfer of internal employee shares has become a widespread problem. A similar restriction is imposed on companies which have changed their status from private companies into public companies and have issued shares to the general public. The internal employees shares in those companies may, upon approval by the authorities, only be listed and transferred publicly within three years time.²⁴

The definitions mentioned above are concerned with individual types of securities and are found in the regulations which deal with the particular type of securities. The legal definition of "*securities*" (*zhengquan*) which defines "*securities*" as a whole first

²⁰ The 1993 Regulations on Internal Employee Shares of Joint Stock Companies, issued by the State Commission for Reconstructing the Economic System on, and effective from, 1 July 1993.

²¹ *id.*, Articles 2, and 5.

²² *id.*, Article 22.

²³ See, for example, *Guo Zhaoqiang and Liang Guobin v. Wu Ganfei and Ye Meifen*, and *Guangdong Province Finance Bureau* [1994] Guangzhou Yuexiu District People's Court, published in Chinese in the *A Selection of the Cases of the People's Courts*, edited by the Supreme People's Court, Vol. 9, pp. 136-139, (Beijing: People's Court Publishing House, 1995).

²⁴ Article 29 of the 1993 Regulations on Internal Employee Shares of Joint Stock Companies.

appeared in the local regulations of Shanghai and Shenzhen cities. In the 1990 Shanghai Securities Trading Regulations,²⁵ "securities" is defined to mean (i) government bonds; (ii) financial bonds issued by banks and other financial institutions; (iii) company or enterprise bonds; (iv) company shares or warrants; and (v) certificate of interests in investment trust funds.²⁶ A similar definition is found in the 1991 Shenzhen Stock Exchange Rules, where "securities" is defined to include (i) various bonds issued by central and local governments; (ii) financial bonds; (iii) enterprise bonds; (iv) shares and related certificates entitling rights and interests thereto.²⁷ The type of securities included in the definitions in the Shanghai and Shenzhen regulations were subject to alteration by the securities authorities.²⁸ At the time when these regulations were promulgated, the Shanghai and Shenzhen branches of the PBOC were in charge of securities regulation in Shanghai and Shenzhen respectively, so it was up to them to approve and add new types of securities to the definition. Although the definitions under the Shanghai and Shenzhen regulations were very brief, they represented an early attempt to develop the law on the definition of securities in China. They reflected not only the scope of the securities market in the Shanghai and Shenzhen stock exchanges at that time, but also the stages of development of China's emerging securities market.

There has been so far no definition of "securities" in the national securities

²⁵ It was promulgated by the Shanghai government on 27 November 1990 and effective from 1 December 1990. It repealed two earlier regulations: Shanghai Share Provisional Regulations (23 May 1987) and Shanghai Enterprises Bond Provisional Regulations (23 May 1987).

²⁶ Article 3 (i-v).

²⁷ Article 2 (i-iv).

²⁸ Article 3 vi of the Shanghai Securities Trading Regulations 1990; Article 2 v of the Shenzhen Stock Exchange Rules 1991.

regulations despite the fact that there are a few national regulations which deal with securities as a whole, such as the 1993 Provisional Measures on Prevention of Securities Frauds, and despite the fact that the expression "*zhengquan*" (securities) appears frequently in these regulations. Nor did the 1986 General Principles of Civil Law of the PRC provide such a definition in the same manner as in the civil codes of some former socialist countries.²⁹ There was, however, an attempt to define "securities" in the drafts of the Securities Law of the PRC. Two approaches, it appears, were competing with each other in the drafting process on the issue of whether or not to include a definition of securities in the legislation. In the 1993 Securities Law of the PRC (draft), a special section was devoted to definitions of the terms used in the statute, "securities" being defined as (i) government bonds; (ii) financial bonds; (iii) company debentures; (iv) debt instruments issued by enterprises, or other organisations with a legal person status; (v) shares; (vi) warrants; (vii) investment funds; and (viii) other securities defined by authorities concerned.³⁰ This definition was, however, not included in the next draft, the 1994 Securities Law of the PRC (draft), in which there was neither a section nor a schedule devoted to definitions of the terms used in the statute. The 1994 Draft defined only a few terms, and the definitions appeared individually and separately among articles of the statute. In terms of legislative technique and style, the approach taken by the 1993 Draft was close to that of foreign securities legislation, in particular, Hong Kong securities

²⁹ See, for example, a definition of "security" is included in the Civil Code of the Republic Kazakhstan, s.2, Articles 129, 130. Butler, W. E. *Securities and Banking Law of the Republic Kazakhstan*, p. 14, (London: Simmonds & Hill Publishing Ltd, 1995).

³⁰ Article 6 (i).

legislation,³¹ whereas the approach taken by the 1994 Draft was closer to Chinese legislation, in which there are no special sections nor schedules devoted to definitions or interpretation. The approach taken by the 1998 Securities Law of the PRC is the same as that of the 1994 Draft. This will be dealt with in details later in the final Chapter.

Commodity and financial futures are not defined as "securities", but they do fall within the scope of securities regulation. Commodity futures (*shangping qihuo*) emerged in late 1980s and early 1990s when markets were set up in some parts of China to allow a few kinds of commodity futures to be traded on those markets. In Shanghai and Shenzhen, for example, futures markets for nonferrous metal were set up respectively. Financial futures (*jingrong qihuo*) emerged when some types of financial futures, such as foreign exchange futures (*waihui qihuo*) and treasury bond futures (*guozai qihuo*), began to be traded in some parts of China and markets were set up thereafter. The CSRC and other relevant authorities promulgated a series of regulations to regulate commodity futures and financial futures.³² At the local level, local governments, in particular the Shanghai and Shenzhen governments, also promulgated various regulations to regulate commodity futures and financial futures in their regions. Although it was expected that futures products would be defined along the line of the definition of securities in the 1998 Securities Law of the PRC, this expectation was not realized by the 1998 Securities Law

³¹ A definition on "securities" is provided by s. 2 of the Hong Kong Securities Ordinance, cap. 333, (1989 ed.).

³² Among them, the 1994 Provisional Measures on Administration of Employees of Futures Companies, issued by the CSRC on, and effective from, 6 December 1994; the Circular on Inspection of Non-Futures Brokerage Companies Which Carry on Futures Brokerage Business, issued by the CSRC and the State Bureau for Industry and Commerce on, and effective from, 27 October 1995; the Provisional Measures on Registration and Administration of Futures Brokerage Companies, issued by the State Bureau for Industry and Commerce on, and effective from, 28 April 1993.

of the PRC. Futures products will continue to be defined and regulated under a separate set of rules and regulations.

B. Securities Business

The Chinese expression for "securities business" is "*zhengquan yewu*", which means, in the context of securities regulation, securities issuing (*zhengquan faxing*), securities trading (*zhengquan jiaoyi*), and related activities (*xiangguan huodong*). "Related activities" normally refers to the custody of securities, account settlement, registration of securities and securities investment advice. There are three other Chinese expressions which are relevant in this context: "*congshi zhengquan yewu*" (*to carry on securities business*) means to carry on business relating to securities issuing, securities trading, and related activities; "*zhengquan congye ren yuan*" (*persons who carry on securities business*) refers to those who carry on securities business, including not only brokers and dealers, but also lawyers, accountants and other professionals who provide services in relation to securities issuing, securities trading, and related activities; "*zhengquan jigou*" (*securities institutions*) refers to, in a broad sense, securities firms, stock exchanges, account settlement systems, places for securities custody and registration, and, in a narrow sense, it refers only to securities firms. However, securities firms are more often expressed as "*zhengquan gongsi*" or "*zhengquan jingying jigou*".³³

Securities Firms (zhengquan gongsi) are the main players in the securities business. Their business activities are regulated by various regulations, in particular, the 1990

³³ For definitions of above expressions in Chinese, see, *Faxue Da Cidian (A Comprehensive Law Dictionary)* (Beijing: China University of Law and Political Science Press, 1991), p. 804.

Provisional Regulations on Securities Firms,³⁴ under which "securities firm" is defined as a financial institution which specially carries on securities business.³⁵ The business a securities firm may carry on is defined as (i) business relating to securities issuing as an agent; (ii) business relating to securities trading as both an agent and principal; and (iii) other related activities, including among others custody of securities and securities investment consultancy, subject to approval by the relevant authorities.³⁶ To set up a securities firm and carry on securities business, the applicant must submit an application to the PBOC, and if the application is approved, a licence for carrying on securities business will be issued to the applicant.³⁷ Certain conditions have to be satisfied in order to set up a securities firm and carry on securities business, such as minimum capital requirements and qualifications of staff.³⁸ The licence a securities firm has obtained could be suspended and revoked under certain circumstances set out in the 1990 Provisional Regulations on Securities Firms and other regulations.³⁹ A power is given to the PBOC to conduct on-site inspection of securities firms and to require information from them whenever necessary.⁴⁰ A similar power is given to the CSRC under Article 69 of the 1993

³⁴ It was issued by the PBOC on, and effective from, 12 October 1990.

³⁵ Article 2.

³⁶ *id.*, Articles 12, 13.

³⁷ *id.*, Articles 4, 7, and 8.

³⁸ *id.*, Article 6 (i-iv). The minimum capital, for example, is required to be no less than Rmb 10 million.

³⁹ The 1993 Provisional Regulations on Administration of Issuing and Trading of Shares, for example, provides that the licence of a securities firm would be suspended or revoked if it falls into the situations prescribed under Article 74.

⁴⁰ Article 19 of the 1990 Provisional Regulations on Securities Firms.

Provisional Regulations on Administration of Issuing and Trading of Shares.

Investment Fund Management Company (*touzi jijing gongsi*) is the Chinese equivalent of United States and United Kingdom investment companies or asset management firms who deal with investment funds (*touzi jijing*). This type of securities firm is a more recent development, and there are fewer of them compared with the general type of securities firm. To set up an investment fund management company and carry on securities business as in the case of securities firms, the applicant has to submit an application to the PBOC and obtain a licence. The 1994 Regulations on Administration of Financial Institutions issued by the PBOC set out a general licensing system applicable to various kinds of financial institutions, including, among others, an investment fund management company. The Shanghai and Shenzhen stock exchanges have also set out requirements for an investment fund to be listed on their stock exchanges.⁴¹ In the 1993 Securities Law of the PRC (draft) a whole chapter was devoted to investment funds, and detailed provisions were proposed to strengthen the overall regulation of business activities of the investment fund management companies.⁴²

Banks (*yinhang*) may carry on a limited range of securities business. The general principle is that banking business and securities business must be separated in management and administration.⁴³ Pursuant to the provisions of the 1995 People's Bank

⁴¹ The Shenzhen Stock Exchange Investment Fund Listing Rules, for example, set out requirements regarding minimum net assets of the fund management company and its operation years.

⁴² The 1993 Securities Law of the PRC (draft), Chapter 7: "Investment Fund".

⁴³ Article 7 of the 1994 Regulations on Administration of Financial Institution.

of China Law of the PRC,⁴⁴ the People's Bank of China may engage in dealing with treasury bonds and other government securities in open markets, but not directly subscribe for and underwrite them.⁴⁵ Pursuant to the 1995 Commercial Bank Law of the PRC,⁴⁶ a commercial bank may carry on business relating to government securities but not to shares and investment funds.⁴⁷ The scope of securities business which a commercial bank may carry on should be stated in the articles of association of the bank and approved by the PBOC.⁴⁸ If a commercial bank carries on business relating to government securities without approval from the PBOC or carries on business relating to shares and investment funds, it will face penalties ranging from fine to suspension and revocation of business licence under Article 74 of the 1995 Commercial Bank Law of the PRC.

Financial Futures Firms (jingrong qihuo gongsi) are defined as one particular kind of financial institution under the 1994 Regulations on Administration of Financial Institutions. In order to set up a financial futures company and carry on financial futures business, a licence has to be obtained pursuant to the 1994 Regulations Administration of Financial Institutions in the same manner as investment fund management companies. The business which a financial futures company carries on is subject to other regulations in addition to the 1994 Regulations on Administration of Financial Institution. Thus, to carry

⁴⁴ It is adopted at the third session of the Eighth National People's Congress on, and effective as of, 18 March 1995.

⁴⁵ Article 22 (v), and Article 28.

⁴⁶ It was adopted at the thirteenth meeting of the Standing Committee of the Eighth National People's Congress on 19 May 1995 and effective from 1 July 1995.

⁴⁷ Articles 3, 43.

⁴⁸ *id.*, Article 3.

on a business relating to treasury bond futures, one is subject to regulations governing treasury bonds futures; to carry on a business relating to foreign exchange futures, one is subject to approval procedures jointly administered by the CSRC and the foreign exchange administrative authorities; and to carry on a business relating to share index futures, one is subject to the 1993 Provisional Regulations on Administration of Issuing and Trading of Shares.⁴⁹

Commodity Futures Firms (shangping qihuo gongsi) are regulated mainly by local regulations promulgated in those regions where commodity futures markets have been set up. In Shenzhen, for example, a licensing system was set up by the 1993 Shenzhen Special Economic Zone Administration of Nonferrous Metal Futures Brokers Provisional Regulations,⁵⁰ under which separate licences had to be obtained in order to carry on the business of dealing in nonferrous metal futures either as an agent or as a principal, and if a company had obtained both licences, it was required to separate that business carried on by the company as an agent from that business carried on by the company as a principal.⁵¹

Securities Brokers (jingjiren) who are employed by securities firms, investment fund management companies, financial futures companies, and commodity futures companies are required to satisfy certain conditions in order to carry on the securities business. Provisions in this regard vary with each other among different regulations, but focus generally on educational qualifications, work experience, and professional records.

⁴⁹ Article 42 provides that an approval must be sought from the SCSC in order to carry on share index futures dealing.

⁵⁰ It is promulgated by the Shenzhen Government on, and effective from, 14 January 1993.

⁵¹ Articles 21, 30, 31.

In some cases brokers have to obtain separate licences in order to be able to carry on securities business in addition to the licence obtained by the company where they are employed.⁵² Advisers who advise on securities investments are subject to regulation as well. In order to prevent advisers from abusing their position and making profits, it was proposed in the drafts of the Securities Law of the PRC that securities advisers offering a professional service and providing advice to their clients should not carry on securities investment in their capacity as an agent of the clients, nor should they engage in dealing in the shares of a listed company with regard to which they provide advice to their clients.⁵³

Lawyers and Accountants, and their firms are subject to securities regulation if they provide professional services relating to securities business. The 1993 Interim Provisions on the Authorization of Lawyers and Law Firms to Provide Legal Services Relating to Securities Business⁵⁴ provides procedures for authorising lawyers and law firms to engage in legal services relating to securities business. The principle is that no lawyer or law firm may provide legal services relating to securities business without authorization. "Legal service relating to securities business" (*zhengquan falu yewu*) is defined as those legal services which are provided in relation to securities issuing, trading,

⁵² For example, Article 13 of the 1993 Shenzhen Special Economic Zone Administration of Nonferrous Metal Futures Brokers Provisional Regulations stipulates that a licence has to be obtained by a broker in order to carry on nonferrous metal futures business in Shenzhen, and Article 14 sets out certain conditions the broker has to satisfy.

⁵³ Article 176 of the 1994 Securities Law of the PRC (draft).

⁵⁴ It is issued jointly by the CSRC and the Ministry of Justice on, and effective from, 12 January 1993.

and other related business, either in the form of legal opinions or other legal documents.⁵⁵ Lawyers who wish to engage in legal services relating to securities business must apply for a certificate and satisfy certain conditions in respect of experience, qualifications, and professional records; a law firm where there are more than three full-time lawyers who have obtained such certificates may apply for a certificate enabling the firm to carry on legal services relating to securities business.⁵⁶ A power is vested in the Ministry of Justice and the CSRC to suspend or revoke a lawyer's or law firm's licence to carry on securities business if it is found that misleading or false documents have been provided.⁵⁷ A similar procedure has been established to authorize registered accountants and accounting firms to engage in services relating to securities business.⁵⁸

Stock Exchanges and Trading Centres. Services provided by stock exchanges and trading centres, including among others securities custody, account settlement and registration, are all within the scope of securities regulation. A regulatory framework was initially established under the 1993 Provisional Measures on Administration of Stock Exchanges⁵⁹ to regulate stock exchanges and the services they provide. One aim of the regulatory framework was to provide a procedure for the setting up of stock exchanges. To set up a stock exchange, an application has to be submitted and examined by the

⁵⁵ Article 3 of the 1993 Interim Provisions on the Authorization of Lawyers and Law Firms to Provide Legal Services Relating to Securities Business.

⁵⁶ *id.*, Articles 4, 5.

⁵⁷ *id.*, Article 7.

⁵⁸ The Regulations on the Authorization of Accounting Firms and Registered Accountants to Carry on Securities Business, issued jointly by the CSRC and the Ministry of Finance on, and effective as of, 14 March 1993.

⁵⁹ It has been replaced by the 1996 Measures on Administration of Stock Exchanges.

SCSC initially and approved by the State Council.⁶⁰ Stock exchanges may not assign their business licence by any means.⁶¹ The Shanghai and Shenzhen stock exchanges are the two national stock exchanges so far approved and although there were discussions to set up a third one, no developments have occurred.⁶² The Shanghai and Shenzhen stock exchanges have both adopted their own rulebooks to regulate securities dealing and listing, information disclosure, account settlement, account transfer and registration, and other services provided in the stock exchanges.

Securities Business. The drafts of the Securities Law of the PRC divided securities business into two categories, namely, "securities management business" (*zhengquan jingying yewu*) and "securities services business" (*zhengquan fuwu yewu*). "Securities management business" is defined to mean the business relating to the distribution of and dealing in securities as principals or as an agent; "securities services business" is defined to mean the business relating to services and advices provided for securities issuing and trading, securities, securities custody, account settlement, account transfer and registration, and securities investment.⁶³ Accordingly, institutions carrying on securities business are divided into "securities management institution" (*zhengquan jingying jigou*) and "securities services institution" (*zhengquan fuwu jigou*).⁶⁴ It is arguable that this division is an unnecessary division in practice and in theory because the line between "securities

⁶⁰ Article 6 of the 1993 Provisional Measures on Administration of Stock Exchange.

⁶¹ *id.*, Article 40.

⁶² Wuhan, capital city of Hubei province in centre China, was one of those cities which voiced strongly their intention to set up the third national stock exchange.

⁶³ Article 6 (v), (vi) of the Securities Law of the PRC (draft) 1993.

⁶⁴ *id.*, Article 6 (vii), (viii).

management business" and "securities service business" is difficult to draw and also because "securities management business" is one kind of securities "services".⁶⁵ To divide securities business into "management" and "services" may therefore cause confusion. On the other hand, the division is helpful to understanding the nature of different types of services relating to securities business, and thus in this sense it is a step forward towards the sophistication in the law on the definition of securities business in China.

C. Territorial Element

"Territorial element" is meant in this context to describe the geographical scope of securities regulation in China's securities regulatory system. A line has been drawn between "*jingnei*" (inside the territory of China) and "*jingwai*" (outside the territory of China), and regulations are divided into those which are applicable to securities activities carried on inside China and those which are applicable to securities activities carried on outside China. "Securities activities carried on outside China" refers to the issuing and listing of securities abroad by Chinese companies or enterprises and by Chinese central or local governments. Another line has been drawn between "*difang*" (local) and "*quanguo*" (national), and accordingly regulations which are applicable locally are "local securities regulation" (*difang zhengquan fagui*) and regulations which are applicable nationally are "national securities regulation" (*quanguo zhengquan fagui*).

A majority of the securities regulations are applicable to securities activities carried on inside China. Some prescribe their geographical scope of application by putting the

⁶⁵ By comparison, all kinds of securities business in the United Kingdom are regarded as "services" under the 1986 Financial Services Act.

expression "*jingnei*" in the title of regulations;⁶⁶ and most by stipulating a provision in the regulations to that effect.⁶⁷ There are still those which neither have the expression "*jingnei*" in their titles nor have a provision in the texts concerning the geographical application of the regulations. The geographical scope of these regulations is presumed in the context of their application. Along with the increase of overseas listing of Chinese companies, securities regulations increasingly are promulgated to apply to securities activities carried on outside China. In contrast to those regulations applicable to securities activities carried on inside China, the regulations relating to securities activities carried on outside China almost always prescribe their geographical scope by having the expression "*jingwai*" in their titles or by having a geographical term in their title, such as "Hong Kong", when they are applicable only to specific country or a region.⁶⁸

Local securities regulations constitute a large part of the securities regulations in China, covering all aspects of securities activities in the local regions. They are applicable locally, which means that their scope of application is confined to the local regions where they are promulgated. For example, in the Guangdong province where Shenzhen city is located, the regulation adopted by Guangdong provincial authority would apply to all parts of the province whereas the regulation adopted by the Shenzhen city authority would only

⁶⁶ For example, the title of the B-share regulation is the Regulations of the State Council on Listing of Foreign Invested Shares by Joint Stock Companies *inside China*.

⁶⁷ For example, Article 2 of the 1993 Provisional Regulations on Administration of Issuing and Trading of Shares stipulates that it is applicable to securities issuing, trading and related activities carried on *within China*.

⁶⁸ For example, the Special Provisions of the State Council on Shares Issuing and Listing Abroad by Joint Stock Companies; the Supplementary Provisions on Implementation by Companies Listing in *Hong Kong* of the Standard Opinion on Joint Stock Companies and Limited Companies.

apply to Shenzhen city. Most local securities regulations bear provincial or city names in their titles and, in addition, there are often provisions which clearly prescribe their geographical application. National securities regulations, on the other hand, are applicable nationally throughout China. If there is a difference between local and national securities regulations, the national securities regulations would prevail. This principle is often expressly acknowledged in local regulations.⁶⁹

D. Comparison with Certain Other Jurisdictions

A fundamental argument over the scope of securities regulation is that the scope should be wide enough to safeguard the market and to protect the interests of investors.⁷⁰ In the United Kingdom and United States systems of securities regulation, the coverage of the definition of "investment" and "investment business" under the United Kingdom Financial Services Act 1986 and the definition of "security" under the United States Securities Act 1933 are both wide. This is also the case in Hong Kong, where at the time of drafting the Securities Ordinance (1974) a broad approach was adopted to ensure that no activity would escape the reach of legislation because of technical statutory loopholes.⁷¹ In China, there is no statutory definition of "securities" and "securities business"

⁶⁹ For example, Article 2 of the Shanghai Securities Trading Regulations stipulates that the Regulations are subject to national law and regulations if there is a difference.

⁷⁰ It was argued in the United Kingdom at the time of drafting the Financial Services Act 1986 that the basic principle should be to cover all types of property except physical objects over which the purchaser has exclusive control after their acquisition. A few suggested that even this was too narrow and that everything acquired with a view to ultimate sale should be treated as an investment, a suggestion rejected as impracticable. See L.B. Gower, *Review of Investor Protection*, part I, Chapter 4, para. 4.02. (London: H.M.S.O., 1984) (Cmnd 9125).

⁷¹ See, Higgins, Mary Faith, *Securities Regulation in Hong Kong 1972 - 77*, p. 75 (Netherlands: Sijthoff & Noordhoff, 1978).

comparable to those in the United Kingdom, United States, and Hong Kong systems of securities regulation, but in practice all the activities relating to securities in China have actually been brought under securities regulation, either nationally or locally. The definition of "securities" adopted in Shanghai and Shenzhen local securities regulations, albeit brief, covers all the types of securities in the Shanghai and Shenzhen stock markets. In drafting the Securities Law of the PRC, a broad approach was adopted in the proposed definition of "securities", as it intended to cover all types of securities in China's securities markets. From a comparative perspective, the scope of securities regulation in China is in line with the stages of development of China's emerging securities market and is a broad definition comparable to other jurisdictions in terms of safeguarding markets and protecting investors.

There is, on the other hand, a concern that the wide scope of securities regulation might bring about negative consequences. In the United Kingdom, there was concern that "innocent" commercial activities might unwittingly be caught by the breadth of investment business defined under the Financial Services Act 1986.⁷² In Hong Kong a major criticism about the Securities Ordinance (1974) was that many of its definitions were too broad and, as a result, many activities would be covered inadvertently which were outside the intended scope of the legislation.⁷³ It was therefore thought necessary to strike a balance to ensure that, on one hand, the coverage was wide enough to safeguard the market and to protect the interests of investors, and on the other hand, would not affect "innocent"

⁷² For details about this concern, see, Freshfields, *Securities Regulation in the UK*, p. 50 (London: IFR Publishing Ltd, 1987).

⁷³ See, Higgins, Mary Faith, *Securities Regulation in Hong Kong 1972 - 1977*, p. 75, (Netherlands: Sijthoff & Noordhoff, 1978).

commercial activities. In the United Kingdom two methods were adopted to balance the definition of "investment" and "investment business" under the Financial Services Act 1986. First, an extensive range of activities was exempted from the activities defined as investment business under the definition of "investment business"⁷⁴ and, second, a power was delegated to the Secretary of State to restrict the definition either generally or for particular purposes.⁷⁵ In China current practice is that any activity would be brought under securities regulation if it were related to securities in one way or another. This may result in a situation where the scope of securities regulation becomes too wide and affects "innocent" commercial activities.⁷⁶ Considering that China is a country with a background of a centrally controlled and over-regulated economy, it is arguable that the issue facing China's emerging securities regulatory system is not whether the scope is wide enough to safeguard the market and to protect the interests of investors, but rather whether the scope should be carefully limited in order not to affect "innocent" commercial activities.

Another question in this respect is how to define exactly the coverage of the scope of securities regulation and how to transfer legislative principles into definitions. The Financial Services Act 1986 in the United Kingdom, which devotes dozens of pages of the Act's first schedule to the definition of "investment" and "investment business", is an

⁷⁴ The Financial Services Act 1986, Schedule 1, Part III Excluded Activities.

⁷⁵ *id.*, s. 2.

⁷⁶ Take regulations on lawyers and law firms as an example. There is so far no detailed provisions which draw a line as to exactly what legal services are meant to be related to securities business and for this reason subject to a special licence. What the regulations have prescribed is a general and broad definition. So those legal services which are not directly related to securities business but indirectly related to them, such as legal advice on investment, may be caught by the regulations.

example of devising a specific definition through legislative technique. The approach favours a specific definition rather than a general and all embracing definition. Accordingly, a comprehensive list of investments is inserted in the schedules to define exactly what constitutes the subject matter of investment activities for the purpose of the legislation.⁷⁷ The activities constituting investment business are further divided into five categories, all of which are defined in detail.⁷⁸

In the United States system, on the other hand, a general definition is supplemented by a wealth of case law interpreting "security" under the Securities Act 1933, including the interpretations of the United States Supreme Court over the past half century in the context of different arrangements.⁷⁹ By devising a specific definition through legislative technique and by construing a general definition through judicial interpretation, the application of regulations could be limited to the scope intended by the legislation. It is a kind of sophistication which is necessary and important in striking a balance between, on one hand, safeguarding the market and the interests of investors, and on the other hand, promoting a free market and commercial development.

By contrast, definitions set out in the legislation in China often are too brief and

⁷⁷ The Financial Services Act 1986, Schedule 1, Part I, Investments. The list includes shares, debentures, government and public securities, instruments entitling to shares or securities, certificates representing securities, units in collective investment scheme, options, futures, contracts for differences, long term insurance contracts, rights and interests in investments.

⁷⁸ *id.*, Schedule 1, Part II, Activities Constituting Investment Business. The five categories of "investment business" are: dealing in investments; arranging deals in investments; managing investments; investment advice; establishing collective investment schemes.

⁷⁹ An early and influential case was the Supreme Court's decision in *SEC v M J Howey Co.* (1946) 328 US 293; 66 S CT 1100; 90 L Ed. 2d. 1244 which gave four characteristics of a "security", namely, the investment of money; in a common enterprise; with an expectation of profits; solely from the efforts of others. For a comprehensive introduction to the definition of "security" and its judicial interpretation, see, McGinty, Park, "What is a Security?", *Wisconsin Law Review*, 1993, p. 1033-113.

general. For example, the definition of "securities" in the 1993 Securities Law of the PRC (draft) and in the Shanghai and Shenzhen regulations are of this nature. This results in uncertainty as to the scope and the application of legislation. A practice applied to limit uncertainty regarding the definition adopted in primary legislation is to issue secondary implementing rules by the relevant administrative authorities. It is true to say that such implementing rules would clarify the definitions to a certain degree and therefore diminish the uncertainty in their scope and application, but again the question arises as to whether the implementing rules themselves adhere to the true intention of the primary legislation. On the other hand, although interpretation by the Supreme People's Court in the form of opinions, replies, circulars, etc., could provide more detailed judicial guidance, the actual cases dealt with by the people's courts at various levels may not be taken as precedents. For all these reasons, it is necessary and important for primary legislation to provide for specific definitions in order to reduce uncertainty about the scope and application of securities regulations.

In the United Kingdom the definition of "investment" under the Financial Services Act 1986 is a broad one, including not only stocks and shares, bonds and debentures and rights thereto, but also commodity and financial futures and options, and long term insurance contracts.⁸⁰ A distinction has, however, been drawn between "investment" and "securities". The latter expression is used to refer to a narrower range of investments in stocks and shares, bonds and debentures and rights thereto, whereas commodity and financial futures and options, and long term insurance contracts are regarded as falling

⁸⁰ The Financial Services Act 1986, Schedule 1, Part I, Investments.

within a wider range of investments.⁸¹ Thus, all securities are investments but not all investments are securities. In China's securities regulatory system, there is no equivalent definition of investment in the sense of "investment" in the United Kingdom under the Financial Services Act 1986. Commodity and financial futures are neither defined as particular types of "securities" in the same way as bonds and shares, nor as particular types of "investment", but they have been regulated within the scope of securities regulation. By comparison, the definition of "securities" in China corresponds to the narrower range of investments of stocks and shares, bonds and debentures and rights thereto as defined in the United Kingdom. It is interesting to note in this context that China's concept of securities is not as broad as those in certain former socialist countries.⁸²

Commodity and Financial Futures and Options. A particular question discussed in the United Kingdom at the time of drafting the Financial Services Act 1986 was whether commodity and financial futures and options should be treated as investments and subject to the regulation of securities law.⁸³ There was almost unanimous agreement that they should. One of the concerns which lead to such unanimity was the scandals and failures of a number of firms, including a large one that was an associate member of

⁸¹ L.B. Gower, *Review of Investor Protection*, (London: H.M.S.O., 1984) (Cmnd 9125), paras. 4.03, 4.06; See also the Financial Services Act 1986, Sched 1, Part I, (7, 8, 9, 10).

⁸² The Republic Kazakhstan, for example, in common with other legal systems of members of the Commonwealth of Independent States and as part of the legacy of Soviet Law, has enjoyed a broader concept of securities than is prevalent in the West. See, Butler, W. E., *Securities and Banking Law of the Republic Kazakhstan*, p.1, (London: Simmonds & Hill Publishing Ltd, 1995).

⁸³ L.B. Gower, *Review of Investor Protection*, (London: H.M.S.O., 1984) (Cmnd 9125), para. 4.03.

commodity exchanges.⁸⁴ The situation caused by those scandals and failures was described vividly by a judge in a trial at the Old Bailey as a "most perilous state of affairs which merits attention by Parliament."⁸⁵ The commodity and financial futures market in China, not surprisingly, is more than a "most perilous state of affairs". In February 1995 a scandal in the Shanghai Stock Exchange drew the attention of the whole nation and led to the closure of the government bond futures market.⁸⁶ The approach adopted by the authorities towards commodity and financial futures in China reflected strongly the concern about the integrity of the market and investor protection, but, on the other hand, it went too far and effectively suspended the development of a commodity and financial futures market in China. In November 1994 the CSRC, in conjunction with three other departments of the central government, issued a circular which launched a nationwide investigation into illegal trading of foreign exchange futures and announced the suspension of experiments with foreign exchange futures for an indefinite period of time.⁸⁷ To bring a "most perilous state of affairs" under the control of securities laws and regulations is one thing, but to suspend the market altogether is another. This approach, though it was intended to safeguard the market and protect investors, in fact hindered the development

⁸⁴ *Id.*

⁸⁵ *id.*, note 5.

⁸⁶ On 23 February 1995, two securities firms were forced into huge selling of government bond futures to cover positions in excess of permitted limits. The final eight minutes of trading saw paper with an underlying value of U.S. \$ 37bn change hands. The market was subsequently closed by the government and those involved in the scandal were sanctioned by CSRC in September 1995 after a three months' investigation. See, "China Blames Two Firms for Bonds Scandal", *Financial Times*, 22 Sept. 1995, p.5; "China Plans to Resume Bond Futures Trading", *Financial Times*, 24 April 1996, p.26.

⁸⁷ For the circular, see *Renmin Ribao (People's Daily)*, 6 Nov. 1994, p.2, and see 28 Dec. 1994, p.2 for a report on a conference organized by the CSRC and three other departments of the central government to implement the circular.

of the commodity and financial futures markets in China.

As the securities market in China is moving towards a unified national market, to adopt a national and unified legal definition of securities becomes an urgent task for defining the scope of securities regulation. In the 1993 Securities Law of the PRC (draft), an attempt was made to adopt such a unified definition, but the definition was not included in the following 1994 Draft. Whether this was due to an oversight or a deliberate omission, the consequence remained the same, and the system of securities regulation had no clear scope and boundary. In the United Kingdom the definition of "investment" under the Financial Services Act 1986 occupies a central position, for not only does it determine the scope of regulation of "investment business", but it also provides a working basis for other relevant definitions in other statutes and statutory instruments.⁸⁸ In the United States the definition of "security" under the Securities Act of 1933 is critical to the application of not only that Act but also the Securities Exchange Act of 1934. Indeed, it is essential for any system of securities regulation to contain a fundamental definition to determine the boundary of securities law. The approach taken by the 1994 Securities Law of the PRC (draft) not to include a definition of securities in the legislation could only result in uncertainty about the scope of securities law in China. Although the 1998 Securities Law of the PRC contains a definition of securities, it is brief and uncertain leaving a large gap to be filled in by the State Council or the relevant securities authorities in the form of implementing rules or interpretation. This is one of the defects in the 1998 Securities Law of the PRC.

⁸⁸ For example, the Public Offers of Securities Regulations 1995.

Chapter III

Institutional Structure

The institutions designated to be responsible for the regulation of and supervision over the securities market on a day-to-day basis are fundamental to the operation of securities regulatory systems. The arrangement of the institutional structure in each country depends not only on its approach to the system of securities regulation, but also on its constitutional and administrative system and its legal tradition. Some bear features of self-regulation, others, of state-regulation, and yet others features of mixed self-regulation and state-regulation. In the United Kingdom where self-regulation has been a traditional approach, the institutional structure created under the Financial Services Act 1986 is basically a self-regulatory infrastructure consisting of a comprehensive network of self-regulatory agencies. In the United States, on the other hand, the institutional structure of securities regulation is essentially a state-regulatory infrastructure, with the Securities and Exchange Commission at the centre. The United Kingdom and United States patterns of the system have had worldwide influence and been followed by other

countries.¹ In recent years emerging securities markets around the world have begun to establish their institutional structure of securities regulation and some have become members of the International Organisation of Securities Commissions (IOSCO).

China began to build its institutional structure of securities regulation in the 1980s when the securities market emerged as a result of the economic reform and open-door policy. The People's Bank of China (PBOC) became the primary regulator of the market. Its regulatory role was supplemented by various government departments, including most importantly the State Commission for Restructuring the Economic System and the State Planning Commission. The Securities Committee of the State Council (SCSC) and the China Securities Regulatory Commission (CSRC) were established in 1992 as the central securities authorities.² At the time when they were established, new arrangements were made by the government to allocate regulatory responsibilities among government departments; these were contained in the Circular of the State Council on Further Strengthening the Macro-regulation of the Securities Market, issued on 17 December 1992.³ In drafting the Securities Law of the PRC, proposals were put forward to change the present institutional structure in order to strengthen the regulatory system and resolve the problems associated with the existing structure, such as overlapping regulatory responsibilities between different authorities. One theme of the drafts was to bring China's

¹ The Hong Kong securities regime, for example, is regarded as a combination of United Kingdom experience with its own. See Tomasz Ujejski, "Securities Regulation", in *The Law in Hong Kong: 1969-1989*, Raymond Wacks (ed.) (Hong Kong: Oxford University Press, 1989), p. 282-301.

² The Circular of the Administrative office of the State Council on Establishment of the Securities Committee of the State Council, 12 October 1992.

³ The document in Chinese is in *Gazette of the State Council of the PRC*, No. 30 1992, pp. 1273-1277.

institutional structure of securities regulation close to international common patterns, and for this purpose the draftsmen took notice of experience in other countries and adapted them where appropriate. On the other hand, a parallel theme was to build a structure which would be in accordance with China's own conditions and characteristics.⁴ It was apparent that the institutional structure proposed by the drafts of the Securities Law of the PRC could not go beyond China's constitutional and administrative system and its legal system.

A. Securities Commissions

There are three tiers of securities commissions in China, namely, the SCSC, the CSRC, and the local securities commissions established in provinces and cities across the country.⁵ The 1993 Securities Law of the PRC (draft) proposed to restructure securities commissions into a single and central securities commission, the State Securities Regulatory Commission (*guojia zhengquan guanli weiyuanhui*), by merging the SCSC and the CSRC into one body and changing local securities commissions into the agents (*paichu jigou*) of the State Regulatory Securities Commission.⁶ Before the promulgation of the 1998 Securities Law of the PRC, the operation of the SCSC, the CSRC, and local securities commissions were in accordance with the powers and responsibilities designated them by the government. These powers and responsibilities have been redefined under the

⁴ See, "Explanations on the Securities Law of the PRC (draft) 1993", by Liu Suinan, chairman of the Financial and Economic Committee of the National People's Congress, on 18 August 1993.

⁵ The term "commission" in Chinese is "*weiyuanhui*" which is also translated as "committee". The SCSC and the CSRC both have the term "*weiyuanhui*" in their titles, but one is commonly translated as "committee" and the other as "commission".

⁶ Articles 139, 142 of the 1993 Securities Law of the PRC (draft).

1998 Securities Law of the PRC.

The State Council Securities Committee. The SCSC is designated to be responsible for matters of basic policy rather than day-to-day securities regulation. There are sixteen committee members selected from various government departments, including a vice-premier sitting as the committee chairman. The routine work of the committee is dealt with by an office set up under the committee. The responsibilities assigned to the SCSC include to: (i) organise the drafting work of securities laws and regulations; (ii) formulate overall securities policies and lay down general rules; (iii) make suggestions and plans for the development of the securities market; and (iv) control over the CSRC.⁷ In a number of regulations the SCSC has been granted powers to approve applications for the issuing and listing of securities. The 1993 Provisional Regulations on the Administration of Share Issuing and Trading provides that all share issues directed to overseas markets must be approved by the SCSC.⁸ This power has been reiterated in the 1994 Special Provisions of the State Council on Share Issuing and Listing Abroad by Companies Limited by Shares.⁹ The power to approve B-share issues has also been vested on the SCSC.¹⁰

The China Securities Regulatory Commission. The CSRC is defined as an executive arm of the SCSC and, as such, it is responsible for regulating securities markets on a day-to-day basis. It has dozens of departments, including, among others, a listing

⁷ The 1992 Circular of the State Council on the Further Strengthening the Macro-regulation of the Securities Market.

⁸ Article 6.

⁹ Article 2.

¹⁰ Article 2 of 1995 Regulations of the State Council on the Listing of Foreign Invested Shares by Joint Stock Companies Inside China.

department, surveillance department, overseas department, and legal department. The head of the CSRC is chaired by the vice-chairman of the SCSC. Special working committees have been set up within the CSRC to deal with particular matters, for example, the Issues Examination Committee (*faxing shenhe weiyuanhui*) was set up in 1993, composed of experts from various sectors, and was given special responsibilities to examine applications for securities issues.¹¹ Since its establishment in 1992, the CSRC has undertaken a substantial volume of day-to-day regulation and supervision. Its responsibilities include (i) to draw up rules of securities regulation; (ii) to regulate securities firms carrying on securities business; (iii) to regulate securities issuing and trading, and the companies which have issued shares to the public; (iv) to regulate securities issuing and listings directed to the overseas markets; (v) to collect statistics in conjunction with other relevant authorities and make suggestions to the SCSC.¹² Apart from these responsibilities, the 1993 Provisional Regulations on the Administration of Share Issuing and Trading conferred on the CSRC the power to investigate cases relating to securities activities.¹³ In the past few years it has carried out a number of investigations either on its own or jointly with other relevant authorities. In addition to the responsibilities relating to domestic matters, the CSRC also deals with relationships with overseas securities regulators. Since its establishment, a number of accords have been

¹¹ See "The CSRC Sets Up an Issues Examination Committee", *Remin Ribao (People's Daily)*, 24 June 1993, p. 2.

¹² The 1992 Circular of the State Council on Further Strengthening Macro-regulation of Securities Market.

¹³ Chapter 7 of the Provisional Regulations on Administration of Share Issuing and Trading. Under Article 68, the CSRC has the power to investigate independently or jointly with other relevant departments any breach by any unit or individual of the regulations, and in the event of a serious breach, an investigation is to be conducted by the SCSC.

signed between the CSRC and corresponding foreign securities regulators.¹⁴

The relationship between the SCSC and the CSRC has been a focus of concern. Criticisms have been voiced about their co-existence. At the time of creating the SCSC and the CSRC, it was stipulated by the government that matters regarding basic policies would be the responsibility of the SCSC, whereas the day-to-day regulation and supervision would be left to the CSRC as an executive arm of the SCSC. This relationship was later formally recorded in 1993 the Provisional Regulations on Administration of Share Issuing and Trading.¹⁵ However, when the SCSC and the CSRC began to operate, the line of responsibility was blurred and it proved to be difficult to have a clear-cut division of functions between them. In exercising its functions, the CSRC often undertook responsibilities which should have belonged to the SCSC while, on the other hand, the SCSC also took over the CSRC's regulatory responsibilities. In 1994, for example, when a company listed on the Shanghai Stock Exchange announced that it was considering whether to convert its legal person shares into B-shares, the CSRC immediately made a decision to stop it.¹⁶ It was arguable that such a decision should have been made by the SCSC rather than by the CSRC since it involved a matter of basic policy, i.e., whether state-owned legal person shares could be converted into foreign-owned B-shares. Similar occasions frequently happened, and as a result a situation gradually emerged whereby the

¹⁴ These are accords signed with the United States Securities and Exchange Commission, the Singapore Securities Authority, Australian Securities Authority. The latest one is with the United Kingdom securities authority, the Securities and Investment Board, see, Tony Walker, "China, UK Sign Accord on Listings", *Financial Times*, 8 October, 1996, p. 34.

¹⁵ Article 5.

¹⁶ See, "The Board of Directors of Shanghai Dazhong Taxi Co. Ltd Plans to Convert its Legal Person Shares into B Shares, but the CSRC Does Not Allow it," *Fazhi Ribao (Legal Daily)*, 26 February 1994, p.1.

CSRC was gaining a more influential position than the SCSC. Questions were consequently raised.¹⁷ Fundamentally, it is the structure of the co-existence of the SCSC and CSRC that is causing these problems. In drafting the Securities Law of the PRC, this structure of co-existence of the SCSC and the CSRC was strongly criticised and formed one of the grounds for proposing a single and central securities commission.¹⁸

The constitutional status of the SCSC and the CSRC was another problem addressed when drafting the Securities Law of the PRC. When the SCSC and CSRC were established, they were not given a status equivalent to that of the ministerial departments under the State Council, China's central government. They were merely treated as non-ministerial bodies under the State Council.¹⁹ In fulfilling their functions as securities authorities of the central government, however, they are promulgating securities regulations and taxing decisions on matters of securities regulation in the same manner as other ministerial departments of the central government in their promulgating regulations and issuing decisions on matters within their respective jurisdictions. The 1982 Constitution of the PRC²⁰ stipulates that ministerial departments under the State Council may issue orders, directives, and regulations within the jurisdiction of their respective

¹⁷ Some scholars were concerned that the position of the SCSC and the CSRC was gradually turning upside down. See, Liu Xiushan, Chen Yongmin (eds.), *Zhengquan Yunzuo yu Guanli 136 Wen (136 Questions on Operation and Regulation of Securities)* (Beijing: People's Court Publishing House, 1995) p. 163.

¹⁸ See, "Explanations on the Securities Law of the PRC (draft) 1993", by Liu Suinan, Chairman of the Financial and Economic Committee of the National People's Congress, on 18 August 1993.

¹⁹ See, the Circular of the Administrative Office of the State Council on Establishment of the Securities Committee of the State Council; the Circular of the State Council on Further Strengthening Macro-regulation of Securities Market. For general background about China's administrative system, see, Chen, Albert H.Y., *Introduction to the Legal System of the People's Republic of China*. (Singapore: Butterworths (Asia), 1992).

²⁰ It was adopted by the Fifth National People's Congress of the PRC at its fifth session on 4 December 1982.

departments and in accordance with the statutes and administrative regulations, decisions, and orders issued by the State Council.²¹ It does not confer the same powers on non-ministerial bodies under the State Council. Apart from 1982 Constitution, some other statutes reflect in their provisions this constitutional position regarding the rule-making powers of ministerial departments of the State Council.²² It was therefore pointed out in the drafts of the Securities Law of the PRC that the power of the SCSC and the CSRC to promulgate regulations, orders, and decisions regarding securities regulation had been conferred and exercised inconsistently with the positions stated in the 1982 Constitution of the PRC and other statutes.²³

The SCSC and the CSRC are accountable to the State Council. This is the position in practice as well as in principle. There are, however, no provisions in current securities laws which stipulate the extent to which they are answerable to and subject to directions from the State Council. By comparison, the 1995 People's Bank of China Law of the PRC²⁴ sets out a general framework to govern the extent to which the PBOC is answerable to and subject to directions from the State Council in formulating monetary policies and in supervising financial services. Under this framework, the PBOC submits major decisions regarding monetary policies to the State Council for approval and makes

²¹ Article 90.

²² The 1990 Administrative Litigation Law of the PRC, for example, stipulates that the people's courts, when dealing with administrative cases, may refer to regulations promulgated by the ministerial departments of the State Council.

²³ See, *"Explanations on the Securities Law of the PRC (draft) 1993"*, by Liu Suinan, Chairman of the Financial and Economic Committee of the National People's Congress, on 18 August 1993.

²⁴ It was adopted by the Eighth National People's Congress at its third session on, and effective as of, 18 March 1995.

other decisions by itself and files them at the State Council.²⁵ In a number of securities regulations the State Council has been appointed as the authority to make decisions or issue approvals regarding securities issues. For example, where there is an application for B-share issues whose face value is over \$30m, the SCSC shall, after an initial examination, submit the application to the State Council for approval.²⁶ The State Council is also appointed, for another example, as the authority to grant final approval to applications for establishing a stock exchange.²⁷ Although these provisions are concerned with the relationship between the SCSC and the State Council and thus prescribe the extent to which the SCSC is subject to directions from the State Council, they are only concerned with certain individual situations. What is needed is a general statutory framework similar to that of the 1995 People's Bank of China Law of the PRC to govern the extent to which the SCSC and the CSRC are answerable to and subject to directions from the State Council.

There are no provisions in present securities laws which stipulate how far the SCSC and the CSRC are answerable to the National People's Congress for their activities. By comparison, Article 6 of the 1995 People's Bank of China Law of the PRC stipulates that the PBOC shall submit to the Standing Committee of the National People's Congress the work report regarding its monetary policies and financial supervision. In the drafts of the Securities Law of the PRC, there was no proposal in respect of the accountability of the securities authority of the central government to the National People's Congress. The

²⁵ Articles 2(ii), 5(i) (ii) of the 1995 People's Bank of China Law of the PRC.

²⁶ Article 2 of the 1995 Regulations of the State Council on Listing of Foreign Invested Shares by Joint Stock Companies inside China.

²⁷ Article 6 of the Provisional Measures on Administration of Stock Exchanges.

1998 Securities Law of the PRC has followed the drafts in this respect. It does not provide a similar provision as that of the 1995 People's Bank of China Law of the PRC to make it clear the scope of accountability of the securities authority to the National People's Congress for their activities. It is regrettable that the 1998 Securities Law of the PRC does not address this issue.

Local Securities Commission. Local securities commissions have been established in provinces and cities in line with the central structure of the SCSC and the CSRC, with one body given responsibilities like those of the SCSC and another with responsibilities like those of the CSRC. To take the Shenzhen Municipality Securities Commission²⁸ as an example, it has thirteen committee members selected from various Shenzhen government departments, including the mayor and deputy mayor sitting as chairman and deputy chairman. Its responsibilities include (i) to organise drafting work of Shenzhen securities regulations in accordance with national laws and regulations; (ii) to draft plans for securities issues and developments of Shenzhen securities market, and to implement them upon approval by the government; (iii) to regulate stock exchanges, securities firms, and other intermediaries, namely, asset valuers, law firms, and accounting firms which carry on securities businesses; (iv) to examine applications of local companies for local listing and to regulate listed local companies; (v) to investigate breaches of securities regulations; the Commission is accountable to the Shenzhen municipal government and subject to directions from the SCSC and the CSRC; a separate office has been set up

²⁸ It was established in 1993 by the Shenzhen municipal government under the Circular of Shenzhen Communist Party Committee and Shenzhen Government on Reforming the Securities Regulatory System and Further Strengthening Macro-regulation of Shenzhen Securities Market, 5 May 1993. The document in Chinese is in "A Collection of Regulation and Documents on Shareholding Reform and Securities Market (1993)", edited by Shenzhen Securities Commission, 1994. pp. 237-241.

under the Commission to be responsible for day-to-day regulation and supervision which has similar departments to those of the CSRC.²⁹ Securities commissions in other provinces and cities are generally structured in the same way as the Shenzhen Municipality Securities Commission, but they may differ from one another in certain aspects as they are also structured in accordance with their local circumstances.³⁰

The relationship between the SCSC and the CSRC, on one hand, and the local securities commissions on the other, like the relationship between the SCSC and the CSRC, is an area of concern and controversy. In general, local securities commissions are subject to directions from the SCSC and the CSRC. Hence, the CSRC, for example, can request local securities commissions to impose punishments on offenders;³¹ investigations relating to major cases are often led by the CSRC in collaboration with local securities commissions. But a tension exists between the SCSC and the CSRC and local securities commissions in relation to the extent to which local securities commissions are subject to the directions from the SCSC and the CSRC. In 1994, for example, when the Shenzhen Municipality Securities Commission issued a notice concerning the listing of warrants of a state-owned share on the Shenzhen Stock Exchange, it was suspended by an urgent

²⁹ *id.*, The 1993 Circular of Shenzhen Communist Part Committee and Shenzhen Government on Reforming Securities Regulatory System and Further Strengthening Macro-regulation of Shenzhen Securities Market.

³⁰ During my study trip to China in 1995, I visited the Shenzhen, Hainan, and Shanxi local securities commissions. The commission of Shanxi province had only about 20 staff, while the commissions of Shenzhen municipality and Hainan province were more than 50. Hainan's commission was set up within the province's Economic Reform Office, while the Shanxi and Shenzhen commissions were separated from their Economic Reform Offices.

³¹ In 1993 the Hainan Special Economic Zone Securities Newspaper published a news article on an intended takeover without checking the news sources. The news was untrue and led to a fluctuation of the share price concerned. The CSRC, after a joint investigation, requested the Hainan local securities commission to deal with the matter and impose penalties to the newspaper. See the reports on this case in *Remin Ribao (People's Daily)*, 10 November, 1993, p. 2 and 18 December 1993, p. 2.

announcement from the CSRC. The reason given was that the Shenzhen Municipality Securities Commission should have not decided the matter on its own without first obtaining directions from the central securities authorities as this was a matter of basic policy.³² The CSRC took the occasion to emphasise that local securities commissions should not decide issues on their own which involved matters of basic securities market policies. At its fourth general meeting in 1995 the SCSC reiterated the position that any listing directed to overseas markets must be approved by the SCSC,³³ and it was apparent that the purpose of such reiteration was to prevent local securities commissions from approving on their own local applications for issuing and listing abroad. The relationship between the SCSC and the CSRC and local securities commission actually reflects the changing pattern of the relationship between the central government and local governments under China's economic reform. On one hand, local governments are demanding more powers and autonomy from the central government whereas, on the other hand, the central government is trying to retain its power and control over local governments.

The State Securities Regulatory Commission. The legislative proposal put forward by the 1993 Securities Law of the PRC (draft) to establish a State Securities Regulatory Commission by merging the SCSC and the CSRC into one body with the status of ministerial departments of the State Council and restructuring local securities commissions into its agents was a natural thought and response to the problems mentioned above

³² The announcement of the CSRC was reported in *Remin Ribao (People's Daily)*, 5 March, 1994, p.2.

³³ The news report on the Fourth General Meeting of the SCSC, *Fazhi Ribao (Legal Daily)*, 16 May 1994, p. 1.

associated with the present structure of securities commissions. The 1994 Securities Law of the PRC (draft) followed in principle the proposal put forward in the 1993 Draft but made an amendment to the effect that the proposed local securities agents should be under dual control by the State Securities Regulatory Commission and local governments, matters regarding regulatory policies remaining at the State Securities Regulatory Commission while other matters were left to local governments.³⁴ The 1998 Securities Law of the PRC has followed the drafts in principle by providing that the State Council's Securities Regulatory Authority may establish agents in order to perform its regulatory functions³⁵ but it is silent in respect of the relationship between the agents and local government. In practice the efficiency of the structure under the 1998 Securities Law of the PRC depends also on overall environments and changes created by further economic reforms in China with regard to the relationship between central and local government.

One can also see the influence of United States patterns of institutional arrangement on the drafting team of the Securities Law of the PRC who sought to bring China's securities regulatory system close to the international common pattern and follow the experience of other countries. In effect the proposal to establish a central State Securities Regulatory Commission would be to create a powerful central securities commission in China similar to the Securities and Exchange Commission in the United States.

The responsibilities assigned to the proposed State Securities Commission included (i) to formulate policies for the securities market; (ii) to issue regulations and rules and

³⁴ Article 6 of the 1994 Securities Law of the PRC (draft).

³⁵ Article 7.

make suggestions for the state securities laws and regulations and amendment thereof; (iii) to approve, supervise, and regulate securities issues and trading; (iv) to approve, supervise, and regulate securities firms, securities services institutions, stock exchanges, over-the-counter trading centres, investment fund companies, and securities associations; (v) to set out standards for the qualifications and codes of conduct for those who carry on securities business; (vi) to supervise information disclosure by securities issuers; (vii) to investigate breaches of regulations by institutions and individuals and impose sanctions.³⁶ It is in fact a combination of all the existing responsibilities assigned to the SCSC and the CSRC.

There are some advantages to restructuring the securities commissions into a single and central securities commission. First, it could solve the problem of overlapping regulatory responsibilities among the SCSC, the CSRC, and local securities commissions. Second, it could solve the problems associated with the present relationship between the central securities commission and local securities commissions. Third, it could increase efficiency and reduce the economic costs of running large manpower at the central and local levels. Fourth, it could avoid confusion which may arise from provisions in other legislation which confers powers on the SCSC or the CSRC. The 1993 Company Law of the PRC, for example, confers certain powers on "the State Council Securities Regulatory Authority". Since it does not specify the SCSC or the CSRC, confusion may arise as to whether a particular power is exercisable by the SCSC or the CSRC.³⁷ Finally, with the growing internationalization of China's securities market, it is important for China to

³⁶ Article 140 of the 1993 Securities Law of the PRC (draft); Article 5 of the 1994 Securities Law of the PRC (draft).

³⁷ There are altogether twelve articles in the 1993 Company Law of the PRC which confer powers on "the State Council Securities Regulatory Authority". They are Articles 84, 85, 86, 131, 139, 153, 155, 157, 158, 163, 164, 172.

develop a co-operative relationship with securities regulatory authorities of other countries. The co-existence of the SCSC and the CSRC may cause confusion and, moreover, it may cause reluctance on the part of foreign regulatory authorities to co-operate with the SCSC, as the SCSC may be seen as a politically-oriented body rather than an equivalent regulatory authority.

From a comparative perspective, the proposal to establish a single and central securities commission in China may be seen as an attempt to bring China's institutional structure of securities regulation close to the international common pattern. But it could not go beyond the limitations of China's constitutional and administrative system. The trend around the world is to set up self-standing securities commissions to regulate the securities market. It is thought that a commission is better adapted than a government department to establish inter-communication with regulatory agencies in other countries and to tackle the problems flowing from the internationalisation of securities markets. It is also thought that such a common approach might facilitate the harmonisation of regulatory procedures.³⁸ The proposed State Securities Regulatory Commission, if it is established to replace the SCSC and the CSRC and given the status of ministerial department under the State Council, would be in fact a government department rather than a self-standing commission, although it is called a "commission" and not a "department".³⁹ To establish the proposed State Securities Regulatory Commission as a self-standing

³⁸ See L. B. Gower, *Review of Investor Protection*, a report presented to Parliament by the Secretary State for Trade and Industry, part I, chapter 3 "The Department or a Self-standing Commission?", para. 309. (g), (London: H.M.S.O, 1984) (Cmnd 9125).

³⁹ It would have in the same status as the State Planning Commission, the State Commission for Restructuring the Economic System, and the State Education Commission, all of which are in their real sense "departments" of the central government.

commission would be impossible under China's present constitutional and administrative system.

B. Government Departments

A number of government departments have been designated to share the responsibilities of regulating the securities market apart from the SCSC and the CSRC, including among others the State Commission for Restructuring the Economic System, the State Planning Commission, and the State Bureau for the Administration of State Assets. The 1992 Circular of the State Council on the Further Strengthening Macro-regulation of Securities Market was a primary document of the State Council in which these government departments were assigned with certain securities regulatory responsibilities. It was in general terms, and more specific responsibilities and roles of these government departments in relation to securities regulation were stipulated in securities regulations and some other government documents. The arrangements were made in accordance with China's own conditions and characteristics.

The State Commission for Restructuring the Economic System. The State Commission for Restructuring the Economic System is an agency of the central government with special responsibilities for China's economic reform. It formulates policies to guide economic reforms with regard to specific areas and to overall economic system. Before the establishment of the SCSC and the CSRC, the State Commission for Restructuring the Economic System played a central role in designing securities policies and directing the development of the securities market. Important regulations promulgated at that period came from the State Commission for Restructuring the Economic System,

such as the 1992 Standard Opinion on Joint Stock Companies and 1992 Standard Opinion on Limited Companies. After the establishment of the SCSC and the CSRC, it was designated with special responsibilities for the matters linked with enterprise reform,⁴⁰ including the issuance and transfer of employee shares. Its responsibility in this respect was to guide the reform and to co-ordinate policies among different authorities. A number of regulations were issued either on its own or jointly with the SCSC, all concerning securities regulation and enterprise reform.⁴¹ As the securities market in China is inseparable from economic reform and, in particular, enterprise reforms, the designated responsibilities of the State Commission for Restructuring the Economic System in relation to securities regulation was a necessary arrangement.

The State Planning Commission. The State Planning Commission is a an agency of the central government with responsibilities for central economic planning in China. Under the system of centrally planned economy prior to the 1978 economic reform, the State Planning Commission was a key body among the central government departments. As a result of the economic reform, China is moving from a centrally planned economy to a market-oriented economy, and the role of the State Planning Commission is gradually diminishing. But central economic planning is still significant and the State Planning Commission seeks to balance China's economy among different industries and sectors. As far as the securities market and securities regulation are concerned, it was assigned responsibilities for formulating overall planning for securities issues annually and

⁴⁰ The 1992 Circular of the State Council on the Further Strengthening of Macro-regulation of Securities Market.

⁴¹ Such as the Regulations on Shareholdings By Company Employees, which was issued on, and effective as of, 3 July 1993.

periodically, and formulating specific planning for securities issues with regard to certain sectors.⁴² The SCSC was responsible for putting forward recommendations concerning securities issue plans to the State Planning Commission for its consideration.⁴³ By giving the State Planning Commission this task, the central government could exercise control over the securities market and its effects on other sectors of the economy through the central economic planning mechanism to ensure that the development of the securities market would be balanced in accordance with overall development of the economy. In early 1980s when the securities markets first emerged, enterprises rushed to raise funds by issuing bonds and shares to redress the shortage of funds from State budget allocations. That situation led to disorder in national finance and investment and to an erosion of the government's overall planning control.⁴⁴ Lessons have been learned, and the State Planning Commission role in central planning control over the securities market has been reinstated.

The State Bureau for the Administration of State Assets. The State Bureau for the Administration of State Assets is an agency of the central government with special responsibilities for the administration of State assets. At present it is undertaking to administer State assets under a new environment in which patterns of public ownership are changing and problems for the administration of State assets are arising as a result of the deepening economic reform. In relation to securities regulation, it is responsible for matters involving State assets, in particular, state-owned shares. Article 4 of the 1994

⁴² The 1992 Circular of the State Council on Further Strengthening Macro-regulation of Securities Market.

⁴³ *Id.*

⁴⁴ See Chapter 1, Section D: China's Securities Regulation in Transition.

Provisional Measures on the Administration of State-owned Shares in Joint Stock Companies⁴⁵ stipulates that the State Bureau for the Administration of State Assets is the competent authority for the administration of state-owned shares. It has powers to supervise and inspect companies in their administration of state-owned shares and may take disciplinary actions against offenders under certain circumstances.⁴⁶ As the transformation of state-owned enterprises into joint stock companies is proceeding and extending throughout China after the experimental stages, the responsibilities and roles of the State Bureau for the Administration of State Assets in respect of the regulation of state-owned shares has become important.

Other Departments of the Central Government. The Ministry of Justice, the Ministry of Finance, and the State Bureau for the Administration of Foreign Exchange all share certain securities regulatory responsibilities. The Ministry of Justice was assigned to regulate lawyers and law firms who provide legal services relating to the securities business. It has the power to authorise jointly with the CSRC lawyers and law firms who apply to engage in services relating to the securities business.⁴⁷ In a similar way, the Ministry of Finance shares the regulation of registered accountants and accountancy firms who carry on business relating to securities activities.⁴⁸ The State Bureau for the Administration of Foreign Exchange shares responsibility with the CSRC for the

⁴⁵ It was issued by the State Bureau for the Administration of State Assets on 28 June 1994.

⁴⁶ Section 5 of the Provisional Measures on the Administration of State-owned Shares in Joint Stock Companies, Articles 33, 34, 35.

⁴⁷ The 1993 Interim Provisions on the Authorization of Lawyers and Law Firms to Carry on Legal Services Relating to Securities Business.

⁴⁸ The 1993 Regulations on Authorization of Accountant Firms and Registered Accountants to Carry on Securities Business.

regulation and supervision of firms who carry on business relating to foreign exchange futures. It also undertakes general responsibility in relation to foreign exchange matters involved in the issue and listing of foreign investment shares.

The relationship between the SCSC and the CSRC, on one hand, and the government departments, on the other, is that of co-operation and consultation. This was expressly stated in the 1992 Circular of the State Council on the Further Strengthening of Macro-regulation of the Securities Market. Regulatory policies often were jointly formulated and regulations often jointly promulgated. This relationship helped develop a coherent regulatory policy when issues were complicated and different sectors were involved. In these areas co-operation and consultation were essential in order to make necessary adjustments to securities policies and avoid inconsistencies. But the arrangement to grant these government departments certain securities regulatory responsibilities created extra tiers of regulators and this in turn led to problems.

First, responsibilities overlap between them. For example, the SCSC, the State Commission for Restructuring the Economic System, and the State Bureau for the Administration of State Assets could all be involved in certain basic policies of the securities market. This raised the question as to who should decide the matter. Second, a structure with many regulators sharing responsibilities could produce inefficiency. This is particularly the case when certain procedures have to pass through securities commissions and government departments, a typical example being the approval procedures for securities issues and procedures for authorizing lawyers and accountants and their firms to carry on securities business. Third, inconsistencies may occur among regulations and rules when they are formulated by securities commissions and government

departments separately, for their points of view may be quite different. Finally, and most importantly, the structure could create a barrier to the adoption of a unified regulatory system under the central State Securities Regulatory Commission proposed by the drafts of the Securities Law of the PRC. In fact, it was these problems that prompted the criticisms in the 1993 Securities Law of the PRC (draft) about the existing institutional arrangements and the proposal to unify the regulatory authorities into a single central securities commission.

Local Government Departments. Similar problems exist at the local levels between local securities commissions and local government departments. The local government departments in charge of economic reform, economic planning, administration of state assets, finance, and justice all share securities regulatory responsibilities in a similar manner as their corresponding central government departments. In Shenzhen, for example, after the establishment of the Shenzhen Municipality Securities Commission, most regulatory responsibilities undertaken previously by the Shenzhen branch of the PBOC and other relevant government departments were moved to the Commission. But the Shenzhen government, in line with the arrangement made by the central government, stipulated that the departments in charge of economic reform, economic planning, finance, and judicial matters would still be responsible for certain regulatory matters in the Shenzhen securities market.⁴⁹ In other provinces and cities similar arrangements regarding securities regulatory responsibilities were made between the securities commissions and other government departments. Because the nature of the arrangement of responsibilities between the

⁴⁹ The 1993 Circular of Shenzhen Communist Party Committee and Shenzhen Government on Reforming the Securities Regulatory System and Further Strengthening the Macro-regulation of the Shenzhen Securities Market.

securities commissions and other government departments at local levels is essentially the same as that of the arrangement at central government level, problems such as overlapping responsibilities and inefficiency, not surprisingly, are part of the local securities regulatory system.

In comparison with the institutional structures of securities regulation elsewhere, China's structure may be unique in that it involves various government departments at both central and local levels apart from the central and local securities commissions. It is a structure which comes out of China's own conditions. A precondition for economic reform in China is to change China into a so called "socialist market economy with China's own characteristics". What this means is a matter of debate. The fundamental elements of the socialist economic system adopted in China before the economic reform in 1979, such as public ownership and central economic planning, have been retained together with the introduction of market economy elements in the economic system. In securities regulation, as in the regulation of other economic sectors, to uphold these socialist elements is one of the main concerns. Provisions regarding state-owned shares and securities issue planning are important in securities regulation. Correspondingly, the State Planning Commission, the State Bureau for the Administration of State Assets, and the State Commission for Restructuring the Economic System are all playing an institutional role in the regulation and supervision of the securities market. In fact, they are often more important than the securities commissions. The State Bureau for the Administration of State Assets, for example, often decides matters involving state-owned shares in a manner which places it above all other authorities, and is thus seen by some

commentators as a "super authority".⁵⁰ In a way this reflects the principle of the supremacy of public ownership which prevailed during past decades in China.

C. People's Bank of China

Before the creation of the SCSC and the CSRC in 1992, the People's Bank of China (PBOC) was the primary regulator of the securities market. Its local branches, especially the Shanghai and Shenzhen branches, regulated the market day-to-day in local regions. After the establishment of the SCSC and the CSRC and local securities commissions, the role of the PBOC and its local branches as a securities authority was assumed by them. Reforms of the banking system and the PBOC started at the end of 1993 pursuant to the Decision of the State Council on Reforms on Financial System,⁵¹ the aim of which was to change the PBOC into a real central bank. Those reforms were later confirmed in the 1995 People's Bank of China Law of the PRC. In relation to securities regulation, the PBOC retained a responsibility for securities firms as part of its overall duties to regulate all types of financial institutions.

The PBOC was initially designated to oversee bond and share markets under banking regulations in the mid-1980s. Its responsibilities in this respect were to approve applications for issues of bonds and shares, to licence securities firms, and to monitor the activities of the securities markets. Those regulatory functions were carried out either by the PBOC itself or in conjunction with other state agencies, including mainly the State

⁵⁰ See, Liu Xiushan, Chen Yongmin (eds.), *Zhengquan Yunzuo yu Guanli 136 Wen (136 Questions on Operation and Regulation of Securities)*, (Beijing: People's Court Publishing House, 1995) p. 164.

⁵¹ The Decision of the State Council on Reforms of the Financial System, 25 December 1993. The document in Chinese is in *the Gazette of the State Council*, No. 31, 1993, pp. 1488-1496.

Commission for Reconstructing the Economic System. Pursuant to the provisions of the 1992 Standard Opinion on Joint Stock Companies, applications for share issues in most cases had to be approved by the PBOC and the State Commission for Restructuring the Economic System. In some of the early local securities regulations, local branches of the PBOC were specifically designated as the authorities over the local bond and share markets. For example, Article 4 of the Interim Procedures of Guangdong Province on the Administration of Stocks and Bonds⁵² provided that the Guangdong branch of the PBOC was the regulatory authority over the securities market in Guangdong Province. A similar provision was contained in the Xiamen city securities regulations, which specifically conferred the authority on the city branch of the PBOC over the city's securities market.⁵³ In national securities regulations there were provisions which conferred powers on local branches of the PBOC over certain matters. For example, Article 11 of the 1993 Regulations on Administration of Enterprise Bonds provided that applications for enterprise bond issues had to be approved by the PBOC in conjunction with the State Economic Planning Commission if the enterprise in question was under control of the central government, or by the PBOC's local branch in conjunction with the local Economic Planning Bureau if the enterprise in question was a local enterprise.

Local Branches of the PBOC. The PBOC's local branches in the cities of Shanghai and Shenzhen were playing a special regulatory role compared with the PBOC's branches in other parts of China. This was because, first, Shanghai and Shenzhen were the places

⁵² It was promulgated by the Guangdong Government on 10 Oct 1986, translated in *East Asian Executive Reports*, 22-23 May 1987.

⁵³ The Procedures of Xiamen for the Administration of Enterprise Stocks and Bonds (for trial use), promulgated on, and effective as of, 1 Sept 1986, translated in *China's Economic News*, 24 Nov 1986.

where the experiments with the securities market were ahead of other parts of the country and where two national stock exchanges were later established. One special role they played was in relation to the regulation of the B-share market, which was not undertaken by any other branches of the PBOC. Under the B-share regulations promulgated jointly by the PBOC and the governments of Shanghai and Shenzhen, the Shanghai and Shenzhen branches of the PBOC were appointed the responsible authorities for the Shanghai and Shenzhen B-share markets respectively.⁵⁴ Together with the Shanghai and Shenzhen Bureaus for the Administration of Exchange Control, they were in charge of the routine work in the regulation of B-share market. Second, it was also because of the special problems which faced the Shanghai and Shenzhen branches of the PBOC. One was how to build a healthy relationship with the Shanghai and Shenzhen stock exchanges, and how to strike a balance between necessary regulatory control and excessive intervention in the day-to-day management of the market. One view put forward by some scholars was that control by the PBOC branches over the Shanghai and Shenzhen stock exchanges was excessive, especially in Shanghai where the control by the PBOC Shanghai branch over the Shanghai Stock Exchange was direct and relatively unfettered by any intervening mechanism.⁵⁵

After the establishment of the SCSC and the CSRC, the PBOC was left with responsibility over securities firms under the regulatory arrangements introduced by the

⁵⁴ Article 4 of the Measures on the Administration of Shanghai Special Renminbi Shares, promulgated by the PBOC and the Shanghai People's Government on, and effective as of, 22 November 1991; Article 4 of the Interim Measures on Administration of Shenzhen Special Renminbi Shares, promulgated by the PBOC and the Shenzhen People's Government on, and effective as of, 5 December 1991.

⁵⁵ See Potter, Pitman B. "The Legal Framework for Securities Markets in China: The Challenge of Maintaining State Control and Inducing Investor Confidence", *China Law Reporter*, 1992, Vol. 7, No. 2, p. 61-94.

1992 Circular of the State Council on Further Strengthening the Macro-regulation of the Securities Market. It had responsibilities for licensing securities firms and supervising their activities. One year later, as a result of reform of the banking system, the PBOC was given overall responsibility for the regulation and supervision of banks of various kinds and other financial institutions, including securities firms.⁵⁶ This overall responsibility was later incorporated in the 1994 Regulations on Administration of Financial Institutions,⁵⁷ under which a licensing system for all kinds of financial institutions was established and the PBOC and its local branches were designated as competent authorities for licensing them.⁵⁸ A separate regulation was promulgated for regulating foreign financial institutions and joint-venture financial institutions operating in China, which designated the PBOC and its local branches as the competent authority to regulate them.⁵⁹ In 1995 the first central bank law of the PRC, the 1995 People's Bank of China Law of the PRC, came into force, which confirmed the PBOC's overall responsibility for all types of financial institutions.⁶⁰ Apart from the regulatory role the PBOC undertook in relation to securities firms, the PBOC is still responsible for government and enterprise bonds. The previous responsibility of the PBOC and its Shanghai and Shenzhen branches for regulating the B-share market

⁵⁶ The 1993 Decision of the State Council on Reforms of the Financial System.

⁵⁷ The Regulations on Administration of Financial Institutions, promulgated by the PBOC on, and effective as of, 28 November 1994.

⁵⁸ Article 2 of the 1994 Regulations on Administration of Financial Institutions.

⁵⁹ The Regulations of the PRC on Administration of Foreign and Joint Venture Financial Institutions, promulgated by the State Council on 25 February 1994, and effective as of 1 April 1994.

⁶⁰ Article 30 stipulates that the PBOC shall exercise supervision and regulation of financial institutions and their activities according to law and administrative regulations; Article 31 confers on the PBOC powers to examine and approve the establishment, changes, termination, and scope of business of financial institutions.

was undertaken by the SCSC and the CSRC in accordance with the 1995 national B-share regulations.⁶¹ It is obvious that after the establishment of the SCSC and the CSRC, the PBOC and its local branches became less involved with securities regulation. But certain powers and responsibilities were left with the PBOC, which created a barrier to a unified securities regulatory system and was a source of overlapping responsibilities, inefficiency, and inconsistency of securities policies.

D. Self-regulatory Organisations

Self-regulatory organisations (*ziluxing zuzhi*) form part of the institutional structure of securities regulation in China. The China Securities Association (CSA), established in August 1991, is a national self-regulatory organization for securities firms and dealers with branches in local regions. Both the Shanghai and Shenzhen stock exchanges have a self-regulatory function in regulating their member firms and market places. In addition to the CSA and the Shanghai and Shenzhen stock exchanges, professional bodies for lawyers and accountants play a role in the regulation of lawyers and accountants and their firms who provide legal services relating to the securities business. Although self-regulatory organisations and their roles in the regulatory structure are encouraged by the government,⁶² the scope of self-regulation they provide is quite limited.

The China Securities Association. The CSA, the first national securities self-regulatory organization established in China, represented a stage in the development of

⁶¹ Article 7 of the 1995 Regulations of the State Council on Listing of Foreign Investment Shares by Joint Stock Companies inside China.

⁶² The 1992 Circular of the State Council on Further Strengthening Macro-regulation of Securities Market.

China's securities self-regulatory organisations. The functions of the CSA are to draft self-regulatory rules; supervise its member firms and dealers, work to advance their rights and interests; and mediate and arbitrate disputes between securities firms or between securities firms and securities exchanges. It is compulsory for securities firms to join the CSA and comply with its self-regulatory rules. In the 1993 Securities Law of the PRC (draft), one chapter devoted to the CSA contained proposals about its future structure and functions.⁶³ One of the responsibilities to be conferred on it under the 1993 Draft was the regulation of over-the-counter securities trading centres, which were to be set up and operated by securities firms.⁶⁴ But this proposal was omitted in the 1994 Securities Law of the PRC (draft) in the Chapter concerning responsibilities of the CSA. The 1998 Securities Law of the PRC has followed the 1994 draft on this issue and has not extended this responsibility to the CSA. An arbitration tribunal, the Securities Arbitration Commission (*zhengquanye zhongcai weiyuanhui*), was proposed by the 1993 Draft to be set up within the CSA. It would specially deal with disputes between securities firms and between securities firms and their clients.⁶⁵ This proposal too was removed from the 1994 Draft. At present the China International Economic and Trade Arbitration Commission (CIETAC) has been designated to deal with disputes involving securities firms with their clients and with securities exchanges.⁶⁶

The relationship between the CSA and the government securities authority was an

⁶³ Chapter VI of the 1993 Securities Law of the PRC (draft).

⁶⁴ *id.*, Article 87 (ix)

⁶⁵ *id.*, Article 147.

⁶⁶ The Notice of the SCSC on Designation of China International Economic and Trade Arbitration Commission as Arbitration Body for Securities Disputes, 26 August 1994.

important issue addressed by both the 1993 and 1994 Drafts.⁶⁷ Proposals were put forward regarding their relationship, which covered the following four aspects. First, the CSA's articles of association and its self-regulatory rules were to be approved by the government securities authority; without such approval, they could not be put in place. The government securities authority also would have the power to issue orders requiring the CSA to amend its articles of association or its rules in the interests of its member firms and public investors. Second, the CSA senior staff would first be selected by its members and then approved by the government securities authority. Third, the CSA would have to apply to the government securities authority for approval of its plans to set up or dissolve local branches, to change senior staff, and to amend or repeal its articles of association or self-regulatory rules. Fourth, the CSA would have to report to the government securities authority within three days about the changes made to its membership and disciplinary penalties imposed on its members. It is obvious that the CSA and its activities would be subject to a close monitoring and control by the government securities authority.

Shanghai and Shenzhen Stock Exchanges. Before the establishment of the SCSC and the CSRC, the Shanghai and Shenzhen stock exchanges were administered by their local governments and supervised by the PBOC. After the establishment of the SCSC and the CSRC, they were brought under the supervision of the CSRC, although their previous relationships with Shanghai and Shenzhen governments remained. In July 1993 the Provisional Measures on the Administration of Stock Exchanges, issued by the SCSC, set out a regulatory regime governing the structure and activities of stock exchanges. Article 3 defines the stock exchange as a self-regulatory organisation, but subject to dual control

⁶⁷ Chapter VI of 1993 Draft; Chapter VIII of 1994 Draft.

by the CSRC and the local government where it is located. The relationship between the Shanghai and Shenzhen stock exchanges and the CSRC, the SCSC, and their local governments has the following aspects. First, their articles of association are examined by the CSRC and local governments and approved by the SCSC; their self-regulatory rules are approved by the CSRC and local governments and filed at the SCSC. Second, the admission of members to the stock exchanges must be approved by the boards of directors of the stock exchanges and the file submitted to the CSRC and local governments. Third, the chairman and deputy chairman of the boards of directors of the stock exchanges are to be recommended by the local governments and the CSRC and then elected by members of the boards of directors, which shall be reported to the SCSC. Both the 1993 and 1994 drafts of the Securities Law of the PRC sought to strengthen control over the stock exchanges by the government securities authority.⁶⁸ Under the draft proposals, the government securities authority would have the powers to order the stock exchanges to amend their articles of association and self-regulatory rules, send supervisory personnel to the stock exchanges, and remove senior staff from their positions if they violate rules.

By comparison with self-regulatory organisations in the United Kingdom, the self-regulatory organisations in China are playing a lesser role in the day-to-day regulation of securities market. The CSA is a national self-regulatory organisation for securities firms and dealers, but the important regulatory responsibilities with respect to them are undertaken by the PBOC and the CSRC. The Shanghai and Shenzhen stock exchanges are self-regulatory organisations by definition, but by no means they could be compared with the London Stock Exchange, which has the status of a "recognised investment exchange"

⁶⁸ Chapter VIII, section 1, 1993 draft; Chapter IV 1994 draft.

under the United Kingdom regulatory system.⁶⁹ In 1995, in the aftermath of the treasury bond scandal which drew the attention of the entire nation, the Shanghai Stock Exchange was blamed for lax regulation and supervision and its president was removed and replaced by someone from the Shanghai Securities Commission who was said to be closer to the Beijing authority.⁷⁰

From the current relationship between the self-regulatory organisations and the government securities authority in China, one can see that self-regulatory organisations are subject to very tight control from the government securities authority in almost all major aspects, either in the form of approvals or in other forms. It is against this background that one can hardly say that self-regulatory organisations in China actually possess a "self status" and a "self regulating function" comparable to self-regulatory organisations in the United Kingdom securities regulatory system and in those systems which have followed that system.

E. Who Will Regulate the Regulators?

To regulate the regulator is as important as to regulate the securities market itself. The mechanisms for control of the securities regulators, either judicial, administrative, or otherwise, depend largely on the strength of a country's legal system. China is a country where law was traditionally conceived of as an instrument at the disposition of the State to control its subjects. After 1949, under the communist regime, law in China was used

⁶⁹ The Financial Services Act 1986 confers on the Securities and Investment Board the power to "recognise" investment exchanges if they meet certain criteria. (see s.37 and Sched.4) The London Stock Exchange is one of the recognised investment exchanges.

⁷⁰ See, "China Blames Two Firms for Bonds Scandal", *Financial Times*, 22 September 1995.

as a weapon for class struggle against class enemies. There was no framework within the Chinese legal system through which State actions could be seriously challenged. The economic reform of 1978 has brought about changes in the way in which law is operating and a framework has gradually been established through which governmental actions may be challenged by way of legal proceedings in courts by individual citizens, legal entities or other organisations. In April 1989 the Law on Administrative Litigation of the PRC was enacted⁷¹ and, together with other statutes and administrative regulations, has significantly changed the system of administrative law. Under the present legal system, securities regulators in China could be subject to administrative review, judicial review, and other control mechanisms.

Administrative Review. Administrative review (*xinzheng fuyi*) is normally the first channel through which those who are dissatisfied with the actions of securities regulators go for a redress. It is generally provided in securities regulations that individuals, legal entities, or other organisations may apply for administrative review in accordance with the law and regulations if they are dissatisfied with the decisions made or the administrative penalties imposed by securities regulators.⁷² Administrative review is governed by the 1990

⁷¹ It came into force on 1 October 1990. Before the enactment of the 1989 Law on Administrative Litigation of the PRC, a system of administrative litigation and of administrative divisions in courts specialising in administrative cases had already been developed. For a brief introduction to the pre-1989 developments, see Albert Chen, *An Introduction to the Legal System of the PRC*. (Hong Kong: Butterworths, 1992) p. 176-178.

⁷² For example, Article 59 of the 1990 Regulations on the Administration of Financial Institution stipulates that if parties are not satisfied with the administrative penalties imposed by the PBOC, they may apply for an administrative review; Article 15 of Implementation by Companies Listing in Hong Kong of the "Standard Opinions for Companies Limited by Shares" Supplementary Provision stipulates that if parties do not agree with the decisions made by the authority concerned they may apply for administrative review in accordance with the Regulations on Administrative Review."

Regulations on Administrative Review, as amended in 1994,⁷³ under which eight categories of administrative actions are subject to administrative review.⁷⁴ The reviewing authority in respect of an administrative action is chosen in accordance with the provisions governing the jurisdiction of review;⁷⁵ usually it is the administrative agency at the next higher level in the hierarchy. For instance, under Article 59 of the 1990 Regulations on Administration of Financial Institutions, the reviewing authority is prescribed to be the next higher level of the PBOC. A review application should normally be made within 15 days of receiving notice of the administrative action, except where law and regulations provided otherwise.⁷⁶ In general this 15 day period is replicated in these securities regulations where administrative review is provided for as a channel for redress. The review is conducted in order to determine whether the action complained of is lawful and proper⁷⁷ and the reviewing authority, upon concluding the review, has the power to quash or vary the administrative action concerned, order the respondent to take fresh action or perform its obligations,⁷⁸ and order compensation if the action has injured the applicant's lawful rights and interests.⁷⁹

⁷³ It was promulgated by the State Council on 24 December 1990, and effective as of 1 January 1991. It was amended on 9 October 1994 in accordance with the Decision of the State Council on Amendment of the Regulations on Administrative Review.

⁷⁴ Article 9 (i-viii) of the 1990 Regulations on Administrative Review.

⁷⁵ *id.*, Articles 11-22.

⁷⁶ *id.*, Article 29.

⁷⁷ *id.*, Article 7.

⁷⁸ *id.*, Article 42.

⁷⁹ *id.*, Article 44.

Judicial Review (Sifa Shencha). If applicants are still dissatisfied after an administrative review, they may invoke the court's jurisdiction to review administrative actions in accordance with the 1989 Law of Administrative Litigation of the PRC, which enables individual citizens, legal entities and other organisations to bring administrative proceedings to challenge the legality of specific administrative actions.⁸⁰ There are eight categories of specific administrative actions subject to judicial review, the first and second of which cover all types of administrative punishments and administrative coercive measures, including detention, fine, cancellation of permits and licence, order to cease production or business, confiscation of property, and freezing of property.⁸¹ As far as securities regulation is concerned, a wide range of the administrative actions of securities regulators could be subject to judicial review. Unlike an administrative review, the court in administrative litigation is only concerned with the legality, not the merits or reasonableness, of the administrative action being challenged.⁸² The court may quash an administrative action where it is not justified, or it involves a misapplication of the law or a violation of legal procedures, or it is ultra vires or an abuse of power; the court may vary an administrative punishment which is obviously unjust; the court may order the defendant to perform a legal duty within a specified time if it refuses to perform or delay such performance. Where lawful rights and interests of individuals have been injured, they

⁸⁰ "Abstract" administrative acts such as the legislative or normative enactments of administrative agencies do not come within the purview of judicial review and are only subject to the system of invalidation of laws and regulations by the National People's Congress Standing Committee and the State Council.

⁸¹ Article 11 of the 1989 Law of Administrative Litigation of the PRC.

⁸² *id.*, Articles 5, 54.

have the right to claim compensation.⁸³

Persons aggrieved by administrative actions may normally choose between administrative review and judicial review. The position before the enactment of the 1989 Law of Administrative Litigation of the PRC was that while in some areas the relevant laws made it mandatory for the remedies through administrative review to be exhausted before administrative litigation could be commenced, in other areas the laws allowed persons aggrieved by administrative actions to take the matter to the courts straight away.⁸⁴ Article 37 of the 1989 Law of Administrative Litigation of the PRC provides that except where there exists an express provision requiring administrative review to be exhausted before litigation is resorted to, persons aggrieved by administrative actions may either apply for administrative review or commence administrative litigation. In accordance with the 1990 Regulations on Administrative Review, if administrative review is chosen, the matter may not be brought before a court during the process of review and, conversely, if the matter has already been taken to the court, an application for administrative review may not be made.⁸⁵ In most securities regulations, the position is that either administrative review or judicial review may be chosen as the forum to seek redress by those who are dissatisfied with the administrative actions of securities regulators.

State Compensation (guojia peichang). The 1995 State Compensation Law of the

⁸³ *id.*, Articles 54, 67.

⁸⁴ See, Albert Chen, *An Introduction to the Legal System of the PRC*. (Hong Kong: Butterworths, 1992), p. 180 and note 61.

⁸⁵ Article 30.

PRC⁸⁶ and the 1996 Administrative Penalty Law of the PRC,⁸⁷ promulgated by the National People's Congress, are expected to have a profound impact on the regulation of administrative agencies and their activities. The 1995 State Compensation Law of the PRC sets out two types of compensation by state administrative agencies, namely, administrative compensation and criminal compensation.⁸⁸ Pursuant to Article 4, which provides for the scope of administrative compensation, victims are entitled to administrative compensation if administrative agencies or their personnel illegally enforce administrative penalties, such as imposing a fine, revoking a permit or licence, mandating the cessation of production and business, and confiscating property, or illegally impose coercive administrative measures, such as confiscating, seizing, and freezing property. Where administrative organs or their personnel in exercising their powers and functions have caused damage by their infringement of legitimate rights and interests of citizens, legal entities, and other organizations, the administrative agencies in question are responsible for compensation.⁸⁹ Article 5 prescribes certain circumstances under which the State is exempted from being held responsible for compensation.⁹⁰

The 1996 Administrative Penalty Law of the PRC sets out the framework for the

⁸⁶ Adopted at the seventh meeting of the Eighth National People's Congress Standing Committee on 12 May 1994, and effective as of 1 January 1995.

⁸⁷ Adopted at the fourth meeting of the Eighth National People's Congress on 17 May 1996 and effective as of 1 October 1996.

⁸⁸ Chapter II Administrative Compensation, Articles 3-14; Chapter III Criminal Compensation, Articles 15-24.

⁸⁹ Article 7.

⁹⁰ They include (i) where the personnel of administrative agencies commit individual acts that have no relation to their exercise of powers and functions; (ii) where citizens, legal entities, and other organizations cause harm through their own acts and (iii) other circumstances prescribed by law.

system of administrative penalties in order to regulate the operation of administrative penalties and protect lawful rights and interests of citizens, legal entities, and other organisations. Article 6 stipulates that where citizens, legal entities or other organizations are dissatisfied with administrative penalties imposed by administrative agencies, they have a right to apply for an administrative review or institute litigation proceeding in accordance with the law, and where they have suffered damages because of administrative penalties imposed illegally by administrative agencies, they have a right to demand compensation in accordance with the law. As abuses of the system of administrative penalty by administrative agencies were extensive in China, the promulgation of the 1996 Administrative Penalty Law of the PRC was seen as an important legal development. As far as securities regulators are concerned, their abuses of the system of administrative penalty will be subject to the 1996 Administrative Penalty Law of the PRC.

Administrative and Criminal Punishments. Another important aspect of regulating securities regulators is through control over abuses of their powers. Both the 1993 Company Law of the PRC and the drafts of the Securities Law of the PRC prescribe circumstances under which regulators could be subject to administrative punishment or criminal liability. These circumstances are of two types. The first is concerned with regulators' powers to approve the issue or listing of securities. Article 221 of the 1993 Company Law of the PRC stipulates that "where the Securities Authority of the State Council approves an application for the public issue of shares or debentures or the listing of shares where the conditions pertaining to these applications have not been met, and where the circumstances are serious, the responsible persons directly in charge and those directly responsible shall be subject to administrative punishment, and where the

commission of a crime is proved, those who are responsible shall be subject to criminal responsibility in accordance with the law". A similar provision was proposed under the 1994 Securities Law of the PRC (draft).⁹¹ The second circumstance is concerned with other abuses of powers by securities regulators, including corruption, acceptance of bribes, and embezzlement. Where a criminal offense is committed, criminal responsibility is to be pursued according to the law, and where the circumstances are less serious, administrative punishment are to be imposed according to the law.⁹² If insider dealing is committed, it is to be punished severely.⁹³ It was proposed that the securities authorities should have the power to dismiss senior personnel of stock exchanges or the CSA from their positions or make recommendation for such dismissals if they have acted wrongfully and done harm to their members and investors in the course of performing their responsibilities and functions.⁹⁴

Supervision by General Public. In addition to the above control mechanisms, a proposal was put forward in the drafts of the Securities Law of the PRC for the establishment of a mechanism whereby the general public would be able to supervise securities regulators. The central idea of the proposal was to set up a system under which securities regulator working procedures and rules would be open to the general public, which thus would be able to supervise securities regulators.⁹⁵ The proposal was clearly an

⁹¹ Article 212.

⁹² Article 162 of 1993 draft and Article 213 of 1994 draft of the Securities Law of the PRC.

⁹³ *id.*, Article 162 (ii); Article 213 (ii).

⁹⁴ Articles 90, 126 of the 1993 Securities Law of the PRC (draft).

⁹⁵ Article 145 of 1993 draft and Article 5 of 1994 draft of the Securities Law of the PRC.

attempt to apply the principle of openness to securities regulation. If the proposal was to be accepted and become the law, unless a detailed structure is developed, it would be hardly workable in practice even if it is a good idea and popular with the general public. The 1998 Securities Law of the PRC has accepted this proposal and it has become the law,⁹⁶ but detailed rules have to be formulated in order to implement it in practice.

⁹⁶ Article 172.

Chapter IV

Regulation of Public Offerings of Securities

The regulation of public offerings of securities (*zhengquan faxing*) and of trading in securities (*zhengquan jiaoyi*) have so far been the two principal concerns of Chinese securities regulations. Provisions governing public offerings of securities and the trading of securities constitute the majority of current securities regulations.¹ In line with the general practice of the Chinese legal system to separate foreign from domestic investments in China,² the regulatory framework for foreign investments in China's securities market is separated from that for domestic securities investments. To reflect this distinction, the framework for offering and trading foreign securities investments will be dealt with separately in the following chapters.

¹ This is also suggested by the fact that the title of the current main securities regulation is "The 1993 Provisional Regulations on Administration of Issuing and Trading of Shares 1993".

² There are, for example, separate contract laws governing respectively matters relating to foreign investments and to domestic investments. Accordingly, the regulatory regimes for foreign investments are separated from those for domestic investments.

As in other jurisdictions, the law governing the public offering and trading of securities in China includes both company regulations and securities regulations. The 1993 Company Law of the PRC and related implementing rules issued under it³ not only have established a national legal framework for the registration of companies, but also provided a body of basic principles for the public offering and trading of company securities. The 1993 Provisional Regulations on Administration of Issuing and Trading of Shares regulates issue and trading of shares and, by extension, regulates the issue and trading of other types of securities too.⁴ At local levels, the regulations promulgated cover a wide range of areas, from company incorporation to local securities offerings, listing, and trading.⁵ The present discussion focuses on national regulations, and where necessary, local regulations, especially those promulgated by Shanghai and Shenzhen.

A. Incorporation

In the several decades after the founding of the People's Republic of China, state-owned enterprises (*guoyou qiye*) were the dominant business form in China. A principal aim of economic reform was therefore to transform these enterprises into modern corporate forms. The 1993 Company Law introduced modern corporate practices to this

³ Among the series of implementing rules is the Regulations on Administration of Registration of Companies, promulgated by the State Council in accordance with the provisions of the Company Law on 6 June 1994 and effective from 1 July 1994.

⁴ Article 2 expressly provided that these Provisional Regulations are applicable to other type of securities in the same way as they are applicable to the issuing and trading of shares.

⁵ For example, in Shanghai company regulations were promulgated as early as in 1992: the Provisional Regulations of Shanghai Municipality on Companies Limited by Shares, adopted by the Shanghai Municipal People's Government on 18 May 1992, and effective from 1 June 1992.

end. Thus, the legal framework introduced by the 1993 Company Law covers not only the incorporation of new companies but also the transformation of existing state-owned enterprises into corporate forms. It defines, on one hand, the incorporation of new companies, their forms, methods, conditions, and formalities and, on the other, the way in which state-owned enterprises are transformed into different types of companies. In order to uphold socialist public ownership and protect state-owned assets in the process of transforming state-owned enterprises, the 1993 Company Law ensures that the process would not affect adversely the state-owned assets and cause losses to them.

Forms and Methods of Incorporation. The 1993 Company Law provides for two types of companies to be established in China: limited responsibility company (*youxian zeren gongsi*) and joint stock company (*gufen youxian gongsi*).⁶ The principal difference between these two types of company lies in the ownership structure: a limited responsibility company corresponds roughly to a private company, whereas a joint stock company is similar to a public company found in some other jurisdictions.⁷ Limited responsibility companies and joint stock companies are both defined as corporate legal persons (*gongsi faren*)⁸ under the 1993 Company Law⁹, and thus enjoy civil rights and

⁶ Article 2. These two types of companies are both defined as limited companies; unlimited companies are not recognised under the 1993 Company Law.

⁷ For a comparison between these forms of Chinese companies and those in United Kingdom and United States, see, Art, Robert C. and Gu Minkang, "China Incorporated: the First Corporation Law of the People's Republic of China", *Yale Journal. of International Law*, 1995, Vol. 20, pp. 273-308, at 291.

⁸ For a discussion of the concept of legal personality in China, see, Fu Tingmei, "Legal Person in China: Essence and Limits," 1993, *American Journal of Comparative Law*, Vol. 41, pp. 261-297.

⁹ Article 3 (1).

bear civil responsibility independently. Shareholders of a limited responsibility company assume liabilities towards the company to the extent of the amount of their capital contribution, and the company assumes liabilities for its debts to the extent of all of its assets; shareholders of a joint stock company assume liabilities toward the company to the extent of the amount of shares held by them, and the company assumes liabilities for its debts to the extent of all of its assets.¹⁰

Two methods of incorporation have been set out by the 1993 Company Law: the "method of promotion" (*faqì chénglǐ*) and the "method of public issue" (*mùjī chénglǐ*).¹¹ The method of promotion means that all the capital prescribed by the articles of association of the company is purchased by the promoters, whereas the method of public issue means that the promoters purchase only a portion of the shares issued by the company, the remaining shares being offered to the general public by subscription. By their nature, a limited responsibility company adopts the method of promotion for its establishment and a joint stock company may adopt either the method of promotion or the method of public issue. The difference between the adoption of the method of promotion or the method of public issue for a joint stock company is that it would immediately become a public company through the method of public issue whereas it would be a closely held company if it were established by the method of promotion.

Conditions for Incorporation. certain conditions are imposed by the 1993 Company Law for the incorporation of a company, which may vary among different types of

¹⁰ *id.*, Article 3 (3).

¹¹ *id.*, Article 74.

companies. Some are common conditions required for all types of companies; others are special conditions required only for a particular type of company. In order to establish a joint stock company, the following conditions have to be satisfied in respect of the statutory number of promoters, the statutory minimum level of registered share capital, the company's name, the company's structure, the premises and the facilities for production and operation, the articles of association, and the public issue of shares.

The statutory number of promoters is five at least, and more than half of them must have residence in China.¹² The statutory minimum level of registered share capital is Rmb 10 million for all types of joint stock companies and Rmb 50 million for listed companies.¹³ The company's name must contain the words "joint stock company" (*gufen youxian gongsi*) and only one name may be used by the company.¹⁴ The company's organisational structure must be in compliance with the requirements under the 1993 Company Law, including among others the requirements to set up a shareholders' meeting, a board of directors, a supervisory board, and a general manager.¹⁵ The company

¹² *id.*, Article 75(1).

¹³ *id.*, Articles 78(2), 158(2). In order to safeguard the adequacy of capital of companies, the 1993 Company Law adopted the principle that the registered capital must be paid-up capital. A joint stock company may not be registered without its subscribers having paid up their subscriptions in full. The premium income derived from issuing shares at a premium is not be incorporated into the registered capital. The form of capital contributions may be in cash, or kind, such as land use rights, industrial property rights, and unpatented technology.

¹⁴ Article 11, 1994 Regulations on Administration of Registration of Companies.

¹⁵ Articles 102, 112(1), 124(1), 112(2), 119(1). The shareholders' meeting shall be constituted by all shareholders and is the authority of the company to whom the board of directors shall report; the board of directors shall have five to nineteen members; the supervisory board shall have at least three members; the general manager shall be appointed and removed by the board of directors, and upon his recommendation, deputy managers and head of financial department are appointed and removed.

must have a permanent location, and there must be necessary conditions for its production and operation.¹⁶

The articles of association of a company comprise mandatory articles and, if necessary, additional discretionary articles. The mandatory articles are prescribed by the 1993 Company Law; the discretionary articles may be stipulated by the shareholders' meeting. Article 79 of the 1993 Company Law sets out the mandatory articles for the articles of association of a joint stock company,¹⁷ some of which, especially those concerning basic constitutional matters such as the company's name and its objectives, are similar to articles contained in a memorandum of association of a company incorporated elsewhere. The articles of association bind the company's shareholders, directors, supervisors, and managers, and they can claim rights and bring legal actions pursuant to the articles of association.¹⁸ All types of company incorporated under the 1993 Company Law must adopt articles of association in compliance with the statutory procedures prescribed by the 1993 Company Law.

The public issue of shares has to comply with the 1993 Company Law. In general it is required that the company's capital be divided into shares (or stocks) of equal value; the public issue must comply with the principles of openness, equality and fairness; equal

¹⁶ *id.*, Article 73 (6).

¹⁷ The mandatory provisions are: (i) the company's name and domicile; (ii) the company's objectives; (iii) the means by which the company is incorporated; (iv) the total number of shares, the value of each share, and the registered capital; (v) the promoters' names and their subscriptions; (vi) the shareholders' rights and obligations; (vii) the member, power, term of office, and operating rules of the board of directors; (viii) the company's legal representative; (ix) the member, power, term of office, and operating rules of the supervisory board; (x) the methods for profit distribution; (xi) the conditions for dissolution of the company, and the methods of liquidation; (xii) the methods for the company's notice and public announcement.

¹⁸ Article 11(1), 1993 Company Law.

shares are to carry equal rights and to confer equal benefits; shares are to be issued at par or, upon the approval of the CSRC, at a premium, but not a discount.¹⁹ These and other principles adopted in the 1993 Company Law have been refined into detailed requirements and standards by further implementing the rules and regulations issued by the State Council and securities regulators.

Formalities of Incorporation through the Method of Public Issue. In general four steps have to be followed in the establishment of a joint stock company by way of public issue. First, approvals have to be sought from central or local government and from the securities authorities; second, the promoters make their contributions and issue the remaining share capital to the general public for subscription; third, the share capital is to be verified and then an inaugural meeting is held at which the articles of association are adopted and a board of directors is elected; and finally, an application is made to the company registration authority for registration of the company, and a report is submitted to the CSRC about the public issue of shares.

The approval by government authorities is compulsory for setting up a joint stock company.²⁰ The approval authority of the central government is the ministerial department in charge of the sector in which the applicant company is engaged; the approval authority of the local government is the provincial government, or the government of autonomous regions and municipalities where the applicant company is located.²¹ After the ministerial

¹⁹ Articles 129 (1), 130 (1) (2), and 136.

²⁰ Article 77, 1993 Company Law.

²¹ The provinces, autonomous regions and municipality cities are the highest local administrative authorities. Throughout the country, there are 22 provinces, 5 autonomous regions, (i.e. those regions where minority ethnics are concentrated and thus more "autonomous" powers are exercised by themselves) and 4

department of the central government or the local competent government has granted the approval, the application is submitted to the CSRC for review. Its review decision is filed at the SCSC.²²

The contribution made by the promoters must be at least 35% of the company's share capital, and may be made with cash or tangible assets, industrial property rights, non-patented technology, and land use rights, but the amount of industrial property rights or non-patented technology is limited to 20% of the registered capital of the company.²³ After the promoters' subscription, the remaining share capital is issued to the general public for subscription. The public issue must satisfy the procedures set out in the 1993 Company Law and the 1993 Provisional Regulations on Administration of Issuing and Trading of Shares. The promoters may not transfer their shares in the first three years after the establishment of the company irrespective of the method of incorporation adopted, i.e. promotion or public issue.

The verification of share capital takes place after the issue has been fully subscribed and paid up. It is carried out by an authorised asset valuer and a certificate issued after the verification.²⁴ The promoters and subscribers may not withdraw their shares after payment except under circumstances where the issue was not fully subscribed or the promoters did not hold an inaugural meeting within 30 days after the verification

municipality cities (Beijing, Shanghai, Tianjin, and Chongqing) which are under direct jurisdiction of the central government.

²² Article 12(3), 1993 Provisional Regulations on Administration of Issuing and Trading of Shares.

²³ Article 83; 80(1) (2), 1993 Company Law.

²⁴ *id.* Article 91(1).

of share capital, or a resolution was passed by the inaugural meeting to cancel the establishment of the company.²⁵ If a promoter or subscriber withdraws his shares and the circumstances under which he makes his withdrawal are not one of these mentioned above, he is subject to a fine of five to ten per cent of the amount he has withdrawn.²⁶

After the verification of share capital, the promoters are required to convoke an inaugural meeting within 30 days. All subscribers must be notified of the meeting 15 days in advance, or alternatively, the promoters may issue a public announcement to the same effect. The meeting may only be held if the subscribers who possess more than half of the total shares issued are in attendance, and all the resolutions passed at the meeting require more than half of the votes of the subscribers who attend the meeting.²⁷ Article 92 of the 1993 Company Law sets out the matters which are to be decided at the inaugural meeting.²⁸ If the company can not be incorporated, the promoters are jointly liable for all the debts and expenses incurred during the preparation of the company and for refunding to the subscribers their money plus interest; if losses incurred during the incorporation are due to the promoters' fault, they are liable to compensate the company.²⁹

²⁵ *id.*, Article 93.

²⁶ *id.*, Article 209.

²⁷ *id.*, Articles 91 (1), 92 (1), 92 (2) (3).

²⁸ They include: (i) to consider the promoters' report on the preparation of the company; (ii) to adopt the articles of association; (iii) to elect directors and supervisors; (iv) to examine and approve the expenses for the preparation of the company; (v) to examine and verify the valuation of the properties contributed by the promoters for their payments of shares; (vi) to adopt a resolution to cancel the preparation of the company if force majeure has occurred or business conditions have significantly changed so that the preparation has been directly affected.

²⁹ *id.*, Article 97.

The final step of incorporation through the method of public issue is registration. The 1994 Regulations on Administration of Registration of Companies set out in detail the procedures and documents required.³⁰ After the inaugural meeting, the board of directors applies to the company registration authority within 30 days for registration, together with the documents required under the registration procedure.³¹ A number of matters are registered and a business licence issued after registration.³² The date on which the business licence is issued after registration is the date on which the company is incorporated.³³ If an applicant uses forged documents to declare registered capital or to obtain registration through fraudulent means, he is subject to imprisonment for up to three years and may additionally be fined up to ten per cent of the falsely declared registered capital if the case is serious.³⁴

³⁰ The Regulations supersede all the previous regulations governing company registration. Under the Regulations, the Bureau of Administration of Commerce and Industry is designated as the authority for company registration.

³¹ They are: (i) an application for registration signed by the chairman of the board of directors; (ii) the approval documents from the central government or local government, and the CSRC; (iii) the minutes of the inaugural meeting; (iv) the articles of association; (v) an audit report on the preparation of the company; (vi) the share capital verification certificate issued by the statutory asset verification body; (vii) a certificate concerning the promoters' status of legal person or natural person; (viii) a document containing the names and addresses of the directors, supervisors, and managers; and a certificate concerning their appointments or elections; (ix) a document concerning the appointment of the company's legal representative, and his identification certificate; (x) the notice of preliminary confirmation of the company's name issued by the company registration authority; (xi) a certificate concerning the company's domicile.

³² They are: (i) the company's name; (ii) the company's domicile; (iii) the company's legal representative; (iv) the company's capital; (v) the company's type; (vi) the company's objectives; (vii) the company's duration; (viii) the names of shareholders of a limited liability company or the names of promoters of a joint stock company.

³³ Article 22, 1994 Regulations on Administration of Registration of Companies.

³⁴ Article 1, 1995 Decision of the National People's Congress on Punishment for Crimes of Violating the Company Law.

After registration, the company is required to make a public announcement about the company's establishment and submit a report to the CSRC about the public issue of shares.³⁵

The procedure for the incorporation of joint stock companies has introduced, on one hand, modern practices of incorporation by establishing a registration system, coupled with a detailed requirements regarding registered capital, procedures for the public issue of shares, and documentation, but on the other, it still relies heavily on the administrative approval procedure which has been the mechanism for government authorities to control economic activities in China during past decades under the centrally planned economy. In fact, approvals by government authorities play such a decisive role in the establishment of a joint stock company that the incorporation of joint stock companies in China is regarded as being by approval but not by right.³⁶

In order to come into legal existence a joint stock company has to satisfy all the conditions and required procedures set out by the company regulations and securities regulations. This is viewed as a "striking feature" from a western lawyer's point of view.³⁷ It is true to say that for a joint stock company to come into being by way of public issue it has to go through a lengthy process. This is not so surprising if one bears in mind that

³⁵ Article 95 (2), (3), 1993 Company Law.

³⁶ An interesting comparison has been made between current Chinese practice and the "special" incorporation process followed in England and the United States until the early 1800s. At that time, each instance of incorporation required special legislation. See, Art, Robert C. and Gu Minkang, "China Incorporated: the First Corporation Law of the People's Republic of China", *Yale Journal. of International Law*, 1995, Vol. 20, pp. 273-308, at 288-290 and accompanying note 102.

³⁷ See, Nee, Owen D. "China's Company Laws Sets Out the Next Stage of Reform", *International Financial Law Review*, 1994, Vol. 13(4), pp. 13-15, at 14.

China is undergoing a transformation to a more relaxed free market economy. The reason, as is often argued, is that the government in this process of transformation has to make a necessary macro adjustment and exercise a control over the flow of social circulating funds and thus protect the interests of the general public. Given that China was under a centrally planned economy for several decades and has no experience with a market economy, these lengthy procedures may be seen as a necessary step before moving to an entirely modern registration system.

Restructure of Existing State-owned Enterprises. An existing state-owned enterprise may be transformed into a limited responsibility company or a joint stock company. Where the choice is a limited responsibility company, it may become a "wholly state-owned company" (*guoyou duzi gongsi*) or a normal limited responsibility company, depending on how many participants are involved and in which branch of the economy the participants are engaged in.³⁸ In general if the state-owned enterprise in question has a sole investor, it will be transformed into a wholly state-owned company, whereas if there are more than one investing state-owned enterprise, they will be transformed into a normal type of limited responsibility company. Where the transformation is into a joint stock company, there may be up to five promoters; otherwise it must be formed by way of public issue.³⁹

³⁸ A "wholly state-owned company" is established solely by government departments or investment institutions authorized by the government. It is relieved of certain organizational requirements normally applied to limited responsibility companies, for example, the department may directly appoint and change directors, hire and dismiss managers, and make key decisions concerning merger, division, dissolution, and the issuance of securities. Thus, a wholly state-owned limited responsibility company is essentially an administration unit of a government agency clothed in corporate form. It is a vehicle for companies engaged in certain special and strategic sectors listed by the government, such as the munitions industry.

³⁹ Article 75(2), 1993 Company Law.

The initial step for existing state-owned enterprises to transform themselves through a public issue of shares is to become a joint stock company in accordance with the 1993 Company Law. They must make arrangements to change the management structures, determine the ownership of assets, clear off debts and demands, have assets valued, and establish the new management structure. A primary concern underlying the measures adopted to facilitate transformation of state-owned enterprises is to protect state-owned assets. The 1993 Company Law strictly prohibits state-owned enterprises from selling state-owned assets at a discount, distributing them free to individuals, or converting them into undervalued shares.⁴⁰ If an enterprise has violated these requirements, the person in charge and others directly involved are subject to administrative penalties, and if a crime is committed, to criminal prosecution in accordance with law.⁴¹ The State Administration of State-owned Assets has been endorsed with the powers to approve matters involving state-owned assets in connection with the transformation of state-owned enterprises.

State-owned enterprises were first transformed into corporate forms of companies in the mid-1980s on an experimental basis in certain parts of China without an established legal framework. The 1993 Company Law has not only provided the statutory basis for transformation, but also laid down certain measures to facilitate the transformation process. Although China's reform of state-owned enterprises has addressed many issues common to those raised in the Independent States of the former Soviet Union and Eastern

⁴⁰ *id.*, Article 81.

⁴¹ *id.*, Article 213.

Europe, it has not adopted the approach of privatization. The term "privatization" (*siyouhua*) is not used in the 1993 Company Law to describe the the reform of state-owned enterprises. Instead, the Law refers to "transforming" (*gaizhu or gaijian*) state-owned enterprises into companies.⁴² This approach reflects the limits of present ideological concerns, i.e., to adapt capitalist practice with regard to China's own conditions and to develop a market economy with Chinese socialist characteristics. The primary objective of transformation is enhance economic efficiency, eliminate continuing losses, and make them more accountable, rather than changing the enterprise structure of public ownership.

B. Public Offerings of Securities

In order to be able to offer securities to the general public, an applicant company has to satisfy the conditions and formalities set out by the 1993 Company Law and the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares. One theme underlying the legislation is to establish uniform control over public offerings of securities.

Conditions for Public Offer of Shares. In accordance with the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares, conditions for public offerings of shares depend on whether it is an initial offering or a subsequent offering to increase share capital, and on whether the issuer is a newly incorporated company or a company transformed. Most conditions are commonly applicable under all circumstances, whereas some others are additional and applicable to issues to increase share capital and

⁴² *id.*, Article 7. For comments see also, Torbert, Preston M. "China's Evolving Company Legislation: a Status Report", *Northwestern Journal of International Law and Business*, 1993, Vol. 14, pp. 1-14, at 6.

issuers whose companies are transformed. First, any applicant company seeking to publicly issue shares must be a joint stock company, irrespective of whether it is an initial or subsequent issue and whether the company is newly incorporated or transformed.⁴³

The conditions for the initial public offering of shares include: the company's business must conform to the industrial policies of the State; only one class of ordinary shares with same rights attached is to be issued; the promoters must subscribe to at least 35% of the shares issued and the total amount of share capital which the promoters purchased must be at least Rmb 30 million unless otherwise provided by authorities; the total amount of shares issued to the general public must not be less than 25% of the company's share capital; employees of the company may not subscribe for more than 10% of the shares to be issued to the general public; companies which plan to issue share capital exceeding Rmb 400m could, subject to approval of the CSRC, reduce the total amount of shares issued to the general public, but in any event, shares after such reduction must be no less than 10% of the total issued shares of the company; the promoters have not committed any serious violation of law within the three years prior to the application for the public issue of shares.⁴⁴ These conditions for initial public offering of shares are also applicable to subsequent offerings to increase share capital and to companies which are transformed.

Additional conditions for subsequent offerings to increase share capital include: shares subscribed in the previous issue have all been paid up in full and at least one year

⁴³ Article 7, 1993 Provisional Regulations on Administration of Issuing and Trading of Shares. Those issuers yet to be incorporated refer to the issuers who have been granted approvals for incorporation or transformation but have not yet been actually incorporated or transformed.

⁴⁴ *id.*, Article 8 (1-6).

lapsed since the previous issue; the proceeds from the last issue have been applied in accordance with the purposes stated in the prospectus and have generated benefits; the company has made profits for the last three years and its distributable profits have been sufficient to pay dividends; the forecast profit rate of the company has exceeded the bank interest rate for savings accounts; and there has been no serious violation of law during the period between the previous issue and the present application.⁴⁵

Additional conditions for companies transformed include: at the end of the year immediately preceding the proposed public issue, the company's net assets must not be lower than 30% of the company's total assets and its intangible assets must not exceed 20% of its net assets unless otherwise stipulated by the CSRC; the company must have made profits for the three consecutive years immediately prior to the application for the proposed public issue. Where the enterprise is a state-owned enterprise, the proportion of its state-owned shares of the total share capital to be issued by the company must satisfy the proportion determined by the government authorities.⁴⁶ The purpose for such a requirement is obviously to preserve the values of state-owned assets and allow the State to retain a high degree of ownership and control.⁴⁷

Shares could be issued at a premium but not a discount. The premium generated from issuing shares over par does not, however, come directly into the registered capital of the company but is allocated to the statutory capital accumulation fund of the company

⁴⁵ *id.*, Article 10.

⁴⁶ *id.*, Article 9 (1-2).

⁴⁷ For further discussion on this point see, Bersani, Matthew B. "Privatization and the Creation of Stock Companies in China", *Columbia Business Law Review*, 1993, pp. 301-328, at 305-06.

prescribed under the 1993 Company Law for the purpose of recovering business losses and funding further expansion of the company.⁴⁸ The 1993 Company Law also requires that any issue of shares at a premium must have been approved by the securities authorities of the State Council.⁴⁹ This requirement would in practice prevent adverse effects resulting from a massive amount of shares issued at a premium and therefore is regarded as a necessary measure enabling the government to exercise macro-control.

A joint stock company which has already been listed on a stock exchange may issue convertible bonds upon a resolution of the shareholders' meeting. The application has to be approved by the securities authorities and to satisfy the conditions for the issue of corporate bonds as well as the conditions for the public issue of shares.⁵⁰ The conditions for the issue of corporate bonds are set out in Article 161 of the 1993 Company Law, including among others that the applicant company must have a net asset value of Rmb 60 million; the accumulated value of the bonds issued must not exceed 40% of the company's net asset value. There are two limits imposed on the issue of corporate bonds: first, the government authorities have the power to set a ceiling on bond issues in any one year, and second, the rate of interest on corporate bonds must not exceed the rates determined by the government authorities, which could limit corporate bond market if it is set too low.⁵¹

⁴⁸ Article 178, 1993 Company Law.

⁴⁹ *id.*, Article 131 (2).

⁵⁰ *id.*, Article 172.

⁵¹ For further discussion of these and other conditions required for the issue of corporate bonds, see, Morphet, Rod, "China's New Company Law", *Butterworths Journal of International Banking and Financial Law*, 1994, Vol. 9, pp. 407-408.

Formalities for Public Offer of Shares. The formalities for the public offer of shares fall into three stages. In the first stage the applicant company engages an accounting firm, an asset valuer, and a law firm to examine and value its assets and financial positions. After this has been properly done, the applicant company can then submit an application for the public issue to relevant government authorities for approval.⁵² Registered accountants and their firms, assets valuers and their firms, and lawyers and their firms examine and verify the applicant company's financial positions in accordance with professional standards and codes of practice. If they are found in breach of their professional standards and codes of practice they may be fined up to Rmb 300,000 and in serious circumstances they may be suspended or banned from the further undertaking of such services.⁵³

The second stage is to seek approval from relevant government authorities. The public issue must be approved by relevant government departments and reviewed by the CSRC. No one is allowed to issue shares to the general public without such an approval.⁵⁴ Depending on its subordinate relationship to relevant government departments, an applicant company submits the application to the local government or the central government which approves the application within 30 days in accordance with certain criteria set out by company regulations and securities regulations, including planning

⁵²Article 12(1), 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares.

⁵³ *id.*, Articles 18, 35. Standards have been set out in the 1993 Provisional Regulations on the Authorization of Accounting Firms and Registered Accountants Engaging in Securities Business, and the 1993 Provisional Regulations on the Authorization of Lawyers and Legal Firms Engaging in Securities Business. For asset valuers, the State Administrative Bureau of the State Owned Assets, in conjunction with the CSRC, has the power to control asset valuers and their firms.

⁵⁴ Article 84(2), 1993 Company Law.

quotas set out by the government. The application is then reviewed by the CSRC whose decision is filed at the SCSC. An approval is granted if the application complies with the requirements of the 1993 Company Law and the 1993 Provisional Regulations on Administration of Issuing and Trading of Shares. Where, after the approval has been granted, it is found that the applicant did not actually conform to the requirements, the approval must be revoked. Under such a circumstance, if the public issue has not started yet, it must not proceed; if it has already started, the subscribers may demand a refund of their subscriptions plus interest from the company.⁵⁵ From the point of view of securities regulation, the review stage carried out by the CSRC is a key stage. In order to improve the review process, a special committee has been set up within the CSRC to be specially responsible for reviewing applications for the public issue of securities, which includes experts, practitioners, and scholars from different sectors.⁵⁶

The third stage is to carry out the public issue itself. After the approval has been granted, the applicant company enters into an underwriting agreement with securities firms to deal with underwriting and placement.⁵⁷ The distribution period shall last no less than 10 days and no more than 90 days and a report on distribution is required to be submitted to the CSRC within 15 days after the distribution period ends.⁵⁸ The applicant company

⁵⁵ *id.*, Article 86(1, 2).

⁵⁶ See a news report about the establishment of this committee in *Renmin Ribao (People's Daily)*, 25 June 1993, p. 2.

⁵⁷ Article 20, 1993 Provisional Regulations on Administration of Issuing and Trading of Shares. The main clauses required for an underwriting agreement include: (i) name and place of the parties and their legal representatives; (ii) distribution method; (iii) distribution period; (iv) class, amount, and issuing price; (v) liability for breach of contract.

⁵⁸ *id.*, Articles 24, 26.

also enters into an agreement with a bank to accept subscriptions on behalf of the company. The bank shall, in accordance with the agreement entered into with the company, accept subscriptions, issue receipts to the subscribers, and provide receipts to relevant authorities if they are required.

Requirements for Prospectus. It is a general requirement that companies have to register their prospectus with the CSRC and disclose information in accordance with the CSRC rules if their shares are to be issued to the general public within China. A prospectus (*zhaogu shu*) must be prepared in accordance with the requirements set out by the CSRC under the 1993 Standards Regarding Content and Format of Prospectus.⁵⁹ A wide range of information⁶⁰ is required to be included in the prospectus, together with the articles of association of the company attached to it. The following statement is required to appear on the cover of a prospectus:

"the issuer warrants that the content of this prospectus is truthful, accurate and complete. No decision of the government and the securities authorities with regard to this issue indicates a substantive judgement or warranty on their part for the value of the shares issued by the issuer".⁶¹

⁵⁹ The 1993 Standards for Disclosure by Companies Issuing Shares to General Public (No.1): Content and Format of Prospectus (for trial use).

⁶⁰ They are: (i) the number of shares subscribed for by the promoters; (ii) the par value of each share and issuing price; (iii) if bearer shares are issued, the total number of shares issued; (iv) the rights and obligations of the subscribers; (v) the date of commencement and termination of the issue and a description of how subscribers may withdraw their subscriptions under the circumstances when issues have not been fully subscribed within the period. (vi) an introduction of the promoters, directors and supervisors of the company; (vii) the purposes of raising fund; (viii) the names of agents and the methods; (ix) a short-term development plan and a profit forecast for the next year verified by registered accountants; (x) information on the business position and the development in the last three years or in the period since its establishment; (xi) the application of the proceeds from previous public issues by the company.

⁶¹ Article 16, 1993 Provisional Regulations on Administration of Issuing and Trading of Shares.

All the promoters and directors of the company, as well as the lead underwriter if there is more than one underwriter, must sign the prospectus to warrant that it contains no false or misleading representation and no material omission of information. They assume joint liability for a misleading prospectus.⁶² The securities firms involved are under an obligation to examine the prospectus before the distribution of shares, and no offer can be made until this has been properly done.⁶³

A prospectus shall be valid for six months; after this period the issue must cease immediately.⁶⁴ A mini prospectus is required to be published in at least one of the national newspapers designated by the CSRC as the authorised newspapers for publishing information related to securities matters. This has to be done within two to five days prior to the commencement of the distribution period and the copies of such mini prospectus must also be made available to subscribers.⁶⁵ Where a false prospectus is found, and a substantial loss occurred, or serious consequences and circumstances are involved, imprisonment for up to five years and a fine up to 5% of the proceeds raised through the issue may be imposed.⁶⁶

Despite the fact that China is still a "socialist country" and its market economic reforms are in progress, there are similarities between China's practice in respect of the

⁶² *id.*, Article 17.

⁶³ *id.*, Article 21.

⁶⁴ *id.*, Article 19.

⁶⁵ *Id.*

⁶⁶ Article 3, 1995 Decision of the National People's Congress on Punishment for Crimes of Violating the Company Law.

law regulating prospectuses and those practices in some countries having a long history with the securities market, such as the items of information required to be put in the prospectus, the format of the prospectus, and the liabilities imposed in the event of a violation of the relevant regulations. In other countries, the law relating to the prospectus or listing particulars is intended to ensure that investors have all the information necessary to make an informed decision about their investments. This is also the case in China. But the regulatory efforts China has made are just a beginning to ensure that investors are able to make informed investment decisions. The regulatory framework created so far relating to the public offering of securities in China is far from being a comprehensive and sophisticated framework when compared to those advanced regulatory regimes in the United Kingdom, the United States, and other western countries. In this sense China needs to catch up in improving its level of investor protection and make sure that investors are well informed and protected at the stage of the public offering of securities.

C. Listing of Securities

A joint stock company may apply to have its securities listed on a stock exchange. This has become a normal practice since the establishment of the Shanghai and Shenzhen stock exchanges in early 1990s. Depending on whether the shares of a company are listed on a stock exchange, joint stock companies are classified into listed companies and unlisted companies. The 1993 Company Law and the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares set out the conditions and procedures for listing domestic investment shares, whereas the conditions and procedures for listing foreign investment shares on the Shanghai and Shenzhen stock exchanges or on a foreign

stock exchange are set out in separate regulations issued in accordance with general provisions of the 1993 Company Law. The following is concerned with the listing of domestic shares. The listing of foreign investment shares is dealt with in Chapter VI.

Conditions for Admission to Listing. To have its shares listed on a stock exchange, a joint stock company must comply with the conditions prescribed by Article 152(1-6) of the 1993 Company Law and Article 30(1-5) of the 1993 Provisional Regulations on Administration of Issuing and Trading of Shares. In accordance with these Articles, an applicant company has to demonstrate that it has been operating for more than three years and has been continuously profitable for the three years prior to the application for listing; it has issued shares to the general public and its total paid-up share capital is not less than Rmb 50 million; at least 25% of the total shares issued are in the hands of general public at the time those shares are admitted to listing and at least 15% are in public hands if the company has registered capital exceeding Rmb 400 million; the number of shareholders holding shares at face value of over Rmb 1,000 is not less than one thousand and the total par value of the shares held by individuals is not less than Rmb 10 million; there are no records of involvement of the company in serious illegal activities during the last three years, and its financial statements contain no false information. Where the company has been transformed, the three year operating period may be traced back without interruption to the operation of the original enterprise; the original enterprise must have been profitable in the three years immediately prior to the application for listing.

Listing Procedures. First, the applicant company has to seek approval from the securities authorities for listing of its shares on a stock exchange, together with relevant

documents for such approval.⁶⁷ Second, the applicant company must submit its application to the listing committee of the stock exchange where it proposes to have its shares listed. The exchange, after receipt of the application, examines it and decides within 20 working days, then filing the decision at the SCSC. If the application is approved, the time for listing shall be arranged. The documents required for submission to the securities authorities and stock exchanges are listed in Article 32 of the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares.⁶⁸ Third, the applicant company has to make a "listing announcement" (*shangshi gonggao*) about its listing to the general public. This is required by the 1993 Company Law and the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares. Article 153(3) of the 1993 Company Law stipulates that once a listing application has been approved, the company shall publicly announce its listing and place its application documents in a designated place for public review. The designated place may include the stock exchange, the premises of the company, and the agents who are involved in the company's listing. Under Article 34 of the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares, the "listing announcement" must contain several items of information, including certain items contained in the company's prospectus.⁶⁹ Under the CSRC rules,

⁶⁷ Article 153, 1993 Company Law.

⁶⁸ They include: (i) the application; (ii) the decision for listing by the general meeting of shareholders; (iii) articles of association; (iv) the registration document of the company; (v) the documents approving public issue of shares; (vi) the financial reports of the company for the last three years or for the period since its establishment, audited by an accounting firm, and an audit report signed and sealed by two or more registered accountants and their firm; (vii) a written recommendation from a member of the stock exchange; (viii) a most recent prospectus.

⁶⁹ They are: (i) the date of approval of trading and the series number of the approval document; (ii) the details of share issue, including the names and shareholdings of ten largest shareholders; (iii) the

a summary of the "listing announcement" is required to be published in at least one national newspaper within three days before the listing date.

In order to improve overall quality of listed companies a six-month "cushion period" (*fudaoqi*) both before and after listing has been established.⁷⁰ The purpose 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. To solve this problem the CSRC issued a notice containing guidelines for the examination and approval of securities firms acting as "coaches".⁷¹ The notice stressed that all securities firms acting as "coaches" must have certain years of experience as underwriters, and individual brokers must have recognised qualifications. These guidelines, to a certain degree, provide a safeguard against the poor quality of securities firms acting as coaches.

resolution of the promoters' meeting or shareholders's general meeting approving the trading of the shares on a stock exchange; (iv) the resumes of directors, supervisors and senior staff of the company and their holdings of shares of the company; (v) the information on the business results and financial position of the company for the last three years or for the period since its establishment; (vi) a profit forecast for the next year.

⁷⁰ See a news report about the introduction of this practice, *Fazhi Ribao (Legal Daily)*, 16 May 1994, p. 1.

⁷¹ The Notice on Examination of Qualifications of Listing Instructors and Related Issues (Guanyu Shangshi Fudao Jigou Zige Shencha ji Youguan Wenti de Tongzhi), CSRC, 18 July 1994.

However, it would be wrong to assume that once the system has been improved and listed companies have been properly coached the quality would be enhanced and listing requirements observed. In reality, the key problem is not that listed companies lack knowledge of the law and requirements for listing, but that they do not comply with them even when they are aware of them. The "coaching" system has certainly helped listed companies raise the awareness of relevant legal knowledge and listing requirements, but what also should be emphasised is listed companies to follow these requirements.

In August 1996 the SCSC brought into force new rules⁷² which require stock exchanges to establish a recommendation system under which listed companies have to be recommended by sponsors before their shares come to the market. This is to ensure that listed companies guided by the sponsors meet the listing requirements and fulfil continuing obligations once they have been listed on the market. In view of the importance of the high quality of listed companies, the recommendation system is a necessary measure to improve the overall quality of listed companies.

D. Dispute Resolution

The provisions contained in the securities regulation relating to dispute resolution generally apply to all kinds of disputes which arise in the public offering of securities and in the trading of securities. The following discussion is therefore concerned not only with the disputes in the primary securities market, but also with those in the secondary securities market.

⁷² Measures on the Administration of Stock Exchanges, promulgated in August 1996, repealed the Provisional Measures on the Administration of Stock Exchanges, 7 July 1993.

Dispute Resolution Provisions under 1993 Provisional Regulations on Administration of Issuing and Trading of Shares. Chapter Eight of the Provisional Regulations on Administration of Issuing and Trading of Shares 1993 deals with the resolution of disputes arising in the course of issuing and trading securities. It is a brief chapter containing two articles, namely, Article 79 and Article 80. To resolve a dispute through arbitration is the main theme of these two Articles. Article 79 provides that the parties to a dispute involving the issuing and trading of shares *may (keyi)* apply to an arbitration body for mediation or for arbitration in accordance with their agreement. Article 80 specifically provides that disputes between securities firms or between securities firms and stock exchanges involving the issuing and trading of shares *shall (yingdang)* be resolved through mediation or arbitration by an arbitration body. Articles 79 and 80 require that the arbitration body be designated by the SCSC or otherwise set up with the approval of the SCSC.

In 1994 the SCSC formally designated the China International Economic and Trade Arbitration Commission (CIETAC)⁷³ as the authorized arbitration body to deal with disputes arising in the course of the issuing and trading of securities.⁷⁴ The CSRC later issued a notice to clarify issues regarding the arbitration of securities disputes.⁷⁵ It

⁷³ The CIETAC, established in the 1960s, has been the central arbitration body to deal specially with disputes in relation to foreign trade and investments.

⁷⁴ The Notice of the SCSC on the Designation of the China International Economic and Trade Arbitration Commission as Arbitration Institution for Resolution of Disputes Related to Securities, 26 August 1994.

⁷⁵ See a news report of the CSRC's notice, *Fazhi Ribao (Legal Daily)*, 22 October 1994, p. 2.

reiterated that disputes involving the issuing and trading of shares⁷⁶ between securities firms or between securities firms and stock exchanges must be resolved by the CIETAC. This position is in line with the distinction made under Articles 79 and 80 of the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares. As far as disputes other than those between securities firms or between securities firms and stock exchanges are concerned, parties may choose the CIETAC as a forum to settle their disputes through arbitration.

The notice also required that there should be an arbitration agreement or a clause in a contract entered into between securities firms or between securities firms and stock exchanges regarding the issuing and trading of shares. If there is no such an agreement or a clause in their contract, they should agree between themselves after a dispute arises. It expressly requires that the arbitration agreement or clause be in the following terms:

"the disputes in relation to the contract, upon a failure of consultation between the parties, shall be submitted to the CIETAC in Beijing for an arbitration in accordance with general arbitration rules as well as specific rules regarding disputes involving securities. The arbitral award shall be final and the parties shall be bound by it."

Articles 79 and 80 and the notices of the SCSC and the CSRC encourage the settlement of disputes through mediation or arbitration, Chinese traditionally preferred methods of dispute resolution. The 1993 Securities Law (draft) also promoted arbitration as the preferred method to resolve disputes involving the issuing and trading of securities and to this end it proposed to set up a special Securities Arbitration Commission

⁷⁶ Although the notice refers to "shares" rather than "securities", it is assumed that it also applies to other types of securities since it is concerned with Articles 79 and 80 of the 1993 Provisional Regulations on Administration of Issuing and Trading of Shares 1993 which, by Article 2, apply not only to shares but also to other types of securities.

(*zhengquanye zhongcai weiyuanhui*) to deal with disputes between securities firms and between securities firms and their clients.⁷⁷ This proposal was not, however, adopted in the 1994 Securities Law (draft), although the 1994 Draft followed the line of the 1993 Draft to promote arbitration as a preferred method for dispute resolution.⁷⁸ Whether or not to set up the Securities Arbitration Commission will depend mainly upon how the advantages and disadvantages of having a Securities Arbitration Commission are balanced. Professionalism is certainly one of the advantages the Securities Arbitration Commission could bring, but on the other hand, such disadvantages as additional costs have to be carefully considered. The 1998 Securities Law of the PRC does not adopt the Securities Arbitration Commission proposed by the 1993 Draft. It sets out instead that the China Securities Association has a function to mediate in the event of disputes between members or between members and their clients.⁷⁹

Disputes Involving Administrative or Regulatory Authorities. Another category of dispute involving the issuing and trading of securities may arise between applicant companies who apply for an issue or listing of securities and the government authorities who have the power to approve such applications. This is dealt with in the 1993 Company Law. Article 227 stipulates that where a government department responsible for the examination and approval of the issuing and listing of company securities refuses to approve an application which has met the conditions prescribed under the 1993 Company

⁷⁷ Article 147.

⁷⁸ Articles 185-187.

⁷⁹ Article 164(5), 1998 Securities Law of the PRC.

Law and other relevant securities regulations, the party concerned may either request a review of the approval decision or start administrative litigation. The same procedure applies when the company registration authority refuses to register an applicant company which has met the necessary requirements. There is no mandatory requirement that a party to these disputes should first seek an administrative review before commencing administrative litigation. It is up to the party concerned to decide whether to go through an administrative review process or to start an administrative litigation proceeding at once.

Dispute Resolution Involving Foreign Parties. Foreign shareholders in Chinese companies may exercise rights or start arbitration or litigation in accordance with the articles of association of the company concerned. Disputes involving foreign parties may be resolved either through courts or arbitration bodies, depending upon whether the provisions in the articles of association of the company concerned specify an appropriate forum for dispute resolution. Thus, under the 1994 Special Provisions by the State Council on Share Issue and Listing Abroad by Joint Stock Companies, disputes arising between foreign shareholders and the company, between foreign shareholders and directors, supervisors and managers of the company, and between foreign shareholders and domestic shareholders of the company regarding matters contained in the articles of association of the company or other matters of the company are to be resolved in accordance with the methods of dispute resolution stipulated in the articles of association of the company.⁸⁰ The applicable law is Chinese law.⁸¹

⁸⁰ Article 29 (i), 1994 Special Provisions by the State Council on Share Issue and Listing Abroad by Joint Stock Companies.

⁸¹ *id.*, Article 29 (ii).

Chinese companies listed in Hong Kong, for example, normally have a compulsory arbitration clause in their articles of association which provides that disputes arising between (i) foreign shareholders and the company; (ii) foreign shareholders and the company's directors, supervisors, managers or other senior management personnel; or (iii) foreign shareholders and domestic shareholders regarding the company's business and its rights and obligations as stated in the articles of association of the company shall be submitted, at the claimant's choice, to arbitration at either the Hong Kong International Arbitration Centre or the CIETAC in China. The arbitration award made by either arbitration body is final.

The forum for dispute resolution is an important factor which affects the confidence of foreign investors in Chinese companies and is thus an area of major concern to foreign investors. The willingness of foreign investors to invest in Chinese listed companies either through domestically-listed B-share or through overseas-listed various shares will depend to a certain extent on the effectiveness of dispute resolution. The people's courts in China are often viewed by foreign investors as being not totally independent from the influence of the government. Foreign investors justifiably worry that disputes may be dealt with by the people's courts under the influence of government officials or even corruption. To establish a truly independent judiciary influenced by no one but the law still has some way to go, which depends on further political and legal reforms in China. The CIETAC has earned a reputation for fairness, independence and incorruptibility, as well as an adequate degree of sophistication in dealing with disputes involving foreign parties. This is a comfort to foreign investors in Chinese companies and their confidence could be enhanced by the referral of disputes to the CIETAC.

Chapter V

Regulation of Secondary Securities Market

The regulation of China's secondary securities market dates from the 1980s, when securities trading centres were set up throughout the country and securities trading commenced. The establishment of the Shanghai and Shenzhen stock exchanges in early 1990s marked a new stage in the development of the regulation of the secondary securities market in China. It has been established as a basic principle that the public trading of securities must be conducted in a securities exchange officially established for the purpose of securities trading.¹ The 1993 Company Law and the drafts of the Securities Law of the PRC both reiterated this principle on a statutory basis.² The basic regulatory framework for the public trading of securities is set out in the 1993 Provisional Regulations on the Administration of Issuance and Trading of Shares and related implementing rules and

¹ Article 29, 1993 Provisional Regulations on Administration of Issuing and Trading of Shares.

² Article 144, 1993 Company Law; Article 32, 1993 Securities Law (draft); Article 17, 1994 Securities Law (draft).

regulations. It covers, among other issues, information disclosure by listed companies, the continuing obligations imposed upon listed companies or individual members of listed companies, takeovers of listed companies, and the prevention of various frauds in the market. Since the establishment of the SCSC and the CSRC, various rules have been issued by them covering aspects of the secondary securities market. After several major scandals occurred during the past few years in the Shanghai and Shenzhen stock exchanges, there has been a shift of regulatory powers from local stock exchanges to the SCSC and the CSRC as part of the government's move to strengthen its control over stock exchanges and bring order to the secondary securities market.

A. Disclosure by Listed Companies

Disclosure requirements imposed on listed companies are a central part of a regulatory regime designed to regulate continuing obligations of listed companies after they have been admitted to listing. The 1993 Company Law stipulates that a listed company shall regularly disclose its financial and business situation to the public in compliance with relevant laws and administrative regulations.³ Specifically, it requires that a listed company must publish a financial accounting report (*caiwu kuaiji baogao*) every half year.⁴ The 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares sets out more comprehensive requirements for listed companies to publish

³ Article 156.

⁴ *Id.*

interim reports, annual reports, and sensitive price information.⁵ In accordance with these general provisions, the CSRC issued implementing rules setting out the content and formats for regarding interim reports, annual reports, and certain other documents to be disclosed to the general public by listed companies.⁶

Interim and Annual Reports. A listed company is required to submit to the CSRC and the stock exchange where it is listed an interim report (*zhongqi baogao*) within 60 days after the end of the first six months of each fiscal year.⁷ The interim report must contain, among other things, a financial report of the company, an analysis of the company's financial and business results, information about any significant litigation involving the company, and information about any changes to the shares of the company.⁸ An annual report (*nianzhong baogao*) is to be submitted to the CSRC and the stock exchange within 120 days after the end of each fiscal year.⁹ It has to be audited by a

⁵ Articles 57-67.

⁶ These rules are: 1993 Standards for Disclosure by Companies Issuing Shares to General Public No. 1: Content and Format of Prospectus (for trial use); 1994 Standards for Disclosure by Companies Issuing Shares to General Public No. 2: Content and Format of Annual Report (for trial use); 1994 Standards for Disclosure by Companies Issuing Shares to General Public No. 3: Content and Format of Interim Report (for trial use); 1994 Standards for Disclosure by Companies Issuing Shares to General Public No. 4: Content and Format of Prospectus for Rights Issue (for trial use); 1994 Standards for Disclosure by Companies Issuing Shares to General Public No. 5: Content and Format of Reports in Respect of Company Shares (for trial use); 1994 Standards for Disclosure by Companies Issuing Shares to General Public No. 6 (part one): Content and Format of Legal Opinion and Lawyers' Work Report (for trial use); 1994 Standards for Disclosure by Companies Issuing Shares to General Public No. 6 (part two): Explanation and Sample of Content and Format of Legal Opinion on Rights Issue by Listed Companies (for trial use). For a brief summary in English of these Standards, see China Law & Practice, 1995 Vol. 9 No. 1, pp. 8-10.

⁷ Article 57, 1993 Provisional Regulations on Administration of Issuing and Trading of Shares.

⁸ *id.*, Article 58.

⁹ *id.*, Article 57 (2).

registered accountant and contain a wide range of information regarding the company.¹⁰ In addition, to comply with the requirements prescribed by the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares, both interim and annual reports have to satisfy the detailed rules issued by the CSRC regarding their content and format.¹¹ the Shanghai and Shenzhen stock exchanges may require listed companies to provide further information in their annual reports.¹²

Interim and annual reports are the most important documents that a listed company is required to publish in accordance with the Company Law and securities regulations. Both interim and annual reports are to be signed by an authorized director or manager of the company and sealed by the company. The reports must be made available to the public for inspection at the company's office, the stock exchange where the company is listed, and the premises of the securities firms which provide services for the company's

¹⁰ *id.*, Article 59. They are: (i) a summary of the company; (ii) a brief description of the company's main products or main services; (iii) a brief description of the industry in which the company is engaged; (iv) a brief description of important assets owned by the company, such as factories, mines and real properties; (v) information on shares of the company, including a list of shareholders holding 5% or more of the company's shares, a list of the ten largest shareholders, and the number of shareholders of the company; (vi) a brief description of the directors, supervisors and senior staff of the company, their shareholdings and their remunerations; (vii) a table and a brief description of affiliates of the company; (viii) an abstract of financial information regarding the company for the last three years or for the period since its establishment; (ix) an analysis of the company's financial position and business results; (x) information on the fluctuation of debentures of the company; (xi) matters concerning major litigation involving the company; (xii) a comparative financial report on the company for the last two years, together with attached tables and notes, audited by a registered accountant; if the listed company is a holding company, a comparative consolidated financial report for the last.

¹¹ 1994 Standards for Disclosure by Companies Issuing Shares to General Public No. 2: Content and Format of Annual Report (for trial use); 1994 Standards for Disclosure by Companies Issuing Shares to General Public No. 3: Content and Format of Interim Report (for trial use).

¹² For example, the Shanghai Stock Exchange requires listed companies to provide details of rights and bonus issues and any other developments which have affected share capital. Furthermore, when an auditor has expressed reservations about a company's annual report, that company must provide details about the measures it took to resolve the problem.

listing. A summary of the interim and annual reports is required under the implementing rules of the CSRC to be published by the company in at least one of the national newspapers designated by the CSRC as the authorized newspapers to publish information concerning the securities market.

Price Sensitive Information. A listed company is required to disclose to the public any "major event" (*zhongda shijian*) which may have a material effect on the price of the shares of the company.¹³ The term "major event" is broadly defined as an event which may affect the market price of the company's shares and is not yet known by general public.¹⁴ For the purpose of this requirement, a list of "major events" is prescribed under Article 60 of the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares.¹⁵ It is required that, upon the occurrence of these major events, a listed company is under an obligation to report promptly to the CSRC and the stock exchange about the events and to disclose their nature to the general public.¹⁶

A listed company is also required to clarify publicly any media report concerning the company which is misleading and might reasonably be expected to affect its share

¹³ Article 60, 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares.

¹⁴ *Id.*

¹⁵ They are: (i) the signing of an important contract that would have material impact on the assets, liabilities or results of the company; (ii) material change in the company's operating policy or business; (iii) major investments or the purchase of high-value, long-term investments; (iv) significant liabilities; (v) the failure to repay any major debt when it becomes due; (vi) major operating or non-operating losses; (vii) a material loss of assets; (viii) a material change in the company's operating environment; (ix) a significant impact on the company's operation resulting from new laws, regulations, policies or rules; (x) a change of chairman of the board of directors, the general manager or over 30% of the directors; (xi) the shareholding of any shareholders who already holds 5% or more of the total issued common shares of the company changes by 2%; (xii) major litigation involving the company; (xiii) and the entering into of liquidation or bankruptcy proceedings.

¹⁶ Article 60, 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares.

price. When such a media report appears and the company believes that it would affect its share price, the company has to clarify it promptly.¹⁷ This requirement has now been further standardized by the notice "Several Problems Concerning the Release of a Clarification Notice by Listed Companies" issued by the CSRC in December 1996.¹⁸

Enforcement of Disclosure Requirements. If a listed company fails to comply with the disclosure rules prescribed by the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares, it would face tough penalties, ranging from fines to cancellation of the listing qualification, depending on the seriousness of the case.¹⁹ In October 1993 Shenzhen Bao An (Holdings) Shanghai Co. Ltd, a listed company on the Shanghai Stock Exchange, was fined Rmb 1 million by the CSRC for a violation of Article 47 of the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares, under which an obligation to report to securities authorities arises when a company's holding of the ordinary shares of a listed company reaches 5% of the total shares of that company.²⁰

Where the reports submitted to the shareholders and the general public by a listed company contain false financial accounting facts, the responsible person in charge of the company and other responsible person directly involved are subject to a fine between Rmb

¹⁷ *id.*, Article 61.

¹⁸ For a summary of this notice, see *China Law & Practice*, June 1997, p. 14.

¹⁹ *id.*, Article 74 (8).

²⁰ *Re Shenzhen Bao An (Holdings) Shanghai Co. Ltd* [1993] CSRC. The case was reported in *Renmin Ribao (People's Daily)*, 23 October 1993, p. 2.

50,000 and 100,000.²¹ Under Article 4 of the Decision of the National People's Congress on Punishment for Crimes of Violating the Company Law, if false financial and accounting reports are disclosed to the shareholders and the general public, the responsible person and any other person directly involved may be subject to imprisonment for up to three years and may additionally be fined up to Rmb 200,000, depending on the seriousness of the case. The same applies where important facts have been knowingly omitted in the financial or accounting reports to the shareholders and the general public. Articles 158-169 of the amended Criminal Law of the PRC have codified the substance of the Decisions of the National People's Congress on Punishment for Crimes of Violating the Company Law.²² As far as company reports are concerned, if a false report is made to the shareholders and the general public, the management personnel of the company who are directly responsible and other personnel directly involved may be subject to a fine or a sentence of up to seven years in serious cases. From all these provisions and rules one can see that the approach taken by the legislative authorities and securities regulators is to enforce disclosure requirements by employing severe punishments. In addition, a more positive approach has been taken to improve the implementation of the disclosure rules. The practice has thus been established whereby all the listed companies are required to set up permanent staff within the company to deal specifically with matters concerning information disclosure. The responsibilities undertaken by such permanent staff include to co-ordinate between the company and the securities authorities, the stock exchanges,

²¹ Article 212, 1993 Company Law.

²² Amendments to the Criminal Law of the PRC, promulgated on 14 March 1997 and effective from 1 October 1997.

and the media. The advantage of this practice is that the specially appointed person would be able to deal with information disclosure more quickly and efficiently and the responsibility would be clearer when things go wrong. In 1997 another positive measure was taken when the CSRC announced that an annual inspection would be carried out to check information disclosure procedures of listed companies. This will no doubt improve the implementation of disclosure rules by listed companies.²³

"Merit Approach" and "Disclosure Approach". One view put forward from a comparative perspective was that China has adopted a "merit approach" rather than a "disclosure approach".²⁴ This view took into consideration the relative dearth of information available to investors, the extensive scrutiny of new issues by the securities authorities, and the background in which the disclosure regime had developed in China. It argued that the merit approach China has adopted was based on its own circumstances and was an inevitable result of the following conditions: China does not yet have a large group of trained financial analysts; Chinese investors generally lack the knowledge and experience necessary to make a disclosure system work; and more importantly, the government authorities have been playing a dominant role in the centrally planned economy and this role is will continue in the foreseeable future even though China has embarked on a transition from a controlled planned economy to a more relaxed market economy. These arguments, though they were put forward in the late 1980s and thus represented a view based upon what had happened then about China's emerging securities

²³ For the brief report about this announcement, see *China Economic Review* (1997) Vol. 7, No. 2, p.14.

²⁴ Stamas, Nikos A. "China's Nascent Securities Market: Some Observations", in R.H. Folsom and J.H.Minan (eds), *Law in the People's Republic of China*, (Dordrecht: Kluwer Academic Publishers, 1989) pp. 639-642.

regulatory system, nevertheless reflect the true picture of China's present disclosure regime and the conditions on which that regime is based. Following the logic of these arguments, whether China could move from the current stage of the disclosure regime towards a full disclosure approach would depend not only on regulatory improvement itself but also, and more crucially, on further economic and social changes that economic reforms would bring about in the future.

Although there is recognition of the importance of information disclosure, and indeed efforts have been made to raise the appropriate standards of the disclosure regime close to common international practice, the transparency of Chinese listed companies still remains low by international practice and standards. One problem is that the information about Chinese listed companies available publicly to investors is still less than the information available in western countries about their listed companies. A more difficult task facing the Chinese securities regulator is how to implement effectively the disclosure requirements. According to a report released by the CSRC in July 1994, the first of its kind regarding the publication of annual reports by listed companies,²⁵ of 183 companies which had been listed on the Shanghai and Shenzhen stock exchanges by the end of 1993, all had published an abstract of 1993 annual report by the end of June 1994. There were, however, 14 companies which did not submit their annual reports to the CSRC and another 34 companies which only submitted abstracts of annual reports instead of the full annual reports required by the CSRC. There were also other irregularities, such as the omission of required information in their reports. One comment made by the CSRC report

²⁵ See for a summary of the report, *Renmin Ribao (People's Daily)*, 19 July 1994, p. 2.

was that these listed companies did not take publishing interim and annual reports very seriously. From a comparative perspective, Chinese companies, when compared with their counterparts in western countries, tend to treat information concerning their companies as their own private matter even if they have become public companies. These traditional influences may have contributed to the difficulties China is facing in its efforts to develop a comprehensive and effective disclosure regime. It is expected that in line with further changes of the social and economic environment in China and with further improvements of the regulatory regime, Chinese listed companies will gradually get used to the way in which a modern company should disclose information.

Since 1992 there has been steady progress in the improvement of disclosure standards, especially when the CSRC issued implementing rules to standardize the content and formats of interim and annual reports, prospectuses, and other documents required to be published for the general public by companies when issuing and listing shares publicly.²⁶ This was an attempt of the CSRC to follow the general practices of other countries to raise disclosure standards in China. However, an effective disclosure regime depends not only on whether there are disclosure standards to follow, but more importantly, as the discussion above shows, on whether there are effective measures to ensure these standards are followed properly. The system established by the CSRC so far, such as the system of special permanent staff in listed companies to be responsible for disclosure matters, is improving compliance with disclosure standards by listed companies.

²⁶ For a full list of these rules, see *supra* note 5 of this Chapter.

B. Other Aspects of Continuing Obligations

Apart from disclosure requirements, listed companies and their directors, supervisors, and other senior personnel are subject to other continuing obligations once their shares are listed on stock exchanges. Those who provide professional services to listed companies are also subject to certain obligations in respect of the company shares which have been listed with their help. Companies whose shares have been issued to the general public but not yet been listed on a stock exchange are likewise subject to the continuing obligations applicable to listed companies.²⁷

Purchase of Own Shares by Listed Companies. Article 149 (1) of the 1993 Company Law stipulates that a joint stock company may not purchase its own shares except where the shares need to be cancelled for the purpose of reducing capital, or where the company merges with another company which holds shares in the company. If a company has purchased its own shares as a result of either reducing its capital or merging with another company, it must register the changes of its share capital and cancel the shares purchased within ten days, and make a public announcement thereafter.²⁸ Pursuant to the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares, the purchase of own shares by a listed company requires the prior approval of the CSRC.²⁹ If the shareholding of an individual person exceed 0.5% of a listed company, the excess amount may be purchased by the company at the lower of the original purchase

²⁷ Article 67, 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares.

²⁸ *id.*, Article 149 (2).

²⁹ *id.*, Article 41.

price or the market price after having obtained the prior approval of the CSRC.³⁰ But if the individual's shareholding has become 0.5% or more as a result of the reduction in the company's total amount of outstanding shares, the excess amount may not be purchased by the company within a reasonable period of time.³¹

On 1 August 1994, Shandong Bohai, a listed company on the Shanghai Stock Exchange, caused its A-share price on the Shanghai Stock Exchange to soar 102% during the course of the day. It did so by repeated trading and false purchases and sales through four individual accounts which did not involve the transfer of ownership of shares. Subsequently, from 1 to 31 August, the company used about Rmb 19.9 million of its own funds to purchase 3,981,200 of own shares. Following an investigation, the CSRC announced that Shandong Bohai's dealing contravened Article 149 of the 1993 Company Law on the grounds that the purchase dealing did not comply with the circumstances prescribed by the provision, namely, when cancelling shares in order to effect a capital reduction or when merging with a company which holds its shares. It also violated Article 41 of the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares since it did not obtain the prior approval of the CSRC. The company was fined by the CSRC Rmb 1m and the senior officer who was directly responsible for the trading was fined Rmb 50,000. In addition, the illegal gain of Rmb 5.9m by the company was confiscated.³² This is one of the reported cases investigated by the CSRC and the stock

³⁰ *id.*, Article 46.

³¹ *Id.*

³² For a summary of the case in English, see "Securities Fraud in the PRC: Case Digest", *China Law & Practice*, 1995, Vol. 9, No. 3, p. 21.

exchange concerned which shows the operation in practice of the statutory and regulatory rules relating to the purchase of own shares by listed companies.

Rights Issue by Listed Companies. In 1996 the CSRC issued a circular to tighten control over rights issues by listed companies as a result of irregularities which happened when listed companies conducted their rights issues.³³ It set out more stringent rules regarding the conditions to be met for a rights issue, the procedure for information disclosure both before and after the offering of rights issues, the amount of shares to be placed with shareholders, and the application of the proceeds of a rights issue. All listed companies which intended to offer a rights issue to their shareholders were urged to comply with these rules and put forward their applications to the regulators accordingly. They were also urged to follow the standard format for documents prescribed by the CSRC regarding rights issues by listed companies³⁴ and comply with the requirements for the submission of relevant documents for the approval of applications.³⁵

Directors, Supervisors and Senior Personnel. Article 147(2) of the 1993 Company Law stipulates that directors, supervisors, and the general manager shall declare their holdings of company shares to the company and not transfer such shares during their term of office. Article 62 of the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares further requires that the directors, supervisors, and senior personnel of a listed company who have holdings of company shares are under an obligation to

³³ Circular of the CSRC on Rights Issues in the Year 1996 by Listed Companies, 24 January 1996.

³⁴ Standard Format of Documents for Renew of Rights Issue by Listed Companies, 3 November 1994. For a brief summary, see *China Law & Practice*, No. 1, 1995, p. 10.

³⁵ The documents required include among others: application, decision of shareholders' meeting, a feasibility report on the use of proceeds raised, a rights issue prospectus.

report the details of their holdings to the CSRC, the stock exchange where the company is listed, and the company itself. If any change occurs in their holdings, they are required to report such within 10 days from the date of the change. They continue to be under this obligation for six months after they retire from or leave office.³⁶ If directors, supervisors and senior personnel make any profit by selling shares within six months of purchasing them or from buying shares within six months of a previous sale, they are required to return the profit to the company.³⁷ Under Article 37 of the 1993 Provisional Measures on the Administration of Stock Exchanges, stock exchanges have an obligation to keep records of shareholdings by directors, supervisors and senior personnel of a listed company and supervise share movements. This position remained the same under the amended 1996 Measures on the Administration of Stock Exchanges.

Restrictions on Share Dealing. Under the the Provisional Regulations on Administration of Issuing and Trading of Shares, certain persons are restricted from purchasing, holding, or selling shares. These restricted persons include accountants, asset valuers, and lawyers who are engaged in the assessment, evaluation, and verification of a particular share issue or a listing on a stock exchange. If they are providing services in relation to a particular share issue, they are not allowed to purchase or hold such shares during the underwriting period and for six months thereafter;³⁸ If they are providing services for a proposed listing, they are not allowed to purchase the shares of the company

³⁶ Article 62(2), 1993 Provisional Regulations on Administration of Issuing and Trading of Shares.

³⁷ *id.*, Article 38.

³⁸ *id.*, Article 40 (1).

before the document which they are preparing becomes public and for five days thereafter.³⁹ The same would apply to those who are involved in the production of other documents for a proposed listing, such as the auditor report or asset appraisals, in that they are prohibited from purchasing shares of the company prior to the release of the documents. Anyone who violates these provisions will be ordered to sell their shareholding and be subject to a caution, confiscation of illegal gains, and a fine between Rmb 5,000 and 50,000 pursuant to the 1993 Provisional Regulations on the Administration of Issuing and Trading of Share.⁴⁰

Suspension and Cancellation of Listing. Pursuant to Article 157 of the 1993 Company Law, suspension of a listing could be imposed by the securities authorities if (i) the share structure of a company has been changed so as to make the company fall short of the requirements necessary for listing; (ii) the company has failed to make public disclosure about its financial situation in compliance with the listing rules or has falsified financial accounting reports; (iii) the company is involved in illegal activities; (iv) the company incurs losses over the last three years. If the consequences of (ii) or (iii) above are serious, or the occurrence of (i) or (iv) has not been rectified within a time limit, cancellation of the listing would be imposed.⁴¹ A listing may also be cancelled when the company is dissolved, or the company is closed down by the authorities, or is declared bankrupt.⁴² Stock exchanges may make decisions on suspension, reinstatement, and

³⁹ *id.*, Article 40(2).

⁴⁰ *id.*, Article 72.

⁴¹ Article 158(1), 1993 Company Law.

⁴² *id.*, 158(2).

cancellation in accordance with their listing rules and the listing agreements between the stock exchange and the company, or in accordance with a request from the CSRC. Suspension and cancellation of a listing is an effective measure to deter listed companies from violating listing rules and disclosure procedures, but it is normally a last resort when other alternative measures could not rectify the circumstances.

C. Takeovers of Listed Companies

There is an emerging trend in China that takeovers of listed companies are used more and more frequently to restructure companies and enhance the efficiency of the company. The existing law in relation to takeovers of listed companies is contained in the 1993 Company Law and the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares.⁴³ While the 1993 Company Law contains general principles for mergers and divisions of companies, the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares provide more specific rules regarding takeovers of listed companies. Together they are the regulatory framework for takeovers of listed companies in China.

Thresholds for Takeovers of Listed Companies. No individual person may hold more than 0.5% of the issued ordinary shares of a listed company. Any shareholding above this limit will be repurchased by the company at the lower of the original purchase price and the market price after having obtained the prior approval of the CSRC.

⁴³ Chapter VII, 1993 Company Law of the PRC: "Merger and Division", including Articles 182-188; Chapter IV, 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares: "Takeovers of Listed Companies", including Articles 46-52.

However, if an individual's holding of such shares has become 0.5% or more as a result of a reduction in the company's total outstanding ordinary shares, the excess holding may not be repurchased back by the company within a reasonable period of time. As an exception to this 0.5% limit rule, it does not apply to foreign investors, including investors from Hong Kong, Macao, and Taiwan, who hold B-shares listed on the Shanghai and Shenzhen stock exchanges and other foreign investment shares of Chinese companies listed on foreign stock exchanges outside China.⁴⁴

Any legal person whose shareholding of a listed company reaches 5% of the issued ordinary shares of the company is required to report its holdings in writing to the company, the stock exchange where the company is listed, and the CSRC, and make a public announcement within three working days of the acquisition.⁴⁵ The same procedure must be followed if a legal person holds 5% or more of the issued ordinary shares of a listed company, and such holding has increased or decreased by a further acquisition or sale, which constitutes 2% of the total issued ordinary shares of the listed company.⁴⁶ In either of these circumstances a legal person is prohibited from further purchasing or selling the company's shares within two working days after the report and public announcement are made.⁴⁷ As in the case of an individual person's holding, if a legal person's holdings of the issued ordinary shares of a listed company exceed more than 5%

⁴⁴ Article 46(2), 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares.

⁴⁵ *id.*, Article 47(1).

⁴⁶ *id.*, Article 47(2).

⁴⁷ *id.*, Article 47(3).

of the issued capital of that company due to a reduction in the issued share capital of the company, it may not be subject to this provision.⁴⁸

If a legal person's acquisition of the issued ordinary share of a listed company reaches 30% of that company's total outstanding ordinary shares, it must make an offer to all the shareholders of that company within 45 days of its holding having reached 30% to take over their shares through cash payment at either the highest price actually paid by the legal person in acquiring such shares in the open market during the 12 months preceding the issue of the takeover offer or the average market price of such shares during the last 30 working days before the issue of the takeover offer.⁴⁹ The tender offer is valid for 30 days calculated from the date of issue of the offer and cannot be withdrawn until the end of the valid period.⁵⁰ Once such a 30% threshold is triggered, the offeror may not further purchase any shares in the company. In other words, it may not purchase more than 30% of the company's total outstanding ordinary shares prior to the issue of a takeover offer.⁵¹

At the end of the offer period, the offeror must acquire more than 50% of the total outstanding ordinary shares of the targeted company under the takeover offer. If the offeror fails to acquire more than 50% of the issued outstanding ordinary shares in the targeted company, the tender offer will be regarded as a failure.⁵² Thereafter, unless the

⁴⁸ *id.*, Article 47(1).

⁴⁹ *id.*, Article 48(1).

⁵⁰ *id.*, Article 49(2).

⁵¹ *id.*, Article 48(2).

⁵² *id.*, Article 51.

offeror issues a new takeover offer, the number of the company's share the offeror may purchase each year may not exceed 5% of the company's total outstanding ordinary shares.⁵³

If the offeror is able to acquire 75% or more of the outstanding ordinary shares of the targeted company at the end of the offer period, the company may no longer publicly trade its shares and will be de-listed from the stock exchange.⁵⁴ Should the offeror hold 90% or more of the total amount of the company's shares at the end of the offer period, all remaining shareholders will have the right to compel the offeror to make a compulsory purchase of their shares on the same terms and conditions as the tender offer.⁵⁵

Reporting Obligations. Pursuant to Article 47 of the 1993 Provisional Regulations on Administration of Issuing and Trading of Shares, a legal person is under an obligation to report to the CSRC, the stock exchange, and the company about its position after it has acquired 5% of the issued ordinary shares of a listed company. A reporting obligation arises again when a legal person's acquisition of the issued ordinary shares of a listed company reaches 30% of that company's total outstanding ordinary shares. Prior to the issue of a takeover offer, the legal person must submit a written report about the proposed takeover to the CSRC and provide detailed information about the company and its proposed takeover offer.⁵⁶ The offeror is further required to warrant that the information

⁵³ *id.*, Article 51.

⁵⁴ *id.*, Article 51.

⁵⁵ *id.*, Article 59.

⁵⁶ *id.*, Article 49.

so provided is truthful, accurate, and complete.

Shenzhen Bao'An (Holdings) Shanghai Co. Ltd, a company based in Shenzhen city, was the first company in China to be fined by the CSRC for its violation of Article 47 of the 1993 Provisional Regulations on Administration of Issuing and Trading of Shares. It was the first case involving an attempted takeover of a listed company since the establishment of the Shanghai Stock Exchange. The takeover failed after the company drove up the share price of Yanzhong Industry, its targeted company, by a wave of speculative purchasing. What was noteworthy about this case was the violation of the reporting obligation under the takeover rules. It did not report its position in Yanzhong Industry after it had acquired over 5% of Yanzhong Industry shares. The company was subsequently punished severely by the CSRC.⁵⁷

D. Maintaining Integrity of Securities Trading Market

To fight against insider dealing, price manipulation, concealment of information, and other illegal market abuses in order to ensure a fair and clean securities trading market is essential for maintenance of the integrity of the securities trading market and the protection of investors. Stock exchanges worldwide all experienced, to a greater or lesser degree, the damage these market abuses could cause to market participants and public investors at large. After the 1930s, when the United States established a statutory framework to strengthen control over securities trading and protect investors, stock exchanges worldwide tended to follow the United States by regulating securities trading

⁵⁷ *Re Shenzhen Bao An (Holdings) Shanghai Co. Ltd* [1993] CSRC. The case was reported in *Renmin Ribao (People's Daily)*, 23 October 1993, p. 2.

more tightly in their fight against various market abuses. This is a common concern facing securities regulators worldwide. It is therefore not surprising that the task of fighting against securities market abuses is at the top of the agenda of the Chinese securities regulator. After the establishment of the Shanghai and Shenzhen stock exchanges, a series of regulations have been promulgated to strengthen the regulation of securities trading. In 1993 the Provisional Measures on the Prohibition of Securities Fraud were promulgated to establish a framework to deal with insider dealing and market manipulation. In addition, other regulations deal with various kinds of securities frauds and market abuses.

Insider Dealing. One major concern that securities regulators and investors have for China's securities market is the issue of insider dealing. The Shanghai regulations promulgated in late 1980s and early 1990s addressed this issue by prohibiting people in certain positions from trading shares, including personnel of the local PBOC, managerial personnel of the stock exchange, employees of the securities firms directly involved in the issuing or listing of shares, and employees of the government agencies who regulate or control the issuers.⁵⁸ The Shenzhen regulations later extended the scope of the prohibitions to "all cadres of the Communist Party and the government departments, and military servicemen."⁵⁹ The purpose of this extension was obvious: to prevent the Party and government officials from abusing their official positions by involving themselves in insider dealing. Apart from the early Shanghai and Shenzhen local regulations, insider dealing rules were also found in the rulebooks of stock exchanges. Article 205 of the 1991

⁵⁸ Article 40(1)-(4), 1990 Measures of Shanghai Municipality on the Administration of Securities Trading.

⁵⁹ Article 29 (iii), 1991 Provisional Measures of Shenzhen Municipality on Administration of Issuing and Trading of Shares.

Rules of the Shenzhen Stock Exchange, for example, prohibited employees of listed companies from trading securities of the company within one month prior to the release of interim or annual reports.

The 1993 Provisional Measures on the Prohibition of Securities Fraud was the first national securities regulation promulgated by central government securities regulators to deal with securities fraud. Its main purpose was to set out the regulatory framework to deal with insider trading. Article 3 states that any institution or individual is prohibited from using inside information to carry out activities of the issuing or trading of securities in order to make gains or reduce losses. "Inside information" (*neimu xinxi*) is defined by Article 5 to mean any unpublished important information which may affect stock market prices and which is known to insiders. A detailed list of such important information is provided by Article 5, including, among others, important contracts, information about issuer debts, major changes to issuer business, major changes to issuer senior personnel, etc.⁶⁰ "Insiders" (*neimu renruan*) is defined as any person who is able to have access to or to obtain inside information by virtue of their holding of the issuer's shares or the office of director, supervisor, or senior management member of the issuer or of a company closely associated with the issuer, or by virtue of their position or status as a member of an association, an official, a supervisor or a professional, or by virtue of the exercise of their duties as an employee or a professional consultant.⁶¹ It is a definition

⁶⁰ Twenty-six headings of information are listed altogether. See, Article 5 (1-26), the 1993 Provisional Measures on the Prohibition of Securities Fraud.

⁶¹ *id.*, Article 6 (1-5) lists persons who are defined as insiders, including among others directors, supervisors, and managers of the issuer; lawyers, accountants, asset valuers, and other professionals who are able to have access to or to obtain insider information; journalist, editors, and the like who are able to have access to or to obtain relevant information, etc.

covering a wide range of relevant persons. "Insider dealing" (*nemu jiaoyi*), by definition, includes not only dealings by insiders themselves, but also dealings by others procured by insiders.⁶²

Punishment for insider dealing is severe. Pursuant to Article 72 of the 1993 Provisional Regulations on the Administration of Issuing and Trading of Shares, penalties range from, depending on the circumstances, confiscation of illegally gained shares and other illegal gains to a fine of from Rmb 50,000 to Rmb 500,000 for insiders who violate insider dealing rules and any other person who obtains inside information by improper means and deals in shares on the basis of such information or procures others to carry out such dealings. The 1993 Provisional Measures on the Prohibition of Securities Fraud further provides that in addition to the confiscation of illegally gained shares and other illegal gains and a fine between Rmb 50,000 and 500,000, insiders and any other persons who violate the insider dealing rules shall be dealt with in accordance with other relevant laws and regulations.⁶³ Article 180 of the 1997 Criminal Law of the PRC (as amended) now provides that where the circumstances are serious, insiders shall be sentenced to a fixed term of imprisonment for up to five years or to criminal detention, and/or a fine of not less than one time nor more than five times the illegal gains. If the circumstances are exceptionally serious, such person shall be sentenced to a fixed term of imprisonment of not less than five years and not more than ten years, and a fine of not less than one time and not more than five times the illegal gains. As far as issuers are concerned, if they are

⁶² *id.*, Article 4 (1-4).

⁶³ Articles 13 (1), (2).

found to have violated insider dealing rules, they will be subject to one or more penalties, including confiscation of illegally gained funds, fine, suspension or cancellation of qualification for issuing or listing securities.⁶⁴

Market Manipulation. Article 7 of the 1993 Provisional Measures on the Prohibition of Securities Fraud prohibit any institution or individual from manipulating securities markets, influencing market prices, creating false markets, and inducing or causing investors to make investment decisions when they are unaware of the true prevailing situation. The first two cases connected with a violation of Article 7 of the 1993 Provisional Measures on the Prohibition of Securities Fraud illustrated that heavy penalties could be imposed by the CSRC to punish market manipulation. The first was the Shandong Bohai Holdings Co. Ltd. case. The Shandong Bohai Holdings Company, a listed company based in Shandong province, caused the price of its A-share on the Shanghai Stock Exchange to rise 102% higher than the previous trading day on 1 August 1994 by "repeated trading and false purchase and sales not involving the transfer of the ownership of shares". Shandong Bohai Holding Company was subsequently fined by the CSRC Rmb 1 million and its illegal profits of Rmb 5.9m were confiscated. In addition, a fine of Rmb 50,000 was imposed on the responsible officer.⁶⁵

The second was J&A case. J&A Securities Shenzhen Development Centre (J&A) conducted trading in Xiamen Haifa A-shares on 18 October 1994 on the Shenzhen Stock Exchange, causing the price of the Xiamen Haifa A-shares to rocket 157% during the

⁶⁴ Article 14, 1993 Provisional Measures on the Prohibition of Securities Fraud.

⁶⁵ Reported in Chinese in *Jingji Ribao (Economic Daily)*, 12 January 1995, p. 6. For a summary of the case in English, see "Case Digest: Securities Fraud in the PRC", *China Law and Practice*, 1995, Vol. 9, No. 3, p. 21.

course of the day. On the following day J&A sold its Xiamen Haifa A-shares and A-share warrants for a profit of Rmb 2.4million. The CSRC confiscated its illegal profits and fined the company Rmb 1 million and the responsible officer Rmb 30,000.⁶⁶

The reports of these two cases in Chinese newspapers focused upon the role of the CSRC in supervising and regulating the securities trading market. There was no comment on the responsibility of the Shanghai and Shenzhen stock exchanges when the companies manipulated the price of the share concerned. It was regarded by commentators as "disturbing" to discover that there was not a sufficient regulatory mechanism in place in the Shanghai and Shenzhen stock exchanges to prevent the occurrence of market manipulation capable of increasing share prices by 102% or 157% during the course of one day.⁶⁷

The Shanghai Stock Exchange was later blamed for the lack of an adequate supervisory mechanism in place to prevent the occurrence of market manipulation when a major scandal involving market manipulation came to light in the Shanghai Stock Exchange during February 1995. Shanghai Wanguo International Securities, the second largest securities firm in China, wilfully violated trading rules by rigging prices and manipulating the treasury bond futures market when it sold treasury bond futures on a large scale to cover positions in excess of permitted limits. The market was later closed

⁶⁶ Reported in Chinese in *Jingji Ribao (Economic Daily)*, 12 January 1995, p .6. For a summary of the case in English see "Case Digest: Securities Fraud in the PRC" in *China Law & Practice*, 1995, Vol. 9, No. 3, p. 21.

⁶⁷ See "Case Digest: Securities Fraud in the PRC" by Philip Gregory, *China Law & Practice*, 1995, Vol. 9, No. 3, pp. 21-22.

by the government authorities.⁶⁸ Mr Guan Jinsheng, the head of Shanghai Wanguo International Securities, resigned after the scandal. He was later charged with bribery of Rmb 294.000 and misappropriation of Rmb 2.4 million of public funds between 1992 and 1994 and sentenced 17 years imprisonment by the Shanghai First Intermediate People's Court.

In order to prevent the occurrence of market manipulation, the CSRC issued the Circular on the Prohibition of Acts of Manipulating Securities Market in October 1996, which reinstated the regulatory position regarding market manipulation established under the 1993 Provisional Measures on the Prohibition of Securities Fraud. Any institution or individual was strictly prohibited from manipulating the market by means of their advantage in capital or information in order to gain profits or reduce losses. In the meantime the PBOC issued the Circular on the Prohibition of Banking Capital Flowing Illegally into the Share Market, which warned that from 1 October 1997 any serious acts, such as manipulation of securities prices by financial institutions, which disrupted financial order would be punished in accordance with the amended 1997 Criminal Law of the PRC. These documents issued by the CSRC and PBOC enhanced the framework established under the 1993 Provisional Measures on the Prohibition of Securities Fraud and thus strengthened the prevention of market manipulation.

Speculation on Securities Market. Speculation on the securities market is also of great concern. During past few years, there has been growing worry on the part of the

⁶⁸ There was wide coverage of this case in both Chinese and English sources. For the case in English, see "China Blames Two Firms for Bonds Scandal", *Financial Times*, 22 September 1995, p.5; "China Plans to Resume Bond Futures Trading", *Financial Times*, 24 April 1996, p. 26.

central government about speculative activities on the securities market. Measures were taken by the CSRC, the PBOC, and other government regulators to tighten control over the securities market. In September 1996 the CSRC suspended trading of some shares which showed unreasonable fluctuations when many securities firms and subsidiaries of main state banks were bidding for share issues and using borrowed funds in such bidding, a practice prohibited by the securities regulations. In the biggest case of wrongdoing by securities firms in the history of China's securities market, twenty-eight firms were punished for their speculative activities. The Huayin Trust and Investment Co., which used a Rmb 2.2bn credit to bid for shares, was fined by the CSRC. Other firms were either fined or were ordered to undergo reorganisation.

Not only securities firms were involved in such speculative activities. State-owned enterprises and listed companies were also involved. This prompted the SCSC in May 1997, in conjunction with the PBOC and other regulators, to issue the Provisions on Strict Prohibition of Speculation in Shares by State-owned Enterprises and Listed Companies, which prohibit state-owned enterprises and listed companies from speculating in shares or providing funds to others for such speculation.⁶⁹ Where they were found engaged in speculation, the persons in charge of the state-owned enterprises or listed companies and persons with direct responsibilities would be dismissed subject to other relevant penalties. The SCSC Provisions were immediately implemented by the Shanghai and Shenzhen stock exchanges. In a Circular issued on 23 May 1997 the Shenzhen Stock Exchange called on its listed companies to check whether they had opened any account in an individual's

⁶⁹ See the report in *Fazhi Ribao (Legal Daily)*, 22 May 1997, p. 2.

name or whether they had provided capital for any speculation in shares. Likewise, state banks were not allowed to become involved in speculation on the securities market by channelling bank funds into securities. The Industrial and Commercial Bank of China was punished after it was found to have provided overdrafts to several securities firms.⁷⁰

One problem is that the term "speculative activities" and "speculation" have not been clearly defined by the securities regulations. Therefore there is no clarity as to what kind of activities should be classified as speculative. This is particularly so with regard to the foreign exchange and futures market, where there is a variety of derivative products. Securities firms dealing in foreign exchange, for example, are generally allowed to enter into derivative transactions, whether involving Rmb or otherwise, for genuine hedging purposes, but they are not allowed to enter into such transactions for speculative purposes. It is difficult, without clear and definite regulatory provisions, to distinguish transactions for genuine hedging purposes and transactions for speculative purposes on the basis of business activities of the firm as set out in its articles of association and authorised by its business licence and the contemplated foreign exchange transaction. Without a solid legal or regulatory definition of "speculative activities" and "speculation", supplemented by further detailed interpretation, there is always a danger that the restrictions on speculation may be over-extended, and activities classified as speculative should have not been so classified.

Prohibition Against Entering Securities Market. In March 1997 the CSRC promulgated the Temporary Provisions on Prohibition Against Entering the Securities

⁷⁰ See the report in *China Economic Review*, 1997, Vol. 7, No. 7, p. 14.

Markets, which marked an important step forward in regulating the secondary securities markets in China. The Temporary Provisions define the "prohibition against entering the securities market" (*jinzhi rushi*) as a ban on certain people against entering the securities market either temporarily or permanently.

Senior management personnel of listed companies, for example, could be banned from entering the securities markets if they use improper means to gain permission to issue or list securities, commit insider dealing, manipulate the market, and use company funds to trade in the company's own securities.⁷¹ They could also be prohibited from holding any senior management post in any listed company or organisation engaged in the securities business for from three to ten years from the day they are banned against entering securities market. In serious cases they could be permanently prohibited from engaging in the securities business.⁷² The Shenzhen Development Bank, a listed bank, was ordered to return Rmb 90m as illegal profit and sell the holding of its own shares after it was found guilty of trading Rmb 311m of its own shares. The company's chairman was banned from entering the securities market for five years.⁷³

To Strengthen Control over Stock Exchanges. To strengthen control over stock exchanges is regarded by the government as vital to ensure the integrity of the securities market. Measures were thus taken by the central government regulator to strengthen the Shanghai and Shenzhen stock exchanges. The first was the promulgation of the 1995

⁷¹ Article 4, 1997 Temporary Provisions on Prohibition from Entering Securities Markets 1997.

⁷² *id.*, Article 6.

⁷³ See the report on this case in *China Economic Review*, 1997, Vol. 7, No. 7, p. 14.

Provisions on the Administration of Stock Exchanges, which stipulate in detail stock exchange supervision and administration over securities trading activities. First, stock exchanges are responsible for discovering, prohibiting, and reporting to higher authorities any act in relation to securities trading that violates relevant laws, regulations, and policies of the government, and second, stock exchanges are responsible for dealing with such violations within the scope of their powers. Stock exchanges are required to conduct inspections on an annual or regular basis to check the financial situation of their members, the system of risk control, and whether relevant laws, regulations, and rules of the stock exchanges are being followed.

Measures were also taken by the CSRC to tighten direct control over the stock exchanges. This included, first, replacing the president and vice-president of the two stock exchanges with persons directly appointed by the CSRC, and second, transferring to the CSRC some of the regulatory powers previously exercised by Shanghai and Shenzhen local regulators. The intention of this centralization was to tighten central government control over the two stock exchanges, strengthen their management, and prevent abuse of the market. But, on the other hand, the consequence of this centralization meant a closer involvement of the central government regulator in the day-to-day running of the Shanghai and Shenzhen stock exchanges and thus raised the question of greater governmental direct intervention in the securities market. It demonstrated the concern of the central government about the securities market and its determination that the securities market should be run properly and market abuses and frauds should be controlled effectively. One reason behind such concern and determination was obviously the possibility that scandals in the securities market could have a profound impact on social and political stability,

always a paramount concern of the central government.

Chapter VI

Regulation of Foreign Participation in China's Securities Market

Before the emergence of the securities market during the late 1980s in China, the choices for foreign investors to invest in China were generally limited to equity joint ventures, co-operative joint ventures, and wholly foreign-owned enterprises. Together they were referred to as "foreign investment enterprises"(FIEs). The securities market in China has opened a new dimension for foreign investment as Chinese companies started to issue B-shares to foreign investors inside China and to issue and list their shares on foreign stock exchanges.¹ Today foreign investors are increasingly interested in investing in Chinese listed companies and more listed companies are expected to become open to foreign investors with the further development of China's securities market. The rationale behind the policy to allow foreign investors participate in China's securities market is

¹ According to the figure given in a speech by the former Chairman of the CSRC, Mr Zhou Dajiong, by the end of September 1996, 82 Chinese companies had issued B-shares to foreign investors, raising \$2.8bn; 24 companies had been listed outside China, attracting capital of \$4.4bn. See the report by Tony Walker, *Financial Times*, 8 October 1996.

consistent with China's general open-door policy to attract foreign investments as part of China's economic development.

A. Regulation of Domestically-Listed Foreign Investment Shares

The regulatory regime of domestically-listed foreign investment shares was initially established in Shanghai and Shenzhen respectively in 1991.² At that time they were referred to as Renminbi Special Shares (*renminbi tezhong gupiao*), or more commonly as B-Shares (*B gu*). The national regulatory framework for domestically-listed foreign investment shares was established by the Regulations on Listing of Foreign Investment Shares Inside China by Joint Stock Companies, promulgated in 1995 by the State Council³ (hereinafter: B-share Regulations). They repealed the Shanghai and Shenzhen regulations and by implication their respective implementing rules and ancillary regulations, such as those governing the registration of B-shares. The terms "B-share" or "Renminbi Special Share" were formally changed into "domestically-listed foreign investment share" (*jingnei shangshi waizi gu*) (for convenience, hereinafter still referred to as B-share). In May 1996, some five months after the promulgation of the B-share Regulations, the SCSC issued the Implementing Rules for the B-share Regulations (hereinafter: B-share Implementing Rules), which took effect retrospectively from the same date as the B-share Regulations.

² 1991 Measures of Shanghai Municipality on Administration of Renminbi Special Shares and 1991 Provisional Measures of Shenzhen Municipality on Administration of Renminbi Special Shares, both of which were promulgated jointly by the People's Bank of China and the Shanghai and Shenzhen Municipal People's Government.

³ It was promulgated on, and in effect from, 25 December 1995. The regulations were formulated by the State Council pursuant to Article 135 of the 1993 Company Law of the PRC, which empowered the State Council to enact separate regulations governing the classes of shares other than domestic A-shares. For the full text in both Chinese and English, see *China Law & Practice*, 1996, No. 3.

The B-share Regulations, together with B-share Implementing Rules, formed the first comprehensive national regulatory framework governing the B-share market.

Legal Nature of B-share. B-shares are specially designed for foreign investors parallel to A-share, which is only for domestic investors. B-shares are registered shares with their par value in Chinese currency to be subscribed for and traded in foreign currency. In terms of the legal rights they confer on holders, B-shares are equal to domestic A-shares regarding the same class of shares. Thus, except for the status of the holders and for currency in which B-shares are subscribed for and traded and in which dividends are paid, B-shares carry the same rights as domestic A-shares in respect of dividends and voting rights. The holders of B-share enjoy these rights in the same way as holders of domestic A-share in accordance with the 1993 Company Law. The term "foreign investors" is defined by Article 4 of the B-share Regulations, which stipulates that a B-share may only be subscribed for or traded by foreign investors who must be: (i) natural persons, legal persons and other organisations from foreign countries; (ii) natural persons, legal persons and other organisations from Hong Kong, Macao and Taiwan; (iii) PRC citizens who are resident overseas; and (iv) such other investors as may be authorised by the securities authorities of the State Council. This definition is wider than the definitions in the previous Shanghai and Shenzhen regulations, which did not include category (iii) as one category of permitted investors.⁴ The significance of this wider definition is two fold: it enlarges the pool of permitted investors for the B-share market;

⁴ Article 14, 1991 Measures of Shanghai Municipality on Administration of Renminbi Special Shares and Article 2, 1991 Provisional Measures of Shenzhen Municipality on Administration of Renminbi Special Shares.

it is a step forward, though a minor step, towards merging the B-share and domestic A-share markets.

Regulatory Authorities. Until the promulgation of the B-share Regulations, the regulatory and supervisory functions regarding the B-share market were performed by the Shanghai and Shenzhen securities authorities in conjunction with the Shanghai and Shenzhen branches of the PBOC and the two stock exchanges. The B-share Regulations changed this arrangement by establishing that the SCSC and the CSRC were responsible for the regulation and supervision of the B-share market, including B-share issues, trading, and related activities. Furthermore, Article 47 of the B-share Implementing Rules delegated to the CSRC powers to adopt specific regulations to implement B-share Regulations for the regulation and supervision of the B-share market. The transfer of regulatory responsibility for the B-share market from Shanghai and Shenzhen local securities authorities to the SCSC and the CSRC was a significant step towards creating a unified B-share market together with a strong central regulatory regime to oversee it. Apart from the authorities of the SCSC and the CSRC, the State Administration of Foreign Exchange (SAFE) could become involved in matters relating to foreign exchange in B-share transactions.

Basic Conditions for B-share Issue. In order to issue B-shares, an applicant company has to satisfy the following conditions prescribed by the B-share Regulations, including among others: (i) that relevant government departments have authorised its establishment as or restructuring as a joint stock company; (ii) its business operations comply with the industrial policies of the State; (iii) it has a sound financial business record and was profitable during the three years prior to the application; (iv) the total

shares subscribed by promoters may not be less than 35% of the total shares the company proposed to issue, and the shares issued to the public must be more than 25% of the company's total share capital; (v) where the applicant company has previously issued B-shares, all the shares issued previously must be fully paid up and the use of the proceeds must be consistent with the purposes originally stated.⁵

A central theme running throughout the B-share Regulations is to strengthen control over B-share issues by the central government. Hence, any B-share issue must obtain approval from the SCSC and, where the par value of the shares proposed to be issued exceeds US\$ 30m, the SCSC refers it to the State Council for final approval. In the same way as the previous Shanghai and Shenzhen Measures, the B-share Regulations prescribe a list of documents that must be submitted by companies when they apply for a B-share issue, including, among others, the feasibility study, prospectus, underwriting agreements and plans, financial statements, asset appraisals, and legal opinions.⁶ Article 18 also requires that the applicant company has to appoint a Chinese securities firm to be the lead underwriter or to be one of them if there is more than one underwriter.

Articles of Association. Article 6 of B-share Regulations provides that the articles of association of B-share companies have a binding force on the company, shareholders, directors, supervisors, managers and other senior management personnel. This is an application of the principle stated in Article 11 of the 1993 Company Law, which recognises on a statutory basis the binding force of the articles of association of

⁵ These and other conditions are set out in Articles 8 and 9, 1995 Regulations on Listing of Foreign Investment Shares Inside China by Joint Stock Companies.

⁶ These and other documents are listed in Articles 11 and 12, 1995 Regulations on Listing of Foreign Investment Shares Inside China by Joint Stock Companies.

companies. The adoption of articles of association by B-share companies has to comply with the procedures provided by Article 73 of the 1993 Company Law regarding the adoption of articles of association by joint stock companies. Joint stock companies adopt articles of association at a shareholders' meeting. In general, articles of association of a joint stock company comprise both imperative and discretionary items. Imperative items are prescribed by the 1993 Company Law, whereas discretionary items may be stipulated by the shareholders' meeting of the company. In accordance with the B-share Regulations, discretionary items can be included in B-share company articles of association dealing with certain special matters in respect of shareholder rights or obligations.⁷ This effectively allows B-share companies to put in their articles certain provisions which facilitate the exercise of rights by holders of B-shares. One example is that B-share holders may receive individual notice of a shareholder meeting by post or by other means of communication in addition to the general notice in the form of public announcements.

Director and Senior Personnel Fiduciary Duties. Article 6 of the B-share Regulations provides that directors, supervisors, managers and other senior management personnel of a B-share company have the duty of good faith and diligence towards the company. This is in effect the application of certain general provisions of the 1993 Company Law, which sets out fiduciary duties for directors, supervisors, and managers of companies.⁸ Additionally, Article 6 of the B-share Regulations extends the category of persons who owe fiduciary duties to the company to members of its senior management,

⁷ Article 5, 1995 Regulations on Listing of Foreign Investment Shares Inside China by Joint Stock Companies.

⁸ Articles 59 to 63, 1993 Company Law.

including the principal financial officers, secretary to the board of directors, and such other persons as are specified in the company articles of association. This extension of the category of persons who owe fiduciary duties to the company may give foreign holders of B-shares additional confidence in the day-to-day management of the companies in which they have invested.

Requirements for Information Disclosure. The general requirement is that information relating to the company must be disclosed to the general public in compliance with relevant laws and regulations and with the disclosure requirements of the relevant stock exchange on which the company is listed.⁹ Article 37 of the B-share Implementing Rules further requires that a B-share company which is to issue both B-shares and domestic A-shares shall disclose information simultaneously to both domestic and foreign investors, and the content of the information so disclosed shall be essentially the same both within and outside China. Documents for information disclosure are prepared in Chinese, and in the event of any inconsistency between the Chinese language and the foreign language translation, the Chinese version shall prevail.¹⁰ If, in addition to the interim or annual reports prepared in Chinese and based on Chinese accounting standards, the company also prepared adjusted financial statements which were based on international accounting standards or other foreign accounting standards, an explanation of any material discrepancies between the two sets of accounts must be given.¹¹ These

⁹ Article 34, 1996 B-share Implementing Rules.

¹⁰ Article 17, 1995 Regulations on Listing of Foreign Investment Shares Inside China by Joint Stock Companies.

¹¹ Article 36, 1996 B-share Implementing Rules.

requirements for information disclosure by B-share companies are closer to the practical reality of B-share companies and in this sense try to ensure the fair and adequate disclosure of information to B-share investors.

It is commonly suggested by analysts that one important reason for the poor performance of the B-share market is the lack of timely information about listed companies. It happened before that some companies did not even properly issue prospectuses to foreign investors. One example is the Shanghai Vacuum Electronic Device, the first state-owned enterprise listed on the Shanghai B-share market.¹² Another practice has caused problems is dual languages and dual accounting standards. In 1993 the results of a B-share company were published in Chinese accounting style and in the Chinese language a week before the English version was compiled according to international accounting standards, which presented a serious problem for foreign analysts.¹³ In order to improve the B-share market, the government tried several times to adopt plans to expand the size of B-share market. For example, in 1994 the number of new B-share companies listed on the two stock exchanges was expanded to almost as twice the number as the previous year. But expansion of the size of the B-share market could not solve the problems relating to the B-share market. It was therefore urged by analysts that a better solution was to increase market transparency by raising the standards of information disclosure and accounting principles. The current national regulatory framework for B-shares in this respect represents an attempt to bring Chinese law and

¹² For the background of the company and comments on its irregularities, see Horvat, Andrew, "Real Estate Madness," *Euromoney*, October 1994, p. 16.

¹³ See "Good Results, Political Action Lift China Shares", a report by Zhang Tingting, *Financial Times Weekend*, 28/29 August 1993.

practice closer to international standards in order to solve the problems relating to transparency and accounting principles.

B. Overseas Listing of Chinese companies

Along with the creation of the B-share market, China began to experiment with the direct overseas listing of large and medium sized state-owned enterprises in 1993. The first international stock market China chose for such direct listing was the Hong Kong stock market. In July 1993 the Qingdao Brewery Company which produces famous Chinese Qingdao beer, became the first state-owned enterprise to be listed on the Stock Exchange of Hong Kong. It was followed by eight others during 1994. In light of the successful Hong Kong experience, the scale of overseas listing was expanded, and other international stock markets were explored. In August 1994 the Shandong Huaneng Electricity Company launched the first share issue on the New York Stock Exchange; In March 1997 Datong Electric Power became the first Chinese company to be listed on the London Stock Exchange. To facilitate and regulate the direct overseas listing of these companies, the State Council, in accordance with Articles 85 and 155 of the 1993 Company Law,¹⁴ promulgated Special Provisions on Share Issue and Listing Abroad by Companies Limited by Shares, which became effective from 4 August 1994 (hereinafter the Overseas Listing Provisions). Together with the 1993 Company Law, the Overseas Listing Provisions have provided a national regulatory framework for direct overseas issue

¹⁴ Article 85 provides that a joint stock company may offer its shares to the general public outside the mainland of China upon the approval by the securities authority of the State Council, whereas Article 155 provides that shares of a joint stock company may be traded on a stock exchange outside the mainland of China upon the approval by the securities authority of the State Council. The State Council is empowered by these two Articles to formulate special rules and measures to govern these matters.

and listing of shares by Chinese companies.

Legal Nature of Shares Listed Overseas. Shares of Chinese companies issued and listed outside the territory of China are registered shares with their par value in Chinese currency. They are to be bought and sold with foreign currencies.¹⁵ This is essentially the same as the domestically-listed B-shares. Similarly, dividends and other payments made by Chinese companies to foreign shareholders are priced and announced in Chinese currency but paid in foreign currencies.¹⁶ The matters concerning foreign exchange are governed by Chinese laws and regulations on foreign exchange.¹⁷ The register of shareholders may be placed abroad under the custody of an agent in accordance with the memorandum or agreement reached between the Chinese and foreign securities authorities.¹⁸ If share certificates are lost, shareholders may apply for a replacement in accordance with the regulations or stock exchange rules of the place where the register of shareholders is held.¹⁹ As far as shareholder rights are concerned, they are the same as those enjoyed by domestic A-share holders in respect of same class of shares. Article 16 of the Overseas Listing Provisions also provides that a beneficial owner may have his shares registered in the name of a nominee in accordance with the laws of the place where the register of shares is held.

¹⁵ Article 3, 1994 Special Provisions on Share Issue and Listing Abroad by Companies Limited by Shares.

¹⁶ *id.*, Article 27.

¹⁷ *id.*, Article 27.

¹⁸ *id.*, Article 17.

¹⁹ *id.*, Article 19.

Regulatory Authorities. The regulatory authorities for direct overseas listing are the SCSC and the CSRC. While the SCSC is primarily concerned with general policy matters and approving applications by companies, the CSRC is responsible for routine regulatory and supervisory matters. Article 4 of the Overseas Listing Provisions provide that either the SCSC or the CSRC may conclude a memorandum of understanding or agreements with foreign securities regulatory authorities to co-operate in regulatory matters regarding the issue and listing of Chinese companies. In practice all the memorandums and agreements reached with foreign securities regulatory authorities have been signed by the CSRC. After the first memorandum was signed with the Hong Kong securities authorities in 1993, the CSRC has signed such memorandums and agreements with a number of foreign securities regulatory authorities. Relevant government departments, such as the department in charge of the registration of companies, also may become involved in regulatory matters regarding overseas direct listing.

Approval and Selection Procedures for Application. Any company wishing to offer and list shares abroad must first obtain the approval of the SCSC. The approval process involves an assessment of various matters, including among others the ability of the issuer to generate sufficient foreign exchange to pay dividends to its overseas holders. Once the approval is granted, the application may be implemented within fifteen months from the date of the approval, and the board of directors of the applicant company may make a detailed arrangement as to how the application is implemented.²⁰ Where the applicant company applies to increase share capital, the time may be less than twelve months from

²⁰ *id.*, Article 8.

the last issue.²¹ This contrasts with domestic share issues, where it is required that the interval between the last issue and the current application for increasing share capital has to exceed twelve months.

In addition to the requirements of the Overseas Listing Provisions, applicant companies have to comply with the requirements of the foreign stock exchanges where they are wish to be listed. These standards are high. There must be an adequate operational record of at least three years under substantially the same management; a full prospectus containing an independent accountant's report prepared meet foreign stock exchange accounting standards; a listing agreement with the Exchange; the market must be kept promptly informed; and a sufficient quantity of shares in public hand must be maintained.²² This is where the weaknesses of Chinese securities regulatory standards are revealed and the frailties of Chinese companies in complying with regulatory standards are scrutinized. On the other hand, it is a process of learning common international regulatory standards by Chinese companies and Chinese securities regulators.

Articles of Association. Article 15 of the Overseas Listing Provisions provides that the articles of association of overseas listed Chinese companies have binding force on the company, shareholders, directors, supervisors, managers, and other senior management personnel. This is the same as in the case of the B-share Regulations and, also, an

²¹ *id.*, Article 10.

²² For more details regarding the procedures and requirements for Chinese companies to be listed on the Hong Kong Stock Exchange, see John Holmes, "Hong Kong: Report," *Butterworths Journal of International Banking and Financial Law*, 1993, Vol. 8, No. 8, pp. 400-402; on the procedures and requirements for Chinese companies to be listed on the New York Stock Exchanges, see Spencer, Lee B. and others "From Shenyang to Wall Street." *The China Business Review*, May-June, 1993, pp. 44-46.

application of the general principle stated in Article 11 of the 1993 Company Law. One difference between the B-share Regulations and the Overseas Listing Provisions regarding articles of association is that the Overseas Listing Provisions require the articles of association of applicant companies to include imperative provisions devised specially for the purpose of offering and listing shares abroad by Chinese companies. For this purpose the SCSC, in conjunction with the Commission for Restructuring the Economic System, issued the Obligatory Provisions for the Articles of Association of Companies to be Listed outside the PRC (hereinafter: Mandatory Provisions) in August 1994,²³ based on an earlier version of mandatory provisions for the articles of association devised specially for companies seeking a listing on the Hong Kong Stock Exchange. Pursuant to the Mandatory Provisions, companies seeking an overseas listing must insert in their articles of association imperative provisions and may not change or delete them.

Duties of Directors, Supervisors, and Senior Personnel. Directors, supervisors, managers and other senior management personnel of companies seeking an overseas listing are under a duty to show good faith and diligence to the company.²⁴ This too is the same position as in the B-share Regulations. The interpretation of "other senior

²³ A total of 166 articles is divided into 21 chapters: 1. general provisions; 2. business objectives and scope; 3. shares and registered capital; 4. reduction of capital and buy-back of shares; 5. financing the purchase of company shares; 6. share certificates and shareholder register; 7. rights and obligations of a shareholder; 8. shareholder general meetings; 9. special voting procedures for different shareholders of different classes; 10. board of directors; 11. secretary to company's board of directors; 12. company managers; 13. board of supervisors; 14. qualifications and obligations of company directors; supervisors, managers and other senior managerial personnel; 15. financial and accounting system and distribution of profits; 16. appointment of accountant firm; 17. merger and division of company; 18. dissolution and liquidation of company; 19. procedures for amending the articles of association; 20. settlement of disputes; and 21. supplementary provisions. For the whole document in both Chinese and English, see *China Law & Practice*, May 1995, Vol. 9, No. 4, pp. 19-59, together with editor's notes at pp. 60-64.

²⁴ Article 23, 1994 Special Provisions on Share Issue and Listing Abroad by Companies Limited by Shares.

management personnel" is likewise the same as that in the B-share Regulations, including the secretary to the board of directors, person in charge of company finance, and other persons specified in the articles of association of the company.²⁵ There are similar but more extensive provisions in the Mandatory Provisions which define the scope of the fiduciary duties of the directors and other senior management personnel, such as the duty to act in the company's best interests, not to make gains in their private interest by taking advantage of their positions and powers, and to ensure fair and equal treatment to and among shareholders. To adopt these standard duties, familiar to western investors in the form of mandatory provisions inserted in company articles of association, is one of the significant steps China has made in its effort to bring securities law and regulations closer to international standards.

Dual Disclosure Rules. If a company has its shares listed on both domestic and foreign stock exchanges, it is subject to a dual disclosure rule which requires the company to announce its interim and annual reports to both domestic investors and overseas investors simultaneously. The information disclosed within mainland China and the information disclosed abroad must not be inconsistent with one another.²⁶ Where, in compliance with the requirements of domestic or foreign laws, regulations, and rules of stock exchanges, there are differences as to the information to be disclosed within and outside mainland China, the company is required to disclose such differences at the same

²⁵ *id.*, Article 15.

²⁶ *id.*, Article 28(1).

time to the different stock exchanges concerned.²⁷ The financial statements must be audited in accordance with international accounting standard acceptable to the relevant foreign stock exchanges where the company is listed. Like the situation in B-share market, one problem facing overseas listed shares is disclosure. Qingdao Brewery company, the first overseas listing of a mainland Chinese company, was more than 100 times oversubscribed at the time when it was listed in Hong Kong. However, investors became disillusioned when they found that financial transparency in the Qingdao Brewery company was not what they expected. Moreover, it was later discovered that the funds raised through its flotation had been used to support other enterprises willing to pay high rates of interest instead of being used for expansion of the company as originally stated in the prospectus.²⁸ Similar problems existed in other Chinese overseas listed companies.

Offering of Overseas Convertible Company Bonds. A recent development in overseas listing is the issuance of overseas convertible bonds. The first overseas convertible bond issue by the Zhenhai Refining and Chemical company in eastern China was listed on the London Stock Exchange in December 1996. The issue was equity related and could be converted into the company's H shares listed on the Hong Kong Stock Exchange. Designed mainly for institutional investors, the bonds were denominated as U.S. dollar and took the form of convertible Eurobonds. Following the Zhenhai Refinery and Chemical Company, a number of companies were granted approval to issue similar convertible bonds in Hong Kong and Luxembourg. In 1997 the State Council promulgated

²⁷ *id.*, Article 28(2).

²⁸ For these and other examples, see, "H-share Recovers Credibility", a report in *Euroweek*, May 1997, p. 16.

the Provisional Procedures for the Administration of Convertible Company Bonds, which became effective on 25 March 1997. Although the Provisional Procedures were applicable only to companies which issued convertible bonds within China, they provided a framework to which reference could be made when considering regulatory matters of overseas convertible bonds. One of the general principles established by the Provisional Procedures was that holders of convertible corporate bonds had no shareholder rights and obligations until such bonds were converted into shares. Presumably this principle would apply equally to overseas convertible corporate bonds.²⁹ Other principles included that the convertible bond could be assigned, pledged or inherited.³⁰

C. Access of Foreign Securities Firms to China's Securities Market

Foreign securities firms came to China one after another to set up offices and to carry on the permitted range of investment business. Most took the view that China could become a huge capital market in the next century and thus justified their move to China in the long term. Barings plc, the former British investment bank, became the first European investment banking group to open an office in Shanghai in 1993. They were followed by other international investment banks. In 1994 Morgan Stanley opened its representative offices in Beijing and Shanghai, and in 1995 it joined with the China Construction Bank to set up the China International Capital Corporation, the first joint venture investment bank. Since then it has undertaken a wide range of investment banking

²⁹ Article 5, 1997 Procedures for Administration of Convertible Company Bonds.

³⁰ *id.*, Article 6.

business in China, advising on capital raising, restructuring and project finance. Although the participation of foreign securities firms in China's securities market has been progressing, it is a rather slow process. One reason is that China has not opened its financial service market on a full scale. Once this process speeds up as a result of China's entry to the World Trade Organization (WTO), the participation of foreign securities firms in China's securities market is expected to accelerate accordingly.

Foreign Investment Share Brokerage. An important regulation issued by the CSRC in 1996 was the Provisional Procedures for the Administration of the Qualification of Domestic and Foreign Securities Trading Institutions to Engage in Foreign Investment Share Business (hereinafter: Provisional Procedures), which became effective on 1 December 1996.³¹ They set out the requirements for carrying on foreign investment share brokerage business in China by domestic and foreign securities trading institutions, together with the application procedures and documents which applicants had to submit when they submitted their application for a Qualification Certificate to Engage in Foreign Investment Share Business (Certificate). After the promulgation of the Provisional Procedures, the CSRC formally started to accept applications.

Article 2 of the Provisional Procedures provides that foreign securities trading institutions wishing to engage in foreign investment share business must obtain a Qualification Certificate from the CSRC in accordance with the Provisional Procedures. The Qualification Certificate is valid for two years from the date of issue and the

³¹ For a brief summary of the 1996 Provisional Procedures for the Administration of the Qualification of Domestic and Foreign Securities Trading Institutions to Engage in Foreign Investment Share Business, see *China Law & Practice*, December 1996/ January 1997, pp. 11-12.

application for renewal must be submitted to the CSRC within a period of three months before the expiry date. "Foreign investment shares" include B-shares and other foreign investment shares of Chinese companies listed outside China. "Foreign securities trading institutions" (*jingwai zhenquan jingying jigou*) are defined to include investment banks, securities firms, and other financial institutions outside the territory of China which are independent legal persons and are qualified to engage in the securities business under the laws of the place where they are located.

The Provisional Procedures further provide that foreign securities trading institutions which have obtained a Qualification Certificate must submit a report to the CSRC by 31 January of each year on their foreign investment share distribution and brokerage business for the preceding year. Where a foreign securities trading institution is engaged in the distribution of foreign investment shares of the Chinese companies listed outside the territory of China, a business report should be submitted to the CSRC within 30 days after the close of each distribution.

Stock Exchange Membership. The Shanghai and Shenzhen stock exchanges have adopted a membership system under which institutions engaged in the securities business, either securities firms or investment fund management companies or investment banks, could become members of the exchanges and be able to access the trading system. Starting from 1992, foreign securities brokers were granted "partial" membership which allowed them to deal directly in foreign investment shares, but their seats were held under the names of Chinese broker nominees. This meant that they had to pay a certain percentage of their commissions to local Chinese brokers who acted as partners. The Shanghai Stock Exchange proposed a plan as early as in 1994 to grant foreign securities

firms "full" membership of the exchange under a reform which intended to eliminate the need for them to trade through Chinese brokers and allow them to operate freely but without voting rights.³² This was introduced later by the Shenzhen Stock Exchange. The proposed reform, though a limited reform not comparable to a "Big Bang" in any way, was nevertheless an important step in the liberalization of China's stock exchanges, as well as a necessary measure to increase their competitiveness among international stock exchanges. At the time the proposed plan of the Shanghai Stock Exchange was discussed, some local Chinese brokers objected to the plan for reasons of their own interests, but the Shanghai Stock Exchange believed that the proposal was a necessary step in the market liberalisation and the Exchange had to take a long term view for the development of the Exchange.³³

In 1997 one of Taiwan's ten largest securities companies was awarded a seat on the Shanghai B-share market despite the political and territorial tension between mainland China and Taiwan.³⁴ This was the first time a Taiwanese-controlled brokerage was allowed to trade shares in the mainland capital market. It showed that the Shanghai Stock Exchange preferred an open policy which could lead the Exchange moving closer to other international stock exchanges.

The liberalization process may bring disadvantages to local Chinese brokers but it is an inevitable and necessary process to pursue for the sustainable development of

³² See "Foreign Securities Firms to Join Shanghai Exchange", a report by John Gapper, *Financial Times*, 28 March 1994.

³³ *Id.*

³⁴ See "Taiwanese in China Shares Coup", a report by John Ridding et al., *Financial Times*, 27 November 1997.

China's stock exchanges. The London Stock Exchange is an example to illustrate this point. As part of the reform in 1986, the so-called "Big Bang", an important change was made to the restrictions on membership of the Exchange to enable member firms to establish the capital base needed to trade competitively in international securities. Thus, from 1 March 1986, member firms could be owned by a single outside corporation, and as a result many firms were bought by United Kingdom and overseas banks and by major overseas securities firms. The new ownership rules led to a further change in November 1986, when voting rights in the Exchange were transferred to member firms instead of residing with individual members, as had been the case since the early nineteenth century. Looking back, the Big Bang was a highly necessary reform which allowed the London Stock Exchange to catch up with rival international financial centres.³⁵ As international securities markets are now becoming increasingly competitive, China's stock exchanges could be far behind other world stock exchanges, including those newly emerged stock exchanges, unless a liberalization process is undertaken to make China's stock exchanges more open and competitive.

Lawyers and Accountants. In parallel with the participation of foreign securities firms in China's securities markets, foreign law firms and accounting firms have jointed in this process to provide financial services to both foreign and Chinese clients. Regulations were subsequently adopted to allow them to participate in China's securities market, the Provisional Regulations on the Authorization of Lawyers and Law Firms Engaging in the Securities Business, issued jointly by the Ministry of Justice and the

³⁵ See, Coggan, Philip, *The Money Machine: How the City Works*, (3rd ed.) pp.1-10, (London: Penguin Books, 1995).

CSRC on 12 January 1993 (hereinafter: Lawyers Authorization Regulations). Foreign law firms are permitted to provide legal services in relation to the issue and listing of shares by Chinese companies on overseas stock markets. The same applies to foreign accounting firms which provide services to assist Chinese companies to list abroad. Article 9 of the Lawyers Authorization Regulations requires foreign law firms to provide information about their firms to Ministry of Justice and the CSRC for examination and approval in order to obtain permissions to provide legal services in relation to the issue and listing of shares abroad by Chinese companies. It also requires foreign law firms to submit their information annually after they have been granted permission to provide such legal services.

To assist Chinese companies to go to overseas stock markets is undoubtedly important, but more important is to assist Chinese local lawyers and accountants to become familiar with the knowledge and skills needed for them to carry on practices with foreign and international elements. Arthur Andersen, a leading international accounting firm, for example, proposed as early as 1993 to establish training centres in China.³⁶ Such training could help local Chinese lawyers and accountants understand international practices and bring China's securities market closer to international standards.

D. Prospects for Liberalization

The liberalization process in the financial services sector in China is an important part of the wider economic reform programme of the country which has been proceeding

³⁶ See "China Practitioners Ready for Their Great Leap Forward", a report by Andrew Jack, *Financial Times*, 12 August 1993, p. 8.

since 1993. Steps have been taken to speed up this liberalization process. First, more cities have been chosen to join the experimental scheme to open themselves to foreign banks and allow foreign banks to set up joint ventures; second, the scope of business undertaken by foreign banks and joint ventures has been enlarged. Some cities have allowed foreign banks to carry on Chinese currency banking business. Third, conditions have been gradually created for foreign financial institutions engaged in the securities and insurance business to participate in China's financial markets.

In Guangdong province (South China), a leading province in economic reform, sixty- seven foreign financial institutions had been set up by the end of 1997.³⁷ In Beijing City, the capital of China, fourteen foreign banks had been granted approval to set up branches by the end of 1997, and twenty foreign financial institutions had in the meantime opened representative offices there.³⁸ Throughout the country, twenty-four cities have been chosen to open up to foreign financial institutions, almost twice the number in 1994, when only 13 cities had been opened up to foreign financial institutions.³⁹ The number of foreign financial institutions in China has been increasing steadily. By the end of March 1997, 158 foreign financial institutions had been set up in China, including 132 bank branches, seven joint venture banks, five joint venture finance companies (*caiwu gongsi*), eight insurance companies, and one joint venture investment bank. In addition, 528

³⁷ See "Guangdong Will not Slow Down the Process of Opening up the Financial Sector", a report in Chinese, *Renmin Ribao (People's Daily, Overseas Edition)*, 4 February 1988, p. 2.

³⁸ See "Beijing Will Further Open up Financial Sector", a report in Chinese, *Renmin Ribao (People's Daily, Overseas Edition)*, 9 February 1998, p. 2.

³⁹ See "China Will Further Open up Financial Sector", a report in Chinese, *Renmin Ribao (People's Daily, Overseas Edition)*, 5 April 1997, p. 2.

representative offices had been set up by different kinds of foreign financial institutions.⁴⁰

An important step was taken in 1996 to liberalize foreign exchange control when China announced that Rmb currency would be convertible under current accounts as of December 1996 in accordance with the convention of the International Monetary Fund.⁴¹ This step opened a new dimension for foreign financial institutions to participate in China's banking and securities businesses. Immediately after the announcement, Shanghai City promulgated the Provisional Procedures for the Administration of the Pilot Scheme for Renminbi Business by Foreign Investment Financial Institutions in the Shanghai Pudong New Development Zone, which effectively enabled nine major foreign banks to obtain licences to engage in Rmb banking business.⁴² In May 1997 the PBOC released the Circular on the Issue of Consolidated Permits for Financial Institutions Undertaking Renminbi and Foreign Exchange Business which consolidated and standardized the regulation of foreign financial institutions in the foreign exchange business. It provides that where the institution has a presence in the form of a branch, the relevant permit will be the Foreign Investment Financial Institution Business Permit, whereas if the institution has separate legal person status, such as a joint venture bank, the relevant permit will be the Foreign Investment Financial Institution Legal Person Permit.

Shenzhen city was allowed to follow the Shanghai pilot scheme as the second city

⁴⁰ *Id.*

⁴¹ The Governor of the People's Bank of China, Dai Xianglong, formally notified this decision to the International Monetary Fund on 27 November 1996.

⁴² For a comment on the Provisional Procedures for the Administration of the Pilot Scheme for Renminbi Business by Foreign Investment Financial Institutions in the Shanghai Pudong New Development Zone, see Fraser White, "Renminbi Financial Services in Shanghai", *China Law & Practice*, Vol. 11, July/August 1997.

after Shanghai. But the full scale involvement of foreign financial institutions in domestic Rmb business is still some distance away. Foreign financial institutions confront significant regulatory hurdles before they can develop a full range of Rmb financial services in both the banking and securities sectors. It was argued that the full scale entrance of foreign financial institutions could seriously undermine the domestic banking system because many local banks are suffering from loan problems and, as the argument goes, the Chinese government is right to be careful about how many foreign financial institutions they allow into the market.⁴³

The government's cautious approach is an underlying factor which contributed to the delay in the promulgation of regulations governing joint venture investment fund management companies. As early as 1994, proposals were put forward by the CSRC to experiment with Sino-foreign joint venture mutual funds.⁴⁴ The drafting work on the Provisional Measures for the Administration of the Sino-foreign Investment Fund Management Company was at the top of the CSRC drafting agenda. But progress was slow. The words of the president of the Shanghai Stock Exchange reflected the government's cautious approach: "Sino-foreign joint venture mutual funds are more complicated. It may take a relatively long time to consider how to take measures to promote this development."⁴⁵ He suggested that international fund managers may need to

⁴³ For more on these arguments, see "Foreign Banks Train Sights on Domestic Debt Markets", a report in *Euroweek*, May 1997, p. 30.

⁴⁴ See "To Experiment with Sino-foreign Joint Venture Mutual Fund Management Companies", a report in Chinese, *Renmin Ribao (People's Daily)*, 30 July 1994, p. 1.

⁴⁵ See an interview by James Harding and others with Mr Tu Guangshao, president of the Shanghai Stock Exchange, "Managing China's Young and Volatile Markets", *Financial Times*, 8 January 1998.

be patient. In 1997, upon the approval of the State Council, the SCSC finally released the Provisional Measures for the Administration of Securities Investment Funds. They established a general framework to regulate fast growing domestic investment funds. Although not directly applicable to Sino-foreign joint venture investment funds, they provides at least some guidelines to foreign investors.

The convertibility of the Rmb in current accounts represents a major step forward in the liberalization of the financial services sector in China, yet the securities market could only open up substantially to foreign investors when and after the complete convertibility of the Rmb is realized. This may take a few more years to become true. Elsewhere in related areas, progress is being made towards a substantial liberalization in financial markets. Starting in 1998, the PBOC has allowed the National News Publishing Office to publish information for the general public which used to be available only within the banking system. This enables foreign investors to access directly information about financial markets, financial statistics, regulatory positions regarding the financial markets, and general monetary policies. It is a measure which could improve the transparency problem about which foreign investors often complained. Early in 1998 seventeen more foreign law firms were granted licences to open offices in China, which brought the total number of foreign law firm offices in China to 67.⁴⁶ These and other developments have signalled that China is moving towards a more open and liberated regulatory environment to encourage foreign investors to participate in China's banking and securities markets.

⁴⁶ See a brief report in Chinese, *Renmin Ribao (People's Daily, Overseas Edition)*, 21 February 1998, p. 2.

Chapter VII

Internationalization of China's Securities Market and Adaptation of Foreign Securities Law

China's economic reform and open-door policy have resulted in closer links with the international community and consequently more international practices and standards are being adopted in various areas of China. The phrase "internationalization of China's securities market" (*zhengquan shichang guojihua*) has become fashionable not only in academic writings but also in official documents.¹ It is used normally to mean, first, to open up China's securities market to the outside world; second, to adapt international securities regulatory practices and standards to China; and third, to develop a co-operative relationship with stock exchanges and securities authorities in other countries.

The experience of bringing China's state-owned companies to the Hong Kong

¹ In 1995 I returned to China for a study trip. One memory that I could not forget was that wherever I went to during my trip I could hear people talking about the internationalization of China's securities market. Various official documents, from those issued by the State Council, the SCSC, and the CSRC to those adopted by the Standing Committee of the National People's Congress, one can easily see that this phrase is used with varying meanings.

Stock Exchange resulted in an interface between China's civil-law socialist legal system and Hong Kong's version of the common law tradition in securities regulatory practices. With greater economic integration between mainland China and Hong Kong and the unification of Hong Kong and China, this interface process will be enhanced in the years to come. In the course of the internationalization of China's securities market, attempts have been made to adapt elements of foreign securities laws and regulations into China's securities regulatory system. This is in line with a general legislative climate in which steps have been made by the national legislative authorities to adopt common international practices and elements of foreign law into China's legal system. It is also a part of the efforts China has made to make the legal system more open and more acceptable to the international community.

A. Experience with Listing Chinese Companies in Hong Kong

The primary concern of the Hong Kong Stock Exchange and the Hong Kong securities authorities at the time when China's state-owned companies came for listing was to ensure that minority shareholders in Chinese state-owned companies would have a level of investor protection comparable with that of shareholders in companies registered in Hong Kong. At that time, the principal protection afforded to investors was contained in the 1992 Standard Opinion on Joint Stock Companies (Standard Opinion), a set of company regulations which operated before the 1993 Company Law. In order to facilitate a Hong Kong listing, Supplementary Provisions to the Standard Opinion were issued which specially applied to companies established under the Standard Opinion and seeking to list in Hong Kong. The Supplementary Provisions attempted to remove the ambiguity

of certain provisions in the Standard Opinion and thereby strengthen investor protection.² However, from Hong Kong's point of view, the strengthened provisions still fell short of the investor protection which existed in Hong Kong. The regulatory bodies in Hong Kong and China together devised additional safeguards to supplement and reinforce the investor protection afforded under the Standard Opinion and the Supplementary Provisions, and in this way provided a solution to the problem of the inadequate legal protection under Chinese law.

First, a Memorandum of Understanding on Regulatory Co-operation was concluded between the Hong Kong Stock Exchange, the Hong Kong Securities and Futures Commission, the China Securities Regulatory Commission and the Shanghai and Shenzhen stock exchanges. It established a framework for the Hong Kong and China securities authorities to share information and co-operate closely in the enforcement of Hong Kong and Chinese securities laws.

Second, the Hong Kong Stock Exchange published amendments to its listing rules in order to accommodate the primary listing of Chinese companies.³ The amendments effectively allowed the primary listing on the Hong Kong Stock Exchange of specially created Rmb denominated foreign investment H-shares which would be issued to the Hong Kong public and traded on the Hong Kong Stock Exchange. The amendments imposed

² For a translation of the Supplementary Provisions to the Standard Opinion on Joint Stock Companies, together with an editorial comment, see *China Law & Practice*, Vol. 7, No. 10, 1993, pp. 34-41.

³ Chapter 19 of the Hong Kong Stock Exchange listing rules is specially concerned with listing overseas companies. However, its primary concern is with companies incorporated in common law jurisdictions, such as Bermuda and the Cayman Islands. A special separate chapter, chapter 19a, was added to the listing rules which is solely concerned with companies incorporated or otherwise restructured in China.

on Chinese issuers regulatory standards comparable to those imposed on existing issuers with a primary listing in Hong Kong and created standards of protection for minority shareholders in Chinese listed companies which were no less favourable than those enjoyed by investors in Hong Kong.

Third, the State Commission for Restructuring the Economic System published Mandatory Provisions for Articles of Association of Companies Seeking Listings in Hong Kong (Mandatory Provisions). They required Chinese applicant companies to include in their articles of association certain imperative clauses for the purpose of protecting Hong Kong investors. They also required these companies to undertake in their articles of association that they would abide by the rules and regulations of the Hong Kong Stock Exchange.

Mandatory Provisions as Bridge of Gap Between Two Regulatory Systems. The Mandatory Provisions were a comprehensive standard form of articles of association which supplemented Chinese company regulations where those regulations did not adequately cover certain areas, such as directors' duties and protection of minority shareholders. This standard form attempted to codify Hong Kong common law on such matters as the responsibility of company directors, protection of minority shareholders, and accounting standards. The underlying consideration was to provide a sufficient level of shareholder protection to H-shareholders in Chinese listed companies. Article 2 of the Supplementary Provisions provided that the Mandatory Provisions must not be amended or deleted except as otherwise provided by national company laws and other relevant administrative regulations. This was to ensure that these imperative provisions would be included in the articles of association of Chinese companies listed in Hong Kong and

would thus provide adequate protection to Hong Kong investors when they purchased H-shares of these Chinese companies.

A central concern of the Mandatory Provisions was directors' duties. Directors, supervisors, managers, and other senior management officers of Chinese companies were required by the Mandatory Provisions to act honestly and diligently and in accordance with the articles of association of the company. The meaning of "an obligation of honesty and diligence" prescribed under Article 57 of the Standard Opinion was interpreted by the State Commission for Restructuring the Economic System to mean "fiduciary duty" as being interpreted under Hong Kong common law. This classification was officially issued to the Hong Kong Stock Exchange through a formal correspondent letter dated 10 June 1993.⁴ Thus, the articles of association of Qingdao Brewery Company, for example, incorporated standard duties and obligations familiar to directors in Hong Kong and in western countries, such as the obligation of a fiduciary not to place himself in a position where his duty and his interest may conflict. These standard duties and obligations were also incorporated into the articles of association of the other eight Chinese companies of the first batch listed in Hong Kong.⁵ It was the first time that Chinese companies had adopted a standard duty of diligence, honesty and good faith in terms of what western directors and lawyers regard as fiduciary duties⁶ and was regarded as an important

⁴ For background and comments, see an editorial note by Nicole Yuen, *China Law & Practice*, Vol. 11, No. 10, 1993, p. 41.

⁵ For brief background on the nine Chinese state-owned companies coming to Hong Kong, see Simon Holberton, "Solution to Chinese Puzzle," *Financial Times*, 13 July 1993, p. 12.

⁶ For an interesting and detailed comparative study on directors' duties in Chinese companies, see Tokley, I. A., "Step by Step: Introducing the Latest Chinese Securities Regulation," *Hong Kong Law Journal* (1995) Vol. 25, No. 1, pp. 98-125 at pp. 118-123.

development of Chinese company law.

Article 2 of the Supplementary Provisions adopted the fundamental common law principle that the articles of association of a company constitute a legally binding contract for the company's acts and governs the rights and obligations between the company and the shareholders. Thus, duties and obligations were framed solely in terms of the company's relationship with its shareholders in those nine Chinese companies listed in Hong Kong. Their articles of association did not contain any provision concerning the establishment of communist party organizations in those companies, nor did they recognise the role of communist party organisations in the relationship between the company and its shareholders. However, communist party organisations were required on a statutory basis in other domestic Chinese companies under company law, and their role in the relationship between the company and its shareholders formed an important part of the articles of association of those domestic Chinese companies.⁷

The difficulty relating to dispute resolution was another major concern at the time. It was solved by incorporating in the articles of association of the nine Chinese companies a provision to the effect that disputes would be adjudicated at the choice of relevant parties in either the China International Economic and Trade Arbitration Commission or the Hong Kong International Arbitration Centre. Arbitral awards in either tribunal are enforceable in either jurisdiction under the 1958 New York Convention on the Recognition and Enforcement of Arbitral Awards, to which both China and Hong Kong

⁷ The role of communist party organizations in shareholder enterprises was emphasized in the Circular on the Role of Party Organisations in Shareholder Enterprises issued by the Central Committee of Chinese Communist Party on 5 August 1994 and was written into the 1993 Company Law.

are parties. In addition, through a series of interlocking contracts signed by the directors and the company, shareholders in those nine Chinese companies would be able to sue a director personally. This provision, as expected by the Hong Kong securities authorities, put pressure on non-defaulting directors in order to act against defaulting directors to avoid their being involved in a legal dispute.⁸

Limitation of Mandatory Provisions. Although the Mandatory Provisions acted as an effective instrument to bridge the two legal systems in the area of company and securities regulation, there were certain difficulties arising from the fundamental differences between the two legal systems. A general difficulty encountered was how to codify effectively Hong Kong case law into Chinese legislation. In China, law is found only in written codes. Cases are used merely for reference, whereas in Hong Kong, as in other common law jurisdictions, case law is a basic source of law. In order to codify Hong Kong case law in Chinese written codes effectively, the drafting team had to extract certain principles which these cases had developed over centuries. As put it by Antony Neil QC, chairman of the Hong Kong Securities and Futures Authorities and the chief representative of Hong Kong team in the negotiation with the nine Chinese companies and Chinese securities regulators: "the whole law on the fiduciary responsibilities of directors and the rights of different classes of shareholders had been built up by the courts since the 1850s and 1860s. To ensure that mainland Chinese directors and managers would be subject to the same legal constraints as their counterparts in Hong Kong, we had to go

⁸ See Simon Holberton, "Solution to Chinese Puzzle," *Financial Times*, 13 July 1993, p. 12.

back to the cases to extract the principles."⁹

This problem gave rise to two others. One is interpretation, and the other is enforcement. It is uncertain how these extracted principles will be interpreted by the people's courts or arbitrators when they deal with individual cases. There are no established cases to look at in Chinese law, and even if there were, the people's courts are not bound to look at them since previous cases do not constitute binding precedents under the Chinese legal system. Equally, it is uncertain whether the codified provisions will be effectively enforced by Chinese people's courts. It is submitted that the effect of codifying such common law obligations cannot be fully appreciated unless the remedies from common law jurisdictions are also codified and adopted, and that such common law remedies are unworkable in theory.¹⁰

Another difficulty encountered was how to ensure that directors of Chinese state-owned companies would fulfil their fiduciary duties to shareholders as prescribed by the Mandatory Provisions and incorporated into the articles of association of these companies. Some argued that the aim of codifying director responsibilities in the articles of association of these companies could not be successfully achieved unless a series of questions were also properly addressed, such as who would enforce the duties and what civil or criminal penalties would be applicable when they breached their duties.¹¹ Others

⁹ *Id.*

¹⁰ Fung, Eugene T. S., "Legal Implications of Foreign Listing for PRC Enterprises with Particular Reference to Hong Kong," *The Company Lawyer* (1996) Vol. 17, No. 2, pp. 35-39 (part I), Vol. 17, No. 3, pp. 73-80 (part II) at p.75.

¹¹ For a discussion of these and other related issues, see Tokley, I. A., "Step by Step: Introducing the Latest Chinese Securities Regulation," *Hong Kong Law Journal* (1995) Vol. 25, No. 1, pp. 98-125.

argued that the directors of Chinese state-owned companies were used to owing their duties and loyalties to the state and the Communist Party. It was therefore quite possible that whenever there was a conflict between the interests of the state and those of shareholders, the directors of these Chinese state-owned companies would place the state ahead of the shareholders despite the mandatory provisions in the articles of association regarding their duties to shareholders.¹² These arguments reflected some of the concerns of regulators and academics about Chinese state-owned companies listed in Hong Kong and about the effectiveness of the mandatory provisions of articles of association of these companies.

B. Future Regulatory Harmonisation Between China and Hong Kong

Hong Kong has now returned to China and become a Special Administrative Region (SAR) of China. This has opened prospects for the securities markets and regulatory systems of mainland China and Hong Kong to become closer as part of integration and convergence.

The Basic Law of the SARHK. The Joint Declaration signed in 1984 between China and UK stated that the Hong Kong SAR would be vested with legislative, executive and independent judicial power, and that the current social and economic systems in Hong Kong would remain unchanged for a period of fifty years after 30 June 1997.¹³ The basic

¹² Fung, Eugene T. S., "Legal Implications of Foreign Listing for PRC Enterprises with Particular Reference to Hong Kong," *The Company Lawyer* (1996) Vol. 17, No .2, pp. 35-39 (part I), Vol. 17, No. 3, pp. 73-80 (part II) at pp. 74-75.

¹³ The Sino-British Joint Declaration on the Future of Hong Kong (the Joint Declaration) was signed on 18 December 1984 and lodged with the United Nations as an international treaty.

policies outlined in the Joint Declaration were expanded by the Basic Law of the Hong Kong SAR of the PRC (hereinafter: Basic Law), adopted on 4 April 1990, which is a constitutional document for implementing the "one country, two systems" policy in Hong Kong after 1997. The Basic Law provides among other things that Hong Kong will remain the status of an international financial centre, that the Hong Kong dollar will retain the currency of the SAR, that no exchange controls will be introduced in the SAR, and that the Hong Kong dollar will remain freely convertible.

Independent Securities Regulatory Authorities. With regard to the day-to-day financial affairs of Hong Kong and its relationship with mainland China in this respect, the concept of "one country, two systems" has now been defined to mean one country with two currencies, two monetary systems and two monetary authorities which are mutually independent. This means that one does not take precedence over the other; one is not superior to the other; and one does not take instructions from the other.¹⁴ This concept also applies to securities regulatory authorities of the two sides. Thus, the CSRC of mainland China and the SFC of Hong Kong will be the two independent securities regulatory authorities, each watching their own markets; the two securities markets will be equal and independent. On the other hand, to promote healthy relations between the two sides would inevitably require the strengthening of co-operation between them. Thus, while the two regulatory authorities remain independent, they will need to improve their ties and strengthen the relationship between the two securities markets. The new era

¹⁴ The summary of a speech given by the chief executive of the Hong Kong monetary authority, Joseph Yam, at a seminar organised by the Bank of England. *Hong Kong DateLine*, a newsletter published by the Hong Kong Government's London Office, 1996, Issue No. 9.

created by the union of Hong Kong and mainland China raises both opportunities and challenges for the development of the securities markets and regulatory systems of the two sides.

Economic Integration and the Role of Hong Kong Securities Market. After mainland state-owned enterprise started to come to Hong Kong for listing in 1993, the Hong Kong stock market acquired a new significance which reflected the territory's special position as a gateway to the vast economic base in mainland China. The role of the Hong Kong stock market as a capital raising centre for mainland China become increasingly important as more mainland companies come to Hong Kong for listing. While these listings brought benefits to the economic development of the mainland, they also helped maintain and consolidate the position of Hong Kong as an international financial centre. The resumption of Chinese sovereignty over Hong Kong accelerated the process of economic integration between Hong Kong and mainland China. The Hong Kong stock market will increase its role as a forum for raising capital for state-owned enterprise of mainland in the course of this integration. There is no doubt that, because of its special relationship with mainland China economically, socially, and geographically, Hong Kong will remain a major venue for the listing of China's state-owned enterprises in the future and continue to play an important role in channelling international capital for Chinese economic development.

Interface of Securities Regulations Between Mainland China and Hong Kong. The fact that Hong Kong has become part of China will have an overwhelming effect on the future direction of the Hong Kong stock market. On the other hand, China's stock market will also be directly affected by the Hong Kong stock market as a better regulated, more

developed, and more open market. In light of the rapid economic development in the mainland China and the integration of Hong Kong and China's capital markets, it is anticipated that there will be more mainland listings in Hong Kong. This will help to deepen the interface of securities regulation between mainland China and Hong Kong, and it is possible that the two systems of securities laws will move towards harmonisation. In the meantime there will inevitably be clashes of the two regulatory regimes, and it is therefore important that the regulators of the two sides work closely together in the years ahead to avert the clashes. To this end it is desirable to build a harmonised regulatory regime between mainland China and Hong Kong as has happened in the European Union where, for example, new methods have been adopted which could do away with the need for multiple filings and provide a uniform system throughout Europe in the domain of company mergers and acquisitions beyond national boundaries.¹⁵ In the United States the multi-jurisdictional disclosure system (MJDS) was established years ago with the neighbouring Canadian securities authority, which made disclosure for two sides more convenient and simple.¹⁶ These and other examples of the harmonisation of securities regulatory practices in Europe and the United States have set good models for China and Hong Kong to consider and learn from in their harmonisation of securities regulatory practices.

¹⁵ Currently companies wishing to merge beyond their national boundaries are obliged to put their case to several different national competition authorities. Under the new method, merging companies will only have to file a single notification with the Commission. See, "MEP's Back Takeover Regulation", a report in *Gazette* (Weekly Journal of the Law Society), 29 May 1997, p. 14.

¹⁶ Grundfest, Joseph A., *"International Cooperation in Securities Enforcement: a New United States Initiative"*, a paper presented on 9 November 1988 at King's College London by Joseph Grundfest, a commissioner of U.S. Securities and Exchange Commission.

On the general level, progress has been made in developing a fully bilingual legal environment in Hong Kong through a project of translating Hong Kong laws into Chinese.¹⁷ The project involved the translation of all existing Hong Kong Ordinances, more than 5,130 enactments totalling some 21,000 pages of text and the bilingual drafting of all new legislation. In addition, facilities have been introduced to allow trials to be conducted in either English or Chinese and court documents to be drafted in either or both languages. It is estimated that more than 60 per cent of cases in Magistrate courts and more than 90 per cent of cases in Labour and Small Claims Tribunals are now heard in Chinese. More cases in District courts and in the High Court will be heard in Chinese in the future.¹⁸ The Hong Kong government has proposed the establishment of a Bilingual Legal System Committee which, as a permanent institutional establishment, would help to guarantee a bilingual legal environment in Hong Kong and to strengthen judicial co-operation between mainland China and Hong Kong.¹⁹ All these developments for the use of the Chinese language for administrative and judicial purposes, contemplated by Article 9 of the Basic Law, undoubtedly will promote the harmonisation of securities regulatory practices between mainland China and Hong Kong..

Hong Kong received the common law under British rule over a hundred years ago; it has become the cornerstone of the legal system of Hong Kong. The Basic Law declares

¹⁷ Colin Gralloway, "Common Law System Confronts Challenges as Unresolved Issues Remain", *China Law & Practice*, Vol. 11, No. 6, 1997, pp. 43-46.

¹⁸ See "Judicial Keeps Autonomy", a report in *Hong Kong DateLine*, a newsletter published by Hong Kong Government's London office, 1997 Issue No. 1, p. 4.

¹⁹ See "Ceremony is Held in Hong Kong for Commencement of 1997 Legal Session", a report in Chinese, *Renmin Ribao (People's Daily) (Overseas Edition)*, 14 January 1998, p. 5.

that most existing laws in Hong Kong shall remain unchanged for fifty years in the Hong Kong SAR. The Hong Kong government decided to invite two serving Law Lords from England to be available to sit on Hong Kong's Court of Final Appeal.²⁰ This will not only promote the quality of justice and the independence of the Hong Kong judiciary, but also create a safeguard to ensure that the common law tradition continues to remain a cornerstone of the legal system of Hong Kong. This and other developments on a general level can not fail to affect the relationship between the securities market and regulatory regimes between mainland China and Hong Kong and promote the integration and convergence of securities regulation of the two sides.

C. Adaptation of Foreign Securities Laws.

The adaptation of foreign securities laws and practices in China's securities regulatory system is an important part of the internationalization process of China's securities market laws. Several general terms have been used to refer to the process of adapting foreign laws and practices in the Chinese legal system, including *Yizhi* (transplant), *Jiejian* (adaptation through borrowing), and *Xishou* (reception). It is agreed among Chinese scholars that there are no substantial differences in meaning between these Chinese terms in this particular context.²¹ Thus, to say that a certain piece of foreign law or some elements of it have been or could be adapted in Chinese law, any of these three terms can be employed to that effect. All three terms are frequently found in academic

²⁰ See a brief report in *Hong Kong Business Review*, October/November 1997, p. 4.

²¹ See Shen Zhonglin, "On Transplanting Law", *Renmin Ribao (People's Daily) (Overseas Edition)*, 14 December 1994, p. 5.

writings and official documents, and are normally interchangeable. This is also true in the domain of securities law and regulation.

Since the 1980s, serious studies have been undertaken in China of international law and practice, as well as foreign laws and practices, including the laws of advanced industrial countries, third world countries, and other countries of the former socialist legal system. A visible change is that Chinese legislative bodies increasingly pay more attention to convergence with common international legal principles and practices and certain foreign laws and practices which suit China's own circumstances. An increasing number of laws drafted by the National People's Congress and its Standing Committee are the result of wide consultation with regard to conventional international practices and relevant laws of a particular foreign country. It has become an official attitude that China may, in developing its socialist market economy, boldly learn and adapt the legislative experience of western economically advanced countries, and certain appropriate provisions may even be directly transplanted into Chinese legislation.²² The laws promulgated by the Eighth National People's Congress and its Standing Committee during its five year term covered a wide range of branches of law, including finance, banking, and insurance laws which, to varying degrees, contained elements of international law and particular foreign laws. The Standing Committee was thus regarded as the most open Standing Committee in the history of the PRC in respect of its attitudes towards the adaptation of foreign law into

²² Mr Qiao Shi, Chairman of the Standing Committee of the 8th NPC, and most other senior officials in charge of legislative affairs, have made these points repeatedly in official speeches and press interviews since 1993.

China.²³

Need for Adaptation of Foreign Securities Laws. The Adaptation of foreign securities law and practice is a natural outcome of the need, first, to attract foreign investors and overseas equities; second, to induce the confidence of foreign investors; third, to facilitate Chinese companies to list abroad; fourth, to fill the gap which exists in Chinese securities laws in order to build a comprehensive securities regulatory system in China; and fifth, to carry out international co-operation with other foreign securities authorities and create a legal environment facilitating such co-operation. To adapt foreign law and practice generally and to adapt foreign securities law and practice specifically are China's voluntary choices; this has not been imposed by external forces. The ultimate goal of such adaptation, as put by legislative authorities, is to benefit China's reforms on the socialist market economy. This is contrasted with the law reform undertaken at the end of Qing Dynasty a century ago, the motivation of which was a mixture of, on one hand, the drive of the Qing government to reform, and on the other, external pressure from foreign countries.²⁴

The need to attract foreign investors caused a radical reform of China's accounting practices developed under the central planned economy. When Chinese companies came to Hong Kong and other international stock markets for listing, it was found that it was time consuming and costly for Chinese companies to convert their existing accounts to

²³ This is the view expressed by most people I talked to during my study trip in China in 1995. I was impressed by the fact that the Legal Affairs Working Committee of the Standing Committee of the NPC had a whole collection of American statutes and I was told it was considering to purchase a set of United Kingdom statutes.

²⁴ See Shen Zhonglin, "On Transplanting Law", *Renmin Ribao (People's Daily) (Overseas Edition)*, 14 December 1994, p. 5.

Hong Kong or international accounting standards. This prompted these companies to overhaul their accounting practices in an attempt to seek listings on international stock markets and attract foreign investors. In the meantime general accounting reform was underway in China when a significant step was taken in 1993 towards rationalising China's enterprise accounting system. The reform introduced the Accounting Standards for Business Enterprises, an important piece of regulation which established a single set of accounting principles generally in conformity with international accounting standards.²⁵ It has been regarded as a landmark reform, which substantially facilitated Chinese companies, including listed companies, in their dealings with foreign investors.

An improved legal and regulatory environment is an essential condition for attracting foreign investment. This is very much the case in securities regulation where a highly sophisticated system of regulation is essential for the protection of investors. Accounting standards was identified as a particular problem. Foreign investors complained that they found Chinese company's accounting procedures difficult to understand and "under-regulated" by western standards. To bring Chinese accounting standards in line with international, therefore, became an urgent task in order to clarify the financial status of a listed Chinese company for foreign investors and meet the tough listing requirements of overseas stock exchanges. When the first nine state-owned enterprises came to the Hong Kong Stock Exchange, they were required by the CSRC to comply strictly with Hong Kong accounting standards and, in particular, their financial reports had to include

²⁵ For an examination of the motivations and processes leading to the promulgation of the standards and an examination of its conceptual content, see, Paul M. Kazenski and Elaine Yin Lingwong, "Unifying Accounting in the People's Republic of China", *International Journal of Accounting*, 1994, Vol. 29, pp. 352-363.

discrepancies arising from variations between Chinese and Hong Kong accounting standards; where discrepancies were connected with profit figures, prudence had to be exercised in allocating dividends.²⁶

In order to induce foreign investor confidence in China's securities market and Chinese listed companies, it was necessary to improve the regulatory environment and bring regulatory standards to meet international standards. By introducing internationally-recognised standards and concepts of information disclosure and fiduciary duties, the unified B-share Regulations attempted to dispel the fears among foreign investors over the arbitrary interpretation and implementation of different sets of local regulations previously in force and improve the regulatory environment for B-share foreign investors.²⁷ Another example is Articles 24-26 of the 1994 Special Provisions on Share Issue and Listing Abroad by Joint Stock Companies, which deal with the appointment and removal of accountants of overseas listed Chinese companies. By adapting the law and practice of Hong Kong, Article 25 requires that if the shareholders' general meeting proposes the renewal or non-renewal of the services of the accountants, the accountants who may be removed or whose services may not be renewed should be given advance notice. The accountants have the right to present their views at the shareholders' general meeting. If the accountants resign at their own initiative, they are required to inform the shareholder'

²⁶ See the speech by Li, Jiange, Vice Chairman of the CSRC, "The Chinese Stock Market in Transition to a Market Economy," at the China Economic Association (CEA)'s annual conference at the London School of Economics; the paper was published by the CEA as one of its Discussion Paper Series.

²⁷ See these and other comments on B-share Regulations: Leung, C.Y., and Lim Seok Hui, "An Overview of China's New B-share Legislative Reforms," *China Law & Practice*, September 1996, No. 7, pp. 20-25 at p.25.

general meeting whether there is any impropriety in the company.

The development of investment funds in China was delayed because of, among other reasons, the lack of a legal and regulatory framework. To adapt relevant foreign legislative experience to fill the gap was therefore a necessary step. The investment fund rules promulgated were an attempt to develop an investment fund law in China along the lines of investment fund legislative experience in Hong Kong and the United Kingdom. Similarly, the Provisional Measures on the Prohibition of Securities Fraud, promulgated in 1993, were an attempt to fill a gap in respect of insider trading regulation although it was a very preliminary piece of regulation.

These are some of the areas about which foreign investors have expressed their concern and where there were no regulations in place. Partly in response to such concerns and partly to conform with international practices, the securities authorities prepared these regulations by transplanting relevant foreign legislative experience. The trend towards the globalization of securities investments is insistently requiring global co-operation among the securities regulatory authorities. As a newly emerged and young securities market, China has to improve international co-operation by adapting common international practice and relevant foreign securities law and regulation to fill the gaps in its legal and regulatory environment.

Methods Used in Adapting Foreign Securities Laws. The successful adaptation of foreign securities law and practice depends, among other elements, on the effective use of a range of methods in studying foreign law and practice and in communicating with foreign legal experts. The methods used in recent years have included, first, the method of consultation with relevant international institutions and foreign legal experts; second,

the method of the invitation of foreign experts to China to share information and help draft legislation, and third, the method of going out to the world capital markets in order to see how their markets and regulatory systems are operating.

New laws and regulations are often drafted on the basis of wide consultation with relevant international institutions and foreign legal experts. For example, in drafting the 1995 Law on the People's Bank of China of the PRC, the World Bank, the International Monetary Fund, and the Asian Development Bank were consulted; in formulating the B-share Regulations, the CSRC, together with the Shanghai and Shenzhen securities authorities, widely consulted investment bankers, accountants, and lawyers from both China and Hong Kong to an unprecedented extent;²⁸ in preparing the 1993 Securities Law of the PRC (draft) the drafting team went to Hong Kong for consultations with securities law experts.²⁹ In all these examples, the relevant international institutional and foreign legal experts were invited to provide their advice and first hand knowledge to help Chinese drafters.

Moreover, foreign experts were invited to China to provide information about how their capital markets and regulatory systems are operating. In 1994 representatives from nine major international stock exchanges were invited to China to take part in a conference organised by the CSRC, the purpose of which was twofold: first, it provided an opportunity for Chinese companies and regulators to understand the listing rules of

²⁸ See Leung, C.Y., and Lim Seok Hui, "An Overview of China's New B-share Legislative Reforms," *China Law & Practice*, September 1996, No. 7, pp. 20-25 at p. 25.

²⁹ See Liu, Suinian, "*Explanations on the Securities Law of the PRC (Draft)*", Chairman of the Financial and Economic Committee of the National People's Congress, presented to the NPC on 18 August 1993.

these international stock markets in order to prepare for the listing of Chinese companies on those exchanges; second, it provided a forum for Chinese regulators to compare their listing rules with a view to determining whether they could be adapted in China so as to improve China's listing rules and practices.³⁰ Such invitations and conferences have now become routine and provide an effective method for promoting a better understanding of foreign securities law and practice and facilitating fruitful communication with foreign legal experts. The PBOC, for example, hosted a conference on investment funds at Beijing in 1998 in conjunction with the Hong Kong Investment Funds Association; more than fifty representatives from nearly thirty countries were invited to present their views on how to regulate securities investment funds.

In addition, legal, regulatory, and administrative personnel were sent abroad to foreign capital markets to see how they are regulated and how their investors are protected. From central government to local government, various groups and delegations made such study visits. For example, Zhou Zhengqing, Chairman of the CSRC, came to Britain in 1997, visiting regulatory bodies, the stock exchange, and several companies; the deputy mayor of Shanghai and his delegation went to Hong Kong to learn how to improve Shanghai's securities industry.³¹ As for those companies seeking an overseas listing, although not all of their directors and management teams could go abroad to have a look, their listings are often assisted by foreign financial and securities institutions as underwriters together with Chinese underwriters. A collateral result of such assistance is

³⁰ See "Domestic Firms Listing Abroad," a news report by Ren Kan, *China Daily (English Edition)*, 6 September 1996, p. 2.

³¹ See the report in *China Economic Review*, 1997, Vol. 7, No. 5, pp. 26-28.

that these Chinese companies and their senior management teams become familiar with the rules and practices of the foreign stock exchanges on which they are listed.

Localization of Foreign Securities Laws. For foreign securities law and regulation to be successfully applied in China, their adaptation should combine China's own conditions and circumstances with foreign legal concepts and practice. A five-year project financed by the United Nation Development Programme to assist China in drafting twenty-two priority laws and strengthen the capacities of Chinese drafters concluded that they could learn literally nothing from the black-letter texts of foreign laws. They could profit only from studying the law and its social consequences in the specific country setting.³² This echoes the view held by some leading Chinese comparative lawyers and academics, which also emphasised the importance of studying the social and cultural conditions of foreign countries in the process of adapting laws from those countries.³³ The experience of Hong Kong in creating a bilingual legal environment showed that it was no easy task to translate English legal expressions into Chinese because "they originate in the English system and reflect the social and cultural context in which that legal system evolved". It was sometimes impossible to identify a Chinese expression to convey fully and accurately the same idea and concept behind the English expression.³⁴

The drafting of the 1993 Company Law was an example of combining China's

³² Seidman, Ann, Robert B. Seidman, "Drafting Legislation for Development: Lessons from a Chinese Project," *The American Journal of Comparative Law*, 1996, Vol. 44, No. 1, pp. 1-44 at p. 38.

³³ See Shen Zhonglin, "On Transplanting Law", *Renmin Ribao (People's Daily) (Overseas Edition)*, 14 December 1994, p. 5.

³⁴ See Colin Galloway, "Common Law System Confronts Challenges as Unresolved Issues Remain", *China Law and Practice*, 1997, Vol. 11, No. 6, pp. 43-46.

own concepts and practices with those of western countries. It was mainly based on China's own conditions and circumstances, but also absorbed legislative experience from foreign countries. Thus, on one hand, various parts of the 1993 Company Law are unique and original to China, such as the provisions regarding State wholly-owned limited liability companies and the provisions regarding the functions of communist party organisations set up within companies. But on the other hand, some concepts are drawn from several different corporate law traditions.³⁵ From western lawyers' point of view, China's company law is not merely a Chinese version of various corporate laws of developed market economies, but a law specifically designed to guide China's economy from state-ownership of the means of production in a state planned economy to a mixture of state and private ownership in an emerging market economy.³⁶

China's legal system, a combination of Chinese ancient legal tradition, concepts from Soviet Russian law and practice, influences from continental European countries, and the impact of China's ten-year Cultural Revolution,³⁷ is seeking a new legal face in the process of China's economic reform and modernisation programmes. The efforts China

³⁵ From the English and Hong Kong stream comes the notion that a company should have at least two shareholders, and unless a stock company, less than fifty (English law on this point has changed to allow a sole promoter company); from the German corporate tradition comes the idea of the supervisory board whose role is to supervise on behalf of the shareholders and employees the work of the board of directors and management; from the American notions of corporate management and justice come the concept that directors and managers can be personally liable for breaches of duty to the company and its shareholders. See Nee, Owen D. "China's Company Law Sets Out the Next Stage of Reform", *International Financial Law Review*, 1994, Vol. 13, No. 4, pp. 13-15.

³⁶ See Nee, Owen D. "China's Company Law Sets Out the Next Stage of Reform", *International Financial Law Review*, 1994, Vol. 13, No. 4, pp. 13-15.

³⁷ For the influence of Soviet Russian laws on China legal system, see, Butler, W. E. (ed.) *The Legal System of the Chinese Soviet Republic 1931-1934*, (Dobbs Ferry: Transnational Publishers Inc., 1983); for a comparative view about China's civil law tradition, see, Merryman, J. H., *"The Civil Law Tradition"*, 2nd.ed. (California: Stanford University Press, 1985)

has made since the 1980s to adapt international conventions and foreign law and practice indicate that the Chinese legislative authorities want China's legal system to be acceptable to the international community, in particular, western business communities. To adapt foreign securities law and practice to China's securities regulatory system is just part of a wide range of adaptation programmes.

Two extreme views are particularly harmful to the adaptation of foreign securities law and practice into China's securities regulatory system: one view opposes the adaptation of foreign securities law and practice into China, and the other favours such adaptation but without any moderation and reservation. The former view over-emphasises China's own conditions and circumstances, whereas the latter indiscriminately favours the West without considering China's own social and cultural conditions. When Arthur Anderson Hong Kong & China, an accounting firm, assisted a Chinese company to become listed on the Hong Kong Stock Exchange, some from the company insisted that they did not want to undergo any restructuring because they wanted the world to see what a socialist company looked like.³⁸ This was an interesting example which illustrated the attitudes of those who had grown up in a closed-door socialist country under the old system in China during the past several decades. Such an attitudes is shared, to a certain degree, by an entire generation in China, especially those who strongly believe in socialism or "socialism with Chinese characteristics". It is, therefore, not surprising to find that some insisted on China's own conditions and on "socialism with Chinese

³⁸ The company was one of the early companies which Mr Meocre Li, managing director of Arthur Anderson Hong Kong & China, visited. He cited the company as an example in his interview with news reporters. See "World Waits for the Second Chinese Wave", a report by Louise Lucas, in *Financial Times*, 2 February 1994.

characteristics", and objected to the adaptation of certain elements of foreign securities law and practice into the drafts of the Securities Law of the PRC. At the other end of spectrum, there are those who advocate the complete transplanting of securities law and practice from western countries into China. Such an attitude ignores completely China's own conditions and circumstances, and the fact that such an adaptation without appropriate digestion would hardly work under China's own economic, legal, social, and cultural conditions.

Securities law and practice in western developed countries are highly sophisticated. The efforts China has made in adapting foreign securities law and practice have improved the securities regulatory system, but is necessary. The research work in China often lacks adequate knowledge about how foreign securities law actually operates in practice; official delegations visiting foreign capital markets often make a brief stay; Chinese legal, regulatory, and administrative personnel sent abroad for longer study are few in number. These are some of the problems which affect the successful adaptation of foreign securities law and practice. More importantly, the decisive condition is the attitudes of legislators and government officials towards such adaptation. Some may support it, and others may not, but it is inevitable that China open its securities market and that the Chinese securities regulatory system be accepted by international investors. Those who do not support the adaptation of foreign securities law and practice may gradually change their attitudes.

Chapter VIII

Socialist Ideologies and Regulation of China's Securities Market

The development of China's securities market and its regulatory regime has not gone beyond the limitations of the socialist ideologies underlying in China's economic reform. On one hand, China is trying to adapt foreign securities laws and bring the securities regulatory regime close to international common practice and standards, but on the other hand, China's securities regulatory regime has been developed against a background where Chinese socialist characteristics are reserved politically and ideologically in the development of China's economic reform. The outcome is that the regulatory culture of China's securities market is distinctively socialist in character. This is especially the case in relations of ownership, economic planning practices, the government's role in securities regulation, and the relationship between government policies and securities law.

A. Socialist Public Ownership

A securities market used to exist in Shanghai city before the establishment of the PRC in 1949, but its existence became ideologically inconceivable in a society where private ownership of the instruments and means of production had been abolished. After 1949 and until the economic reform in 1979, State ownership on behalf of the whole people prohibited the existence of stocks and shareholdings in state-owned enterprises, as well as the existence of a capital market in China. During the 1950s, Yugoslavia postulated social ownership as a higher level of development than state ownership. During the 1970s in Eastern Europe limited private ownership and entrepreneurship were allowed to improve the quality of goods and services.¹ Influenced by these changes and reforms in the countries of the former socialist family, China began to reform its state-owned enterprises by attempting to transform them into shareholding companies, although the line China pursued was different from other former socialist countries in that it did not pursue privatization.²

The rapidity of the reforms of State-owned enterprises led some scholars to predict that all state-owned enterprises would be replaced by shareholding companies.³ However, contrary to this prediction, these reforms were hampered by ideological concerns of public and private ownership of business enterprises in the Chinese economy. Some argued that

¹ Butler, William. E. "Marxian Concepts of Ownership in Soviet Law", 1985, 23 *Columbia Journal of Transnational Law*, at p.281.

² For a review of China's reform in this respect, see Cao, Lan, "The Cat That Catches Mice: China's Challenge to the Dominant Privatization Model", *Brooklyn Journal of International Law*, 1995, Vol. 21, No. 1, pp. 97-178.

³ See, eg, Ying, L., "Some Thoughts on the Reform of the Ownership System in Our Country", *Renmin Ribao (People's Daily)*, 26 September 1986, p. 5.

the emergence of private ownership of stock did not conflict with socialist ideologies so long as the overall national economy was subject to State control; others argued that the emergence of stocks and shareholding in business enterprises was fundamentally in conflict with the perception of socialist public ownership.⁴ In 1984, when the Beijing Tianqiao Department Store Company first issued shares to the public, it faced an ownership identity problem. The company sold 51 percent of its shares to the government, 26 percent to banks, 20 percent to some other enterprises, and 3 percent to individuals. Consequently, when it came to register the company, it was not sure what type of ownership it should claim and what type of company should be registered.⁵ This confusion originated in the classification of Chinese enterprises into either state-owned or collectively-owned enterprises as in other socialist countries,.

In 1987 the government issued the Regulations on the Issuance of Bonds by State-owned Enterprises, under which State-owned enterprises were permitted to raise financing through bond issues but not issue shares, whereas collective-owned enterprises were permitted to issue shares but not bonds. The approach was deemed consistent with the requirements of socialism since the government and State enterprise bonds did not transfer ownership of property owned by the whole people, and the collectively-owned enterprises stocks reflected the ownership interests of shareholders but did not entail loan

⁴ Potter, Pitman B. "The Legal Framework for Securities Markets in China: the Challenge of Maintaining State Control and Inducing Investor Confidence." *China Law Reporter*, 1992, Vol. 7, No. 2, pp. 61-94 at p. 63.

⁵ Mei, Xia, et al. *The Re-emerging Securities Market in China*, (Westport: Quorum Books, 1992), at pp. 72-73.

commitments that the enterprises might not be able to perform.⁶ On a general level, the 1986 General Principles of Civil Law 1986 insisted upon the primacy of socialist ownership of the means of production, but it supported strongly the notion that China's industrialization would be achieved by permitting individuals to conclude contracts on their own and organize collective juridical or corporate persons that would act independently in accordance with the market. The function of civil law was to further and protect this development.⁷

Since 1987 two main themes have been running throughout the development of securities regulation in China: one is to ensure the primacy of socialist ownership and the other is to restrict foreign ownership in state-owned companies. These two themes are presented by various provisions regarding issue and listing of domestic A-share, issue and listing of B-share, overseas listing of Chinese companies, state-owned assets valuation, and takeovers, etc. The ultimate aim of these provisions is to maintain state majority shareholding while facilitating the reform on state-owned enterprises and the development of a securities market in China. A dilemma remained of reconciling private ownership of company shares with the ideology of socialist public ownership of the means of production. The solution was to strike a balance between private and public ownership of state-owned companies. Because of the fact that a majority of shares is always retained by the State, some scholars use the term "securitization"(*zhengquan hua*) rather than

⁶ Potter, Pitman B. "The Legal Framework for Securities Markets in China: the Challenge of Maintaining State Control and Inducing Investor Confidence." *China Law Reporter*, 1992, Vol. 7, No. 2, pp. 61-94 at pp. 63-64.

⁷ For more on the 1986 General Principles of Civil Law, see Jones, William C., *"Basic Principles of Civil Law in China,"* (ed.) (New York: M.E.Sharpe, 1989).

"privatization"(*siyou hua*) to describe the process in which properties of state-owned enterprises are divided into shares and sold to the public.⁸

To Ensure that the State Remains in Control of the Ownership of State-owned Enterprises. Early securities regulations in Guangdong and other provinces generally included a provision to the effect that the total amount of shares issued for public subscription by state-owned enterprises upon transformation into joint stock companies could not exceed 49% of the total shares of the enterprise. The purpose of such provision was to ensure that the state-owned enterprises retained the controlling interest of transformed enterprises. In the early 1990s, when national measures were promulgated to regulate the shareholding system, a similar position was adopted in respect of the rate of State-owned assets in transformed shareholding companies. It was required that state-owned shares must be a "controlling majority"(*konggu diwei*), which meant that state-owned shares must be 51% or more of the total share capital.

With the establishment of the Shanghai and Shenzhen stock exchanges in late 1991 and the listing of Chinese companies abroad, large state-owned enterprises were increasingly transformed into joint stock companies and given greater autonomy to raise capital at home and abroad. However, the state always maintained a majority shareholding in these companies. In addition, the total amount of shares held by individuals was restricted by the regulations. Thus, for example, Article 29 of the Shenzhen Securities

⁸ Chen, Jianfu. "Securitization of State-owned Enterprises and the Ownership Controversy in the PRC," in *The Sydney Law Review*, 1993, Vol.15, pp.59-85. This article analyses the securitization of state-owned enterprises in the context of economic, legal and ownership reforms. It firstly reviewed the initial step towards securitization; then analyzed the World Banks proposal to securitize state-owned enterprises; third, it discussed the ideological, political, and economic debates; finally it examined various theories of property rights of state-owned enterprises.

Regulations restricted the total shareholding of each individual to 50,000 yuan; Article 46 of the 1993 Provisional Regulations on Administration of Issue and Trading of Shares provided that no individual may hold more than 0.5% of the outstanding ordinary shares of a listed company. One underlying concern of these provisions was to maintain the primacy of socialist public ownership and protect State-owned assets by limiting private ownership over the means of production. It reflected the fundamental concern of socialist law that ownership and control of property are "the keys to effective control over society."⁹

It is noticeable that Chinese company regulations categorise various classes of shareholders not only by reference to the nature of the share held but also by reference to the nature of the shareholders. A distinction has been made between domestic and foreign shareholders, i.e. A-share holders, B-share holders, H-share holders, N-share holders and other foreign shareholders, and between various classes of domestic shareholders, i.e., state-owned shareholders, legal person-owned shareholders, and individual-owned shareholders. This categorisation is accompanied by a corresponding restriction on the transfer of a certain type of share. For example, the transfer of state-owned shares must be approved by the relevant government departments and such transfers must not adversely affect the rights and benefits of state-owned shareholders.¹⁰ This effectively guaranteed the domination of state-owned shares in the total share capital and ensured control of state-owned companies. Takeovers, as a mechanism of monitoring

⁹ Butler, William. E. "Marxian Concepts of Ownership in Soviet Law", 1985, 23 *Columbia Journal of Transnational Law*, at p. 281.

¹⁰ Article 36, 1993 Provisional Regulations on Administration of Issuing and Trading of Shares forbids state-owned shares from being transferred without approval from the relevant department.

the management of companies, are meaningless in this situation because a bidder who is holding other types of shares rather than state-owned shares cannot normally gather enough shares to take over the control of a state-owned company. From the investor point of view, the fact that the government has a controlling interest in almost all listed companies would inevitably give rise to concern over politically-appointed management and its competence, which could directly affect their image and performance in the securities market and the confidence of domestic and overseas investors.

To Restrict Foreign Ownership. The policy to open up China's economy to foreign investment has always been accompanied by the need to control the foreign presence in China in order to prevent the dilution of Chinese equities. Foreign investors are not allowed to subscribe, trade, or hold state-owned shares, legal person-owned A-shares, and individual-owned shares, but may invest only in Rmb denominated foreign investment shares, i.e. B-shares, H-shares, N-shares, etc. The previous Shanghai and Shenzhen B-share regulations stipulated that B-share issuers who were transformed from state-owned enterprises may only issue the number of B-shares approved by the PBOC, and if the issuer was a monopoly or otherwise a key industrial sector, the PBOC had to ensure that the controlling stake remained in the hands of the state. To this end, a ceiling was often placed on the percentage of foreign ownership in Chinese listed companies. In June 1995 the State Planning Commission, in conjunction with several other government regulators, issued the Tentative Provisions on the Directing of Foreign Investments, which divided foreign investments into four categories, namely, "encouraged", "permitted", "restricted", and "prohibited". The SCSC and the CSRC had to follow these guidelines in their examination and approval of the issues and listing of B-shares and other foreign

investment shares.

With more foreign investment coming into China, the fear of dilution of Chinese equities is becoming a sensitive issue. The transfer of legal person-owned shares into B-shares, for example, was an area where positive discussion stalled over the concern that control over state-owned companies would pass into foreign hands. On 25 January 1996, the CSRC suspended the trading of a listed company because it had transferred some state-owned shares to a foreign shareholder.¹¹ Such concerns were also reflected in the Sino-foreign Equity Joint Venture Law of the PRC, which provided that a change of the total registered capital requires the unanimous approval of the board of directors. If the Chinese party decided not to give up control, then the directors appointed to the joint ventures would be unlikely to approve the change. In certain industries, especially state monopolies or otherwise key sectors, it is illegal for the Chinese party to allow foreign parties to have a majority share.

In recent years there has been growing concern that many state assets are being sold off cheaply to foreign investors. Regulations have been issued to tighten control over state-owned companies preparing to issue and list shares. The regulations included the Administration of State Assets Valuation Procedures,¹² and the Regulations on the

¹¹ It was the Shanghai-listed company Sichuan Guanghua Chemical Fibre. The event which triggered the suspension was a sale of state-owned share in Guanghua Chemical to Nimrod, a company listed in the United States. The sale made Nimrod the Chinese company's largest shareholder with a 25.4 per cent interest. The sale was not pre-approved by the CSRC when it took place in 1995. For more examples and underlying issues, see Mary L. Riley, "PRC Markets: Securities Regulatory Commission," *International Commercial and Company Law Review*, 1996, Vol. 7 No. 3, p. C-42.

¹² It was promulgated by the State Council on, and effective from, 16 November 1991.

Supervision of Assets of State-Owned Enterprises,¹³ to name only a few. A system has been established by these regulations under which the appraisal on state-owned assets must be carried out by the authority in charge of State asset administration when a state-owned enterprise proposes to transform it into a shareholding company. The enterprise must then submit the certificate of this official appraisal to securities regulators when it applies to issue or list its shares.

In 1996 the State Administration of Foreign Exchange reported that there had been a large unexplained flow of funds out of China.¹⁴ It was believed that the majority of those funds was channelled into Hong Kong's stock market for speculation in Chinese listed companies or Chinese-controlled listed companies, popularly known as red chip companies. Subsequently, the State Council issued the Notice on Strengthening Controls over Overseas Share Issues and Listing (the Notice) on 20 June 1997, which set out guidelines aiming to tighten the government's control over approvals for overseas share issues and listing and for asset injections, most of which had been under priced.¹⁵ The Notice emphasised that any offending Chinese enterprise would be punished by the CSRC in accordance with the 1993 Provisional Regulations on the Administration of Issuing and Trading Shares, and the responsible official of the government department in charge of

¹³ It was promulgated by the State Council on, and effective from, 24 July 1994.

¹⁴ See a report in *China Economic Review*, 1997, Vol. 7, No. 8, pp. 14-15.

¹⁵ The Circular provides that where Chinese assets are transferred to or injected into Chinese or controlled overseas companies for listing purposes, the Chinese owner of such assets must obtain prior approval at several levels of government within China. Approvals will be granted in accordance with the State's industrial policies, relevant regulations, and an overall annual quota prescribed by the State Council. For the entire document in Chinese and English together with a commentary, see "Red Chips Face Quotas under New Rules" by C.Y. Leung, see *China Law & Practice*, July/August 1997, pp. 47-50.

the enterprises concerned would be subject to administrative discipline.

In a similar move to protect state-owned assets from being exposed to high risk in the domestic securities market, the SCSC in May 1997, in conjunction with other government authorities, issued the Strict Prohibition of Speculation in Shares by State-owned Enterprises and Listed Companies, which strictly prohibited state-owned enterprises and listed companies from speculating in shares or providing funds to others for such speculation.¹⁶ Soon afterwards the Shenzhen Stock Exchange issued a notice calling for strict implementation of the SCSC's circular.¹⁷

It has been officially admitted that the reform of China's state-owned enterprises is unsatisfactory. From a budgetary perspective, state-owned enterprises are still a heavy burden on the State. They cost the State more in subsidies than they contribute to the State in revenues. This is having a knock-on effect on the banking system. By the end of 1995, for example, some 220bn yuan was owed by state-owned enterprises to state banks in unpaid interest.¹⁸ In 1997 the reform of state-owned enterprises was put on the top of the agenda of the government. At the XV Communist Party Congress held in September 1997, a major change in policy was announced to the effect that the State would in future focus on 1,000 or so key state-owned enterprises, allowing the rest either to go into

¹⁶ For a summary of the Circular in Chinese, see *Renmin Ribao (People's Daily, Overseas Edition)*, 22 May 1997, p. 2.

¹⁷ The Notice on Strict Implementation of the SCSC's Strict Prohibition of Speculation on Shares by State-owned Enterprises and Listed Companies. It called on listed companies to check whether their companies had opened several A-share accounts, whether there were any accounts opened in an individual's name or whether any capital was provided for the buying and selling of shares by individuals. In the event of the existence of these circumstances, relevant action must be taken by 22 June 1997.

¹⁸ See a brief report in *China-Britain Trade Review*, August 1996, p. 14.

bankruptcy or to be sold to the private sector. In order to implement these policy changes, the CSRC issued the Circular on Share Issue in 1997, which announced that large and medium sized state-owned enterprises would be given priority to issue shares, and securities regulators and other government authorities would encourage and support these enterprises to improve their capacities and competitiveness through such issues.¹⁹

China has believed and still believes that state-owned enterprises are the most valuable items of state assets apart from state-owned land.²⁰ This was a common phenomenon in most former socialist countries.²¹ It is a matter of fact in China that state-owned enterprises constitute the core of the modern industrial sector. Strategically important industries, such as energy, transportation, communications, and major manufactures remain in the hands of state-owned enterprises. Although the recent policy changes have opened new prospect for state-owned enterprises, especially large state-owned enterprises, to restructure themselves flexibly, the ownership issue has to be resolved first and fundamentally both in theory and in practice before state-owned enterprises can fully utilize the securities market in the future.

B. Socialist Economic Planning

Before the economic reform of 1979, enterprises were financed solely through

¹⁹ The CSRC on Making a Success of Work on Issuing Shares in 1997, released on 10 September 1997.

²⁰ In his speech at XV Communist Party Congress, President Jiang Zheming said that state-owned enterprises are the backbone of China's socialist market economy.

²¹ See, Zweigert, Konrad, *Introduction to Comparative Law*, 2nd ed. rev., Chapter V "The Socialist Legal Family", pp. 296-358 at p. 337. (Oxford: Clarendon, 1987).

budgetary allocations under the old central planning system. Funds were allocated according to priorities set out by the planning authorities and went primarily to state-owned enterprises with dominant positions in the economy. After the economic reform, the financial freedom given to enterprises to issue and list securities opened a new dimension for financing enterprises which to a certain extent allowed them to initiate their own developments in order to compete in the marketplace. This change, however, greatly affected State planning and overall control. New projects were undertaken outside governmental planning which placed significant pressure on general infrastructure such as transportation, energy, and raw materials; deposit savings in state-owned banks were decreasing as a result of investments moving to the securities market. These and other examples illustrated a situation whereby the government and enterprises often clashed with each other. To deal with this situation, the government has to strike a balance between the financial freedom of enterprises and the need for State planning and overall control.

Quota System. This was a system under which the central government limited the amount of capital to be raised in provinces, municipalities, and other local regions and the number of companies to be listed on national or foreign stock exchanges. Once they received their allocations, the provinces and municipalities would decide which companies should be sent up to the CSRC or the SCSC to receive final approvals for their issues and listings of shares. In 1994 a company specialising in Chinese traditional medicine was included in the list of companies to be sent abroad for listing, which, from a foreign underwriter's point of view, was not a logical company to be chosen for the international

stock markets.²² Here the method of selecting companies for listing -- not according to what investors want but according to the quotas allocated to localities -- may explain why such a typically Chinese company was selected for listing on the international stock market. As far as the applicant companies are concerned, they must, on one hand, meet the criteria to ensure an issue or listing, and on the other hand, they have to try every means to lobby local government departments and local securities regulators in order to qualify as one of the candidate companies selected under the quota of a particular province or municipality. Although, generally speaking, companies selected in this way are companies of high quality, the quota system has not always allowed the best companies to surface through a fair competition.

In addition to the quota system, the regulations limited the amount of capital to be raised by companies through certain means. For example, Article 28 of the Regulations on Shareholding of Internal Employees of Joint Stock Companies restricted the shares to be placed among company employees to no more than 2.5 per cent of the total amount of share capital which the company has issued. Similarly, a ceiling of 30 per cent was imposed upon the allotment of shares to existing shareholders by listed companies.²³ The primary reason for these restrictions, as explained by the government, is the need to control the scale and pace of the securities market in line with government macro-economic planning.²⁴ In 1994, faced with the problem that companies had ignored a 10

²² Roell, Sophie "Breaking the Taboo," *Euromoney*, February 1996, pp. 80-82.

²³ The CSRC announced Provisional Regulations on the Allotment of Shares by Listed Companies, *Fazhi Ribao (Legal Daily)*, 18 December 1993, p. 2.

²⁴ *Id.*

per cent limit in respect of shares placed among their internal employees, the regulatory authorities suspended the approval process for internal employee share placement in order to curb these and other irregularities.²⁵

Central Planning. This means that the total amount of share or debt securities to be issued in a given year is planned by the central government. The State Planning Commission, in conjunction with the PBOC, the Ministry of Finance, and the SCSC, first proposes the annual scale of securities to be issued and listed on stock markets and then submits the proposal to the State Council for final approval. A total of 5.5 bn Yuan, for example, was set for the issue of new shares in 1994. Once the annual scale has been confirmed by the State Council, government securities regulators approve applications in accordance with this annual scale. Article 2 of the B-share Regulations, for example, requires that the SCSC should grant approvals for B-share issues within the annual scale decided by the government. In other words, the SCSC may not approve applications for B-share issues beyond the annual scale set by the central government.

In order to implement the government's annual scale and planning of securities issue and listing, securities regulators reiterated time and time again that companies must not issue securities outside the state plan and their issues must be approved by the relevant government authorities. Measures were taken to penalize those companies who ignored the regulations and government warnings to carry out issues without approval. The tension between the need to exercise planning control by the central government and the need of enterprises to finance themselves by issuing securities in order to survive and

²⁵ See "The CSRC Releases Certain Policies Regarding the Development of Securities Market", a report in Chinese in *Renmin Ribao (People's Daily)*, 6 February, 1994, p. 2.

compete in the marketplace has thus become an important factor in the development of China's securities market. In fact, as early as 1990, before the establishment of the Shanghai and Shenzhen stock exchanges, the government's concern that securities issues should be an integral part of state planning was expressed through regulations restricting enterprises from issuing their own bonds without the approval of the PBOC and State planning authorities.²⁶ In 1994, in order to resolve the difficulties in selling government treasury bonds, it was directed that there was to be no public offering of debt or equity by enterprises until the treasury bonds had been sold.

Socialist Market Economy and Prospects for the Future. In his trip to Southern China in 1992, the former leader Deng Xiaoping pointed out that socialism does not necessarily mean a planned economy, nor does a market economy necessarily mean capitalism. His trip marked a turning point in China's economic reform, for from then on the reform started to pursue the so-called "socialist market economy". The overall objective of a socialist market economy in the next few decades was written into the Constitution of the Chinese Communist Party in late 1992, and into the 1982 Constitution of the PRC in early 1993.²⁷ Since 1993, the reform towards a socialist market economy has brought significant changes to the country's economic system, which in turn has affected the development of the securities market and securities regulatory regime.

The efficiency of western capital markets lies in their connection with an economy

²⁶ Potter, Pitman B., "The Legal Framework for Securities Markets in China: the Challenges of Maintaining State Control and Inducing Investor Confidence", *China Law Reporter*, 1992, Vol. 7, No. 2, pp. 61-94, at p. 70, and note 60.

²⁷ Article 15 of the Constitution of the PRC was amended to read "... the State shall adopt a socialist market economy ..." See the Amendments to the Constitution of the PRC, adopted by the first session of the Eighth National People's Congress on 29 March 1993.

based on the price system.²⁸ In the same way China could not efficiently allocate capital unless it first reformed the price system by allowing the prices of all goods and services to reflect supply and demand. As put by one commentator: "the unlikely prospect of a planning system allocating capital efficiency would be a stroke of fortune, unless the planners have exceptional knowledge of society's resources and of its demand for goods and services."²⁹ As a result of reforms of the price system, China has created a basic market price system to replace the old system under which the prices of goods and services were controlled by the planning authorities. There are now only about thirty kinds of goods, whose prices are still under planning control, as compared with more than one thousand types of goods previously under such control.³⁰ This change is having a fundamental influence on the efficiency of China's securities market.

In 1997 the PBOC announced its intention to abolish the loan quota system in the State banks and to stop assigning lending quotas to each bank. Instead the PBOC would exercise control over lending through guidelines and by regulations which monitor the

²⁸ This is because "the price system sends signals, in the form of higher and lower profits, to investors as to whether a business is performing effectively and whether demand and supply are in equilibrium. If there is little demand for a firm's products, its profits should drop. Accordingly, investors will not invest in an enterprise unless they expect an upturn in profits, perhaps caused by a rise in demand. In this way, capital is not wasted by being invested in the production of goods for which there is little demand. In contrast, if the demand for a firm's products exceeds supply, the price of the product will rise in a price system economy. This increases the firm's profits, attracting more capital from investors. This capital can then be used to expand production to increase supply to meet demand." Stamas, Nikos A., "China's Nascent Securities Market: Some Observations", in R.H. Folsom and J.H. Minan (eds), *Law in the Peoples' Republic of China*, (Dordrecht: Kluwer Academic Publishers, 1989) pp. 639-642 at p. 641.

²⁹ *Id.*

³⁰ See "Outstanding Achievements of the Economic Reform", a report in Chinese in *Renmin Ribao* (*People's Daily, Overseas Edition*), 14 August 1997, p.1.

asset quality of each bank.³¹ It is quite possible that the current quota system adopted in respect of securities issues and listing will be abolished as the securities market reform moves forward. The selection of companies to be brought to the market is not regarded as the role of an investment bank but, as put by foreign commentators, "it is very much a State Planning Commission and the CSRC show".³² This could also change when more attention is paid to professional advice from investment banks, stock exchanges, accountants, lawyers, and the like in the process of selecting companies for listing. The development of China's economic reform indicates that inevitably more practices of a market economy system will be adapted whereas those of the old central planning system will be abandoned.

A proposal has been put forward to rename the State Planning Commission as the State Development Planning Commission, which would be less involved in daily administration than its predecessor and would assume greater powers over macro-economic policy. Although it remains to be seen what changes, if any, this reform would bring to the securities market and securities regulatory regime, it is good news in that it is a further step along the road towards the separation of policy from administration in order to give companies and enterprises greater control over their own affairs.

C. Role of State Regulatory Authorities

The role of the securities regulator is fundamental to the smooth operation of the

³¹ According to a news report from *China News Digest* (<http://www.cnd.org>), 28 December 1997.

³² Roell, Sophie, "Reining in the Free Market," *Euromoney*, July 1996, pp. 147-149 at p. 147.

securities markets and the protection of investors. Without the regulators, the securities markets themselves could be destroyed and the protection of investors would be in doubt. But excessive involvement in the securities market by government regulatory authorities could equally be destructive to the market and harmful to investor confidence. China is a country where the government authorities are accustomed to extensive involvement in the administration of the economy and market activities. Although the economic reform has brought changes to the way in which the Chinese government administers the economy, the government still has an excessive role in the economy. As far as the securities market is concerned, there has been excessive involvement from the government and its securities regulator through, first, extensive approval procedures, and second, administrative intervention in the securities market.

Approval Procedures. In China official approvals are basic to most economic activities. The securities industry is no exception. Approval procedures are required at every stage of corporate and securities activities, ranging from the incorporation of companies, issuance of shares, listing of shares, to the trading of shares. It is often a lengthy process. If foreign investments, such as B-share investments, are involved, additional approvals are required from separate authorities. Equally, additional approvals will be required where the applicant companies wish to list their shares on a foreign stock exchange. As discussed in Chapters IV, V, and VI, applicant companies are subject to extensive government control through approvals from departments in charge, local provincial or municipal governments, state assets administrative bureaus, the SCSC, the CSRC, and finally, perhaps by the State Council itself in the process of incorporation, transformation of state-owned enterprises, and the issue and listing of domestic or foreign

investment shares.

Approval procedures could verify the quality of applicant companies and thus provide additional comfort to investors and promote the integrity of the securities market. The CSRC, for example, argued that in selecting companies the needs of international investors are taken very seriously, and the experience of the CSRC could be critical in timing and pricing for those companies which have no idea of what is involved in listing internationally.³³ From an economic perspective, the government argues that it has to exercise necessary macro control over the development and expansion of the securities market. This is another justification for the system of government examination and approval. However, compared with practices in western countries, the following problems arise from the system of governmental examination and approval in respect of securities activities.

First, the CSRC has taken on more roles than it should as a regulator. In conjunction with the SCSC and other government authorities, the CSRC has overall responsibility for the regulation and supervision of China's securities market. As discussed in Chapter II, the scope of the functions and powers of the CSRC is wide, ranging from approving companies to be listed on domestic and overseas markets, to intervening in the market if there is such need. It is an all-embracing role. This is particularly the case in respect of overseas listing, as put by the CSRC regulator: "for overseas listing, we do have regulatory functions, but we also play a very important role in educating, advising

³³ *Id.*

and co-ordinating. So we are educator, adviser, co-ordinator and, last of all, regulator."³⁴ It is arguable that the advisory role is not one which should be undertaken by a regulator. From a comparative perspective, for example, the Securities Exchange Commission in the United States does not make any determination of the merits of an offering when conducting review processes, but rather only examines the adequacy of the disclosure in the registration statement.³⁵ In contrast with the practice of the SEC in this respect, the CSRC has much wider discretion to approve or disapprove applicant companies or other related matters.

Second, the criteria which determines which companies are allowed to issue shares and to be listed are not always commercial criteria. Government priorities and political considerations are often as relevant. Local governments are frequently warned by the SCSC and the CSRC that in selecting candidate companies for share issue and listing, attention should be paid to central government priorities which may differ from those of local governments. At one time, for example, companies operating in infrastructure or other primary industries were treated by the central government as top priorities, whereas companies operating in real estate development were singled out by the SCSC and the CSRC as being inappropriate candidates. In 1995 Mr Zhou Beifang, the head of the Shougang Company, China's third-largest steel-maker and a listed company on the Hong Kong Stock Exchange, was arrested for "economic crimes". It was believed that he had close ties with the family of a top political leader in China and a Hong Kong influential

³⁴ *Id.*

³⁵ Beller, Alan L., et al, "Access to the US Capital Market," *International Financial Law Review*, 1994, Vol. 13, Supp April (PRC), pp. 17-24.

businessman, Li Ka-Shing, who held a 12 per cent stake in Shougang company and helped the Shougang company to be listed on the Hong Kong Stock Exchange. This story, if true, illustrates that political connections may sometimes be involved in the listing process. One of the first Chinese companies to issue convertible bonds on the international market was the Shanghai Tyre and Rubber Company. At the time when its application was going through the approval process, China and Britain were in a difficult relationship because of the Hong Kong issue. Political considerations weighed against the company's preferred choice of the London Stock Exchange and instead it was sent to Luxembourg to list its convertible bonds.

Third, approval procedures involve various authorities and separate approvals, which may cause serious problems to applicant companies. Different regulators may have different views on the same question, and applicant companies have to clear all the hurdles to obtain the necessary approvals for their applications. This may also be a lengthy and unpredictable process. In November 1994 the State Administration of Foreign Exchange (SAFE) forced Lehman Brothers to withdraw its proposed \$468million bond issue for the Beijing Expressway because the SAFE had not approved the issue, despite the fact that other necessary approvals had been obtained.³⁶ In such a multiple approval process, different departmental interests, various local interests, and differing opinions among departments or regulators may jeopardize an issue or listing application. Even if an applicant company manages to pass through all the approvals, it may still find that it

³⁶ "The SAEC had not approved of the transaction and wanted to make a show of power," said the head of capital markets at one US investment bank in Hong Kong, see, "Chinese Capital Feels the Chill," a report in *Euro money*, December 1994, pp. 25-27.

has missed time schedules for the issue and listing which are a vital element in the operation of stock markets, especially international stock markets.

Fourth, companies are subject to an exceedingly large number of approvals by government authorities in order to issue and list shares as compared with other countries. It is a common complaint in China that companies have too many "mothers-in-law", i.e., government departments which interfere in their commercial activities. One justification for the existence of these "mothers-in-law" advanced by the government is the need to protect State assets from misappropriation when state-owned enterprises are transformed into joint stock companies and shares issued to the public. It is true to say that the misappropriation of State assets in the process of transforming state-owned enterprises happened often and therefore the government "mothers-in-law" should be there to deter such misappropriation. On the other hand, large number of governmental approvals creates barriers to companies for the exercise of their autonomous management rights, which is precisely what the government wishes to promote as part of the establishment of China's socialist market economy.

Administrative Intervention in the Securities Market. One aim of economic reform in China is to promote the use of legal and market means rather than administrative in the regulation of market and economic activities. However, government intervention in the securities market through administrative means is still a problem in China. In August 1994, in order to counteract a long fall in the value of the A-share index, the CSRC introduced a series of emergency measures, including a temporary freeze on the issue and listing of new shares, tightened control over the distribution of bonus shares, and the

promotion of multi-channels for pumping funds into the stock market.³⁷ The central idea behind those emergency measures was to raise prices by restricting supplies and thus boost the market. A dramatic but volatile revival was sparked by those measures in the domestic A-share index. In the first week of trading following the CSRC announcement, Shanghai's A-share index gained 113 per cent, and in Shenzhen the index rose by 74 per cent. As put in a World Bank report: "this amounts to unwarranted market manipulation of a major nature."³⁸ The CSRC later admitted that the decision to adopt those measures was a mistake and resumed the approval of listings at the end of 1995. The artificial attempts made by the CSRC to boost the market through administrative means was also criticized by leading academics and economists. Professor Xiao Zhuoji from the Beijing University Economics Institute said that it was a relatively negative provisional measure intended to artificially restrict the number of listed companies and the quantity of shares on offer. What matters is stimulating demand for shares while increasing supply.³⁹

However, given the fact that China's securities market has numerous individual investors and a high sense of speculation, proper government intervention in the securities market seems necessary in order to lead the market from its highly speculative nature to one of sensible investment. It is necessary to boost investor confidence in the market when it is in the investors' interests to do so. But what the government should not be doing is to intervene in the market excessively through administrative measures, which

³⁷ There were many reports on the announcement of the CSRC about these measures in both domestic and international media; see among others, *The Guardian*, 2 August 1994

³⁸ Roell, Sophie, "Reining in the Free Market," *Euromoney*, July 1996, pp. 147-149 at p. 146.

³⁹ See "B-share Market Reportedly to be Opened to Domestic Investors", a news report, *Summary of World Broadcast (SWB)*, FE/2079 G/3, 20 August 1994.

will inevitably damage the healthy development of the securities market. In order to address problems such as chaotic financial order and rampant investment growth, the government adopted a series of intervention policies which required securities regulators to adopt similar intervention measures. Although such problems could be solved temporarily by these policies and administrative measures, a permanent solution depends on further reforms of the market economy, not on frequent government intervention in the economy in general and in the securities market in particular.

It has been officially recognised that "the government is handling many affairs it should not handle, it can not handle, and it could not handle well."⁴⁰ As a part of wider administrative reforms, the ministries of the central government will be reduced to twenty-nine from about forty at present time, and the number of civil servants in the central government will be cut in half.⁴¹ It is anticipated that these changes would bring further alterations to the functions of government agencies, including government securities regulators.

D. Government Policies and Securities Law

The development of China's securities market and regulatory regime is strongly influenced by ongoing policy changes. At each period of economic reform, adjustments were made to take into account the ideologies promoted by the Communist Party and government policies regarding the direction of economic reform in China. These

⁴⁰ Luo Gan, the State Council general secretary, uttered these words in his speech to the NPC in March 1998. See the report in *China-Britain Trade Review*, April 1998, p. 3.

⁴¹ *Id.*

adjustments subsequently led to changes of government policies in respect of the securities market and securities regulatory regime. Thus, government policies in respect of securities market and securities regulatory regime have been constantly shifting in accordance with the general policy of the country's economic reform. This is not surprising as the development of the securities market is far in front of the experiments with a socialist market economy. Primacy is given to government policies over regulatory principles and standards set down in formal laws and regulations. Regulatory provisions are constantly amended to comply with changing government policies. This has created uncertainty and inconsistency, and Chinese and foreign investors are faced with an unpredictable legal and regulatory environment.

In April 1987, for example, the Circular on the Share and Bond issued by the State Council presented a cautious policy of the central government and was a shift away from its previous policies regarding the issue of shares by state-owned enterprises. It was more restrictive than previous local government measures regarding the issue of shares and bonds by local state-owned enterprises. In late 1993 the approval procedure for the issue of internal employee shares was suspended due to the changing policy of the government which effectively tightened control over such shares.⁴² In 1994 a series of policy adjustments were made by the central government in order to curb supply and demand on the securities market.⁴³ Again in 1997 a sudden shift in government policy regarding

⁴² See "The SCSC Releases Certain Policies Regarding Development of Securities Market", a report in Chinese in *Renmin Ribao (People's Daily)*, 6 February, 1994, p. 2.

⁴³ See Section C of this Chapter.

treasury bond issuance led to investors moving to inter-bank and other markets.⁴⁴ These examples illustrate the consequences the constant policy changes of the government in regulating the securities market in China.

Policy Stability and Consistency. Policy stability and attendant consistency in the regulatory regime is essential to promote the steady development of China's securities market as well as to induce investor confidence. Given the fact that China is in a period of transition from a centrally planned economy to a socialist market economy, it is arguably impossible that the securities market will operate in an environment of policy stability and a consistent regulatory regime. It will inevitably be influenced constantly by changes in policies of the central government regarding macro-economic control. However, a stable and predictable legal and regulatory environment is vitally important, although to a certain extent this is impossible, partly because of the constant policy changes and partly because in practice policies are treated as law. Under the Chinese socialist legal system of past decades, government policies have always been a legitimate legal or regulatory source to fill gaps in laws and regulations. Because securities laws and regulations in China generally lag behind the rapid developing securities market, there is a pressing practical need to apply government policies to the wide range of issues China's securities market.

The uncertainty resulting from constant policy changes and the substitution of laws and regulations with policies adversely affects investor confidence, especially of international investors, in China's securities regulatory regime. A paramount consideration

⁴⁴ According to a news report from *China News Digest* (<http://www.cnd.org>), 1 November 1998.

in choosing the applicable law in international finance is certainty of laws and regulations, simply because financiers, professional advisers, and investors at large need to be assured certainty with regard to the issues they are concerned with.⁴⁵ Several years ago a comment made by China's premier Li Peng, which suggested that China's stock market was "experimental", contributed to the great doubts in international investor confidence in China's stock market;⁴⁶ the change of the CSRC head three times within just a few years since its establishment in 1992 contributed to constant uncertainty as to the future direction of the CSRC. However, efforts have been made to build a unified, consistent, and transparent system of securities laws and regulations in China, which has provided some comfort to international investors. In the long term, to build a consistent, transparent, and predictable system of securities laws and regulations in China depends not only upon policy stability, but also upon the general solution to the problems caused by the relationship between law and policy in China.

⁴⁵ See Tennekoon, Ravi, *The Law and Regulation of International Finance*, (London: Butterworths, 1991).

⁴⁶ See "World Stock Markets: Chinese Markets Still Down in the Doldrums - a Year of Little Cheer for Equities," a report in *Financial Times*, 28 December 1994.

Chapter IX

Investor Protection

Investor protection is the ultimate goal of securities regulation. Whether investors can be adequately and effectively protected is an important criterion by which to judge a country's securities regulatory regime. The importance of investor protection has been recognised in China's securities market and securities regulatory regime and efforts made to improve regulatory arrangements in order to provide adequate protection for domestic and foreign investors. But to achieve a high level of investor protection is not an easy task in China, where the old economic, social, and legal systems are under transformation and new systems are being constructed.

A. Unified National Securities Law

People are often impressed at how rapidly the securities market in China has developed in the years since the establishment of the Shanghai and Shenzhen stock exchanges. They are impressed by the increase of listed companies and volumes of

transactions in the two exchanges. B-share offering was launched in December 1991, shortly after the A-share market was opened to domestic investors. By the end of 1992, there had already been eighteen B-share offerings on the Shanghai and Shenzhen stock exchanges, all of which were launched within a matter of twelve months. When the Shanghai Stock Exchange celebrated the fourth anniversary of its opening, the A-share listings had increased from eight to 169 within four years.¹ Some foreign commentators regarded the development of China's securities market as an experiment of the most capitalistic nature in China's economic reform. In their view the establishment of the Shanghai and Shenzhen stock exchanges in a socialist country was remarkable enough, and even more remarkable was that the market, with hardly any history or established framework, was opened to foreign investors shortly after the opening of the domestic market.²

Legislation Behind the Development of Securities Market. Legislation, however, is lagging behind the rapid development of the securities market. In August 1992 a riot occurred outside the Shenzhen Stock Exchange over a shortage of A-share application forms when queues of crowded and anxious people fought their way through security guards and each other to purchase documents which were not themselves share application forms but which would only entitle them to participate in a lottery for an opportunity at a later time to apply for shares. This incident was regarded by foreign commentators as a typical reflection that the market was booming too fast and regulation was falling

¹ See "Shanghai Securities Market Has Gradually Improved", a report in China in *Renmin Ribao (People's Daily) (Overseas Editions)*, 16 December 1994, p. 1.

² Chao, Tien-yo, "Hong Kong and China: a Special Report," *International Financial Law Review*, 1993, Supplement March, pp. 24-32 at p. 25.

behind.³ With the rapid development of the securities market, investment funds became a focal point, and funds were set up one after another. However, they were created in the absence of a nationally unified code of legislation and were therefore not standardized in many ways. Provisional national regulations for investment funds finally came out in 1997 and temporarily solved the problem of the absence of a nationally unified code of legislation. The most cited example in this context is the drafting work for the Securities Law of the PRC, which started in 1992 but was delayed time and again.

In general, the following reasons have contributed to the "lagging" situation of Chinese securities laws. First, there has just not been enough time to create a regulatory infrastructure which could accommodate the rapid development of China's securities market. There is general consensus that China has come a long way in a short time. Second, ideological uncertainty has given rise to debates over the future direction of China's securities law, and these have affected the speed of the establishment of a regulatory infrastructure in China. As discussed in Chapter VIII, in the areas of property ownership, the relationship between the planned economy and market economy, and the ideological uncertainty which arises in the course of China's transition from a socialist planned economy to a socialist market economy are serious obstacles to the development of China's securities market and its regulatory regime. Third, different views and even tensions between various government regulators have delayed the regulatory development. The main reason for the delay of the Securities Law of the PRC, which had undergone numerous rounds of drafting, was the failure to resolve differing views between

³ See, Well, Dennis, "Unlisted Investments in China," and "Listed Investments in China," appeared respectively in the August and September editions of *China-Britain Trade Review*, 1992.

government regulators over certain important matters. Some regarded this as a power struggle behind the legislative process between the SCSC and the CSRC, on one hand, and the PBOC and other central and local government authorities on the other.⁴ One reason for the delay of the plan to allow foreign funds to invest in the domestic A-share market and provide finance for China's securities firms was the power struggle between the CSRC and the PBOC. The process of drafting relevant regulations by the CSRC to implement the plan was interrupted by the PBOC when the PBOC itself started to draft regulations on investment fund management. The looming regulatory battle between the CSRC and the PBOC has become an issue of great concern. Investors, especially foreign investors, are worried that if it becomes a continuous battle, it will adversely affect the development of China's securities market and the securities regulatory system.⁵

To establish a comprehensive national unified securities law is an urgent task for the protection of investors. The promulgation of the 1993 Company Law and related implementing rules replaced previous temporary company regulations with a statutory framework and improved investor protection in certain areas. The drafting of the Securities Law of the PRC was started almost at the same time as that of the 1993 Company Law, but it could not be adopted as scheduled. This disappointed domestic and foreign investors, as they were looking forward with confidence to the nation's first securities law -- a law that would bring market supervision, licensing and regulation under one authority. It is therefore no surprise that the situation was described by foreign

⁴ See "Zhou's Burden", a report by Tony Shale, *Euromoney*, May 1995, p. 14.

⁵ Soutar, Tim, et al, "Beijing and Shanghai Report: China Halts All Domestic Share Issues," *Burterworths Journal of International Banking & Financial Law*, 1994, Vol. 9, No. 10, pp. 502-503.

commentators as "dismaying and ineffective".⁶ Although the promulgation of the 1993 Provisional Regulations on the Administration of the Issuing and Trading of Shares intended to create a uniform framework for the issuance and trading of A-shares in China, the scope of regulation is limited and the rules remain provisional. After 1993, most of the securities regulations applicable at the national level issued by securities regulators were provisional administrative rules (*guizhang*). The enactment of the 1998 Securities Law of the PRC is no doubt an important stage in establishing a comprehensive national unified securities law in China. It no doubt strengthens the investor protection and helps build confidence in the securities market. However, just as other Chinese statutes, it provides general principles rather than detailed rules. It needs time to develop further detailed implementing rules in accordance with the statutory framework it established. In addition, problems have to be resolved in relation to the application of 1998 Securities Law of the PRC in practice.

A guiding rule for legislative work in economic areas in China is that legislation should initially be brief and later gradually be supplemented by detailed rules; legislators should not wait to prepare a "complete entire set of law". This unwritten rule was advocated by late Deng Xiaoping as part of his pragmatic theory on China's economic reform. It has influenced various economic legislation, including securities legislation. It explains why a significant number of laws and regulations in China are labelled "provisional", or "trial use". Given the fact that China is transforming to a new system and rapid changes are part of this transition, and given the fact that China's securities market

⁶ See "Disputes Delay Securities Law - Local and Foreign Stockbrokers Want One Authority to Administer a Single Set of Rules." a report by Simon Holberton, *Financial Times*, 7 November 1994.

is a young market, it is impossible to expect a comprehensive, stable, definitive, and detailed set of securities laws to be in place. On the other hand, incomplete, uncertain, indefinite, and brief regulations of a temporary nature inevitably create uncertainty for investors. A balance must therefore be struck between the need for rapid changes and the need to make securities laws more comprehensive, stable, definitive, and detailed. The enactment of the 1998 Securities Law of the PRC is a major step towards this direction.

Another instrumentalist aspect of the Chinese legal system is that laws and regulations on foreign investments represent a special set of rules aimed at achieving a special goal. Securities regulations governing foreign securities investments are a separate set of rules to promote foreign investments and to impose certain restrictions to them. For example, different disclosure regimes have been established for domestic and foreign investors, under which issuers of foreign investment shares have to prepare financial statements in accordance with international accounting standards, whereas issuers of domestic shares do not. This distinction reflects the recognition that foreign investors would be unwilling to invest in companies about which they did not have sufficient information. Foreign expert commentators, while accepting that discrimination between domestic and foreign investors is not unusual in developing countries, nevertheless regarded China's approach as being unique in creating various information disclosure standards among different types of shares and different types of investors.⁷

Similarly, it is not surprising to hear foreign participants in China's securities market insist that the various categories of fiduciaries and fiduciary duties should be

⁷ Spencer, Michael, "Securities Markets in China," *Finance & Development*, 1995, Vol. 32, No. 2, pp. 28-31.

standardized in the interests of fairness and certainty, including the holders of B-shares, H-shares, and N-shares, and amongst domestic investors who do not enjoy the same level of protection in those companies which have issued only domestic A-shares.⁸ There is no doubt that it is in the interests of domestic and foreign investors to have a consistent, coherent and comprehensive national securities law.

The B-share Regulations and B-share Implementing Rules promulgated in 1995 represented a step towards a uniform securities law in China. The next expected step is the unification of A-share, B-share, H-share, N-share, and other foreign investment shares. China's announcement in 1996 of the convertibility of Rmb in current accounts has paved the way for making the Rmb freely convertible by the third millennium. The impact of the convertibility of Rmb on securities regulation is far reaching. As the Rmb becomes freely convertible in stages, foreign investment shares consequently converge with domestic investment shares and the regulatory unification of A-share, B-share, H-share, N-share, and other foreign investment shares may then be achieved.

B. Implementation and Enforcement of Securities Law

A comprehensive system of securities laws does not necessarily mean there is adequate protection for investors. They must be properly implemented and effectively enforced, without which the securities laws themselves can not guarantee adequate investor protection. Since the early 1980s, China has undertaken on a massive legislative programme, the most productive period in the history of the PRC. Yet implementation and

⁸ Leung, C.Y. and Lim Seok Hui, "An Overview of China's New B-share Legislative Reforms," *China Law & Practice*, September 1996, No. 7, pp. 20-25 at 24-25.

enforcement have fallen behind and remain a serious problem. There are more rules than adherence. It is officially recognized that legislation has lagged behind the development of market reform, and that implementation and enforcement of laws have lagged behind the legislation. These two "behinds" are particularly true of securities market reform and securities laws and regulations. *The Role of the CSRC.* As a regulator in charge of the day-to-day supervision and regulation of the securities market, the CSRC is at the forefront of the implementation and enforcement of securities law and regulations. The CSRC has been given the power to conduct investigations, either on its own or in conjunction with other authorities, into any breach of securities law by any institution or individual. The power to investigate serious cases is, however, retained by the SCSC. Chapter 7 of the 1993 Provisional Regulation on the Administration of Issuing and Trading Shares deals with investigative powers and penalties for violations of regulations. Other regulations contain similar provisions regarding compliance and enforcement.⁹ In addition, Articles 207, 210, 212, 221 of the 1993 Company Law provide legal responsibility for false prospectuses and financial information and granting approvals to applicant companies which have not satisfied the conditions regarding incorporation and share issue and listing. The penalties range from a warning, fine, to revocation of the issuing and listing qualification. If criminal offenses have been committed, criminal liability will be imposed on those responsible. Although the CSRC has successfully investigated into a number of major cases since its establishment in 1992, it has limited numbers of staff and experience. In some respects, the CSRC has been shaped on the

⁹ For example, Chapter Five of the 1993 Provisional Measures on Prohibition of Securities Fraud set out the legal responsibility for insider dealing, market manipulation, and other securities frauds.

model of the Securities Exchange Commission in the United States, but it is not in a position to monitor the market effectively without more staff and experience. Moreover, due to the problems mentioned in Chapter III, such as the status of the CSRC and its relationship with the PBOC, the CSRC has not obtained proper "status and authority", which may affect the implementation and enforcement of securities regulations.

The Role of Stock Exchanges. Stock exchanges are responsible for daily surveillance of listed companies and securities trading. These powers and functions are governed by the Measures on the Administration of Stock Exchanges promulgated in August 1996, which replaced the Provisional Measures on the Administration of Stock Exchanges issued in July 1993. Under the 1996 Measures, stock exchanges have assumed more responsibilities for market administration and surveillance. A Stock Supervision Committee, established in each stock exchange, has specific and detailed powers and functions in supervising listed companies and securities trading. In February 1995, after a scandal involving treasury bond futures occurred in the Shanghai Stock Exchange, the Exchange was criticised for being lax in its rules regulating market supervision and surveillance. The central government tightened control over the Shanghai and Shenzhen stock exchanges by replacing the local heads of the two stock exchanges with officials from the CSRC. The Measures on the Administration of Stock Exchanges reinforced such control by providing that the president and deputy president of the stock exchanges shall be appointed by the SCSC in the future. Lessons have been learned by the stock exchanges and more efforts made to prevent irregularities and frauds. The Shanghai Stock Exchange, for example, began to organise compulsory intensive training courses for traders. One purpose of these courses is to educate traders in the law and help them

comply with securities regulations and trading rules.

The People's Courts and the People's Procuracy. Since the emergence of the securities market in China in the 1980s, the people's courts and the people's procurators have faced various cases involving securities and securities transactions which were new to them. The lack of experience became a major problem. To overcome such challenges and difficulties, measures were taken to help judicial personnel understand the securities market. The Supreme People's Procuracy, for example, encourages staff to take part in training courses organised by securities regulators or banking regulators.¹⁰

Another problem the people's courts and the people's procurators have to face is the lack of applicable securities laws. The principles stated in the 1986 General principles of Civil Law and other laws, such as the Contract Law of the PRC, are often too general or too remote for the courts to apply to the cases involving securities transactions. For example, to apply the principle of "honesty and truthfulness" as set out in the 1986 General Principles of Civil Law to a concrete case is not always an easy task for the courts to undertake. The amendments to the 1979 Criminal Law of the PRC have created new offenses dealing with securities, banking, and the financial market.

The lack of laws has been greatly improved in respect of criminal matters. As far as foreign investors are concerned, they have to be worried about the people's courts and people's procuracy. Apart from the lack of applicable laws, statutory interpretation, and uncertain outcomes of cases, they are concerned about interference in the judicial process

¹⁰ See the Circular of the SCSC, the PBOC, and the Supreme People's Procuratorate on Strengthening the Prevention of Securities Frauds by Those Who Engage in Securities Business, issued on 9 June 1995. The Circular in Chinese can be found in *China Procuracy Yearbook 1996*, pp. 308-310.

by Party or administrative authorities. Judicial independence in China is still some time away, although improvements have been made as a result of legal reform. The China International Economic Trade Arbitration Commission has, during the years since its establishment, earned internationally a reputation for fairness and independence and possesses an adequate degree of sophisticated experience. This is some comfort to foreign investors since they would normally resolve their cases involving securities transactions through arbitration.

A Complex Social Process. The implementation and enforcement of securities law, just as the implementation and enforcement of any other law, is a complex social process involving the inter-relationship of different social factors. In China the complexity of this process is closely linked with the economic reform and the transition China is undertaking from a socialist to a mixed society economically and ideologically. The following three factors, among others, have particularly contributed to the difficulties of implementing and enforcing securities laws.

First, the incomplete legal and regulatory system. As these systems in China are still being built, there are always loopholes and grey areas in legal and regulatory systems. Quite often there is no clear line of demarcation between right and wrong on some issues, which gives rise to opportunities for violations of securities laws and regulations. This in turn makes it difficult for regulators to implement and enforce securities law.

Second, social changes accompanying the economic reform and their effects. For example, the transition from a centrally planned economy to a market system has created ample opportunities for corruption and bribery to become a serious social problem. Although Communist Party officials have been formally banned by the Disciplinary

Commission of the Communist Party from trading on the stock market, having private business interests, and accepting gifts of negotiable securities, it is extremely difficult to enforce these rules effectively. It is a common phenomenon for the Communist Party and government officials to take advantage of their positions and make private gains from the securities market one way or another.

Third, people's attitudes towards law and regulations. It may be difficult to believe that the attitude of a large percentage of the population in China towards law and regulations can be described as "you do not have to follow law and regulations unless someone may be killed or money stolen," But this attitude is a reality in China. Although educational campaigns have been carried on to raise people's consciousness of law and change their attitudes towards law, the problem of "legal blindness" (*Famang*) remains. As far as securities law is concerned, there are serious problems of "legal blindness". To take information disclosure as an example, people, including those who hold important positions such as company directors, often do not take information disclosure rules seriously even though these rules are vital to the protection of investors. The examples discussed in previous Chapters, such as irregularities in submitting annual reports by some companies, are common in China's emerging securities market.

In order to improve the implementation and enforcement of laws and regulations, the National People's Congress Standing Committee issued the Several Provisions on Inspections and Supervision of Law Implementation and Enforcement in September 1993.¹¹ These Provisions have for the first time established a system under which the NPC

¹¹ For an English translation of the Provisions, see *Summary of World Broadcast (SWB)*, FBIS-CHI-93-180, 20 September 1993, pp. 25-26.

Standing Committee and its special committees conduct routine inspections on the implementation and enforcement of the laws adopted by the NPC and its Standing Committee. Inspections teams normally consist of one team leader and several members. Experts and officials from law enforcement authorities, as well as from local people's congresses, are invited to take part in inspections. Since the establishment of the system in 1993, inspections, carried out in respect of about twenty enactments, have proved to be an effective means to improve their implementation and enforcement. No such inspections have been carried out in the area of securities law, but it is expected that securities law will be given attention in future inspections.

Another important means to improve implementation and enforcement is education and training. Its importance has been recognised by the regulators, law enforcement authorities, and companies. The different types of educational and training courses on the securities market organised are a welcome trend. However, it will take time for the general public to be aware of legal rules and comply with them. It will also take time even for professionals and regulators to learn how the stock market works in China and how to regulate it more effectively.

Co-operation in Cross-border Enforcement of Securities Law. The growing internationalisation of investments and the investment business in the past decades has resulted in a closer link between world securities markets. In the meantime the internationalisation of securities markets has brought about problems of jurisdiction and the cross-border enforcement of securities laws. The turbulence of financial markets worldwide has brought chaotic disruption to the stability of international financial systems and to social stability. There is therefore an urgent need to strengthen co-operation among

banking and securities regulators worldwide and promote international regulation of the financial markets. In 1995, after the collapse of Barings Bank, the Windsor Conference was held in Britain, at which it was proposed jointly by the Basle Committee on Banking Supervision and the Technical Committee of the IOSCO to develop a common regulatory framework for international financial markets and take cross-border regulatory action when emergencies, such as the collapse of Barings Bank, occur.¹²

Back in the 1970 - 80s, the Securities Exchange Commission in the United States argued that securities frauds are global and thus encouraged certain initiatives for international co-operation in securities enforcement in the form of mutual assistance treaties in an effort to combat increasing securities fraud.¹³ Since then, the SEC has promoted other initiatives in international regulatory cooperation, for example, the Multi-jurisdictional Disclosure System (MJDS) with Canada.¹⁴ Simon Lorne, legal counsel to the SEC, argued that "the problem is that if you do not get harmonized regulatory procedures worldwide the worst practices will immigrate to the least regulated markets and that is not in anyone's interest."¹⁵ This is exactly what happened in China. There have been cases which revealed that certain people who had been declared to be unfit to carry on investment business in other countries trading in futures products in China.

¹² See "Regulators to Set International Guidelines Today", a report by Richard Lapper, *Financial Times*, 16 May 1995, p. 30.

¹³ See "US International Cooperation in Securities Enforcement: A New United States Initiative", a speech presented by Joseph A. Grundfest, commissioner of the SEC, 9 November 1988, at King's College London.

¹⁴ *Id.*

¹⁵ See an interview with Simon Lorne in *International Financial Law Review*, 1994 (4), p. 48.

It is therefore vitally important for China to take part in international efforts in cross-border enforcement of securities laws. Pursuant to Article 4 of the 1994 Special Provisions on Share Issue and Listing Abroad by Joint Stock Companies, the SCSC or CSRC may conclude a memorandum of understanding or an agreement with foreign securities authorities to co-operate in the regulation and supervision of Chinese overseas listed companies. The CSRC has so far signed several memoranda of understanding (MoU) with securities authorities of foreign countries, including among others, those of the United States, United Kingdom, Singapore, Australia, Japan, and Malaysia. These MoU have established regulatory frameworks for technical assistance, information sharing, and co-operative enforcement of Chinese securities laws and those of foreign countries. After China joined the IOSCO in 1995, the question of how to improve and strengthen China's involvement in international co-operation with other securities regulators has become an important subject of study and research. Extensive involvement in international co-operation would in turn require the improvement and strengthening of China's domestic overall legal system, foreign exchange management, financial market, and enterprise reform. Without a sound overall domestic environment, China's involvement in international co-operation in cross-border enforcement of securities laws would be significantly limited. It is a logical relationship. For example, the need for international judicial co-operation has resulted in an improvement in China's legal system in respect of international judicial assistance.¹⁶

¹⁶ See Chen, Tung-pi, "International Judicial Assistance in China: Plodding into the Twenty-first Century", Vol. 26 *The International Lawyer*, 1992, pp. 387-412.

C. Balance Between Too Much and Too Little Regulation

There are three main schools of thoughts regarding the regulation of financial markets in the City of London.¹⁷ The first school advocates a free market view, that a financial market works best when it is free from regulation; government regulations in the City only introduce distortions into the market which prevent it from working efficiently. The second school advocates the opposite view. In essence, it argues that the City is in a position to frustrate economic policies; the freedom of capitalists and the City must be limited in order to protect the majority investors. The third school advocates a compromise view between the first and second schools. It recognises, on one hand, that the City is a vital part of the economy, but on the other, it does not advocate a free City nor allowing it to pursue activities untrammelled by regulations. Although the discussion of these views is in the context of the financial market in the City of London, it may have general theoretical application.

Indeed, regulation is essential to the protection of investors, but excessive regulation is destructive of a successful and competitive securities market. History has witnessed, on one hand, numerous stock market crashes and heavy losses by ordinary investors, but on the other hand, continuous deregulation to make the securities markets more open and competitive. The key lies in striking the right balance between a free stock market and a heavily regulated stock market. The balance may vary in accordance with the economic, legal, social, and other conditions of each country at each period of its social and economic development.

¹⁷ Coggan, Philip. *The Money Machine: How the City Works*, (3rd ed.) (London: Penguin Books, 1995), at p. 174.

In the history of the Hong Kong regulatory regime, there has been a constant tension between increased government intervention and statutory regulation, and the forces which favour the free unregulated market in the tradition of the laissez-faire economy for which Hong Kong was known. Free market forces, throughout most of Hong Kong's history, had the upper hand in securities trading, with the result that, until the late 1970s and early 1980s, Hong Kong's regulatory structure had remained less sophisticated than those in developed jurisdictions.¹⁸ Following the October 1987 worldwide stock market crash, the Hong Kong regulatory framework and risk management system were overhauled and many reform proposals recommended by the Securities Review Committee were implemented. A balance was thus struck between the degree of prudential regulation necessary to ensure the continued reliability and high reputation of goods and services and the degree of freedom necessary to ensure that the market remain vigorously innovative and competitive. Since then the improved financial infrastructure and the fair and transparent regulatory regime in Hong Kong have attracted international investors and have met the demands of the sophisticated financial market place.

In the United States, after the Great Crash of 1929, restrictions were placed on the financial markets. As a result, international business began to flow to other countries, especially to London where there were fewer restrictions. Facing the increasing competition worldwide, New York abandoned many of the restrictions, and international business moved back to the United States. These examples show that it is important for

¹⁸ Ujejski, Tomasz, "Securities Regulation," in Raymond Wacks (ed) *The Law in Hong Kong: 1969-1989*, (Hong Kong: Oxford University Press, 1989), pp.282-301; Higgins, Mary Faith, *Securities regulation in Hong Kong 1972-1977* (Alphen aan den Rijn: Sijthoff & Noordhoff, 1978).

China, as a young securities market, to learn lessons from other countries and strike the right balance between the degree of regulation and the degree of freedom.

Securities regulation in China has, however, put more emphasis on the protection side and consequently restricted the development of a healthy and competitive securities market. This has been particularly prevalent in the financial futures market. In May 1994 the CSRC ordered the closure of most of China's futures trading centres and futures brokerage firms. Only a few were allowed to operate on a trial basis. The Crackdown on the Blind Development of the Futures Market Several Opinions issued in March 1994 by the SCSC stated that "share index futures and other index futures shall not be developed." These measures were criticized as having a negative effect on the development of China's financial futures market. Some commented that "it has given the impression that whenever the CSRC finds something wrong, or something against its regulation, it would naturally close it. But that is not the best way to develop a market."¹⁹

There are three main grounds on which the CSRC and other government regulators justify a tightly regulated securities market in China. The first justification is to limit speculative activities on the securities market. Thus, the measures to order the closure of the financial futures trading centres and financial futures firms, ban state-owned enterprises and listed companies from engaging in trading shares, and prohibit banks from providing loans for investment in the securities market are all to restrict speculation. It is true to say that in China the securities market has been speculative, especially in the early periods, highly speculative. However, speculation is unavoidable. Securities firms and

¹⁹ Roell, Sophie, "Reining in the Free Market," *Euromoney*, July 1996, pp. 146-149.

individual investors have to speculate: they have to speculate with regard to securities prices, and they have to speculate in the companies in which they invest. To criticize speculation in the securities and financial futures markets and impose various restrictions is to ignore the basic facts of a securities market. The need is, therefore, to strike a balance between excessive and normal speculative activities. It seems that the CSRC and other government regulators have gone too far in this respect.

The second justification is to protect state-owned assets. There has been a serious concern by government and securities regulators that state-owned assets may be lost as a result of the emergence of the securities market.. Many regulations and measures adopted by the CSRC and other relevant government regulators have reflected such concern, and the protection of state-owned assets has been a high priority of the government in the development of the securities market. These regulations and measures include to ban State commercial banks from engaging in the investment fund and share business, to ban state-owned enterprises and listed companies from engaging in trading shares, and to tighten control over asset injection in Chinese overseas controlled companies. It is understandable that the protection of state-owned assets is an urgent issue from the government point of view and accordingly measures should be taken to protect state-owned assets. But the emphasis on the protection of state-owned assets is often at the cost of significantly reducing the degree of freedom necessary to ensure an innovative and competitive market. The tightened control over assets injection in Chinese overseas controlled companies may, for example, affect their competitiveness in the international market.

The third justification is to protect general public investors and maintain social

stability. Given the fact that in China ordinary individual investors lack risk-awareness but are eager to gain profits through securities investment, it is important for government regulators to pay attention to their interests. There used to be a time, for example, when thousands of institutions, some legal and others illegal, were calling themselves brokers and selling their products to masses of ignorant investors. Under circumstances such as this, firm control and regulation is necessary to protect the interests of ignorant investors. But as China's securities market becomes more mature and sophisticated, and knowledge about securities among ordinary individual investors is improving, the focus of attention of the government regulator should shift from protecting individual investors to relaxing certain regulations to promote a fair, open, and competitive market subject to the right balance of regulation.

In relation to the protection of general public, the government and securities regulators have always put the purpose of maintaining social stability at the top of its agenda. The government and securities regulators are concerned that the stock market should not be allowed to become a source of social instability. There were, for example, riots over the share subscription form outside the Shenzhen Stock Exchange, and there were people who committed suicide after they had lost money in the stock markets. These events had their impact on social stability. The turbulence in some Asian financial markets have sent out warning signals to China and neighbouring Asian countries. While there is no doubt that the CSRC should put the task of maintaining social stability at the top of its agenda, a balance needs to be struck between maintaining social stability and promoting an innovative market.

In western countries a distinction is often made between professional sophisticated

institutional investors and unsophisticated ordinary individual investors, and different systems of protection are adopted for each respectively. The philosophy behind such distinctions is to offer protection to those investors who need it without over-extending the reach of regulation so that it covers those investors who can fend for themselves. From a commercial point of view, a high level of investor protection is often accompanied by a high level of inconvenience, inefficiency and costs, and thus affects the competitiveness of the market. By exempting institutional or otherwise sophisticated investors from a certain burden of regulatory requirements, a competitive market can be promoted whilst the interests of ordinary individual investors are protected. China has not so far made such a distinction, partly because of the early stage of development of the securities market, and partly because of the regulatory philosophy of China's securities regulator.

D. Strong and Efficient Regulator

Regulators are essential to the protection of investors. A strong and efficient regulator must deliver adequate standards of supervision and investor protection which the securities industry and the public expect. The United Kingdom has announced plans to create a new super regulator, to be established as a single financial service regulator with a full range of powers now available in the existing self-regulatory bodies. The change will involve a massive centralization of supervisory powers under the new regulatory body, the enlarged Securities and Investment Board (SIB). It is the biggest shake-up in the City's regulatory regime for more than a decade. The proposed change has revealed certain common problems in securities regulation, so it is valuable to consider the

proposal to see what, if any, China's securities regulators could learn for the development of the securities regulatory regime.

In accordance with the proposed plans, the enhanced SIB will take control of the three existing self-regulatory organisations (SROs): the Securities & Futures Authority, the Investment Management Regulatory Organisation, and the Personal Investment Authority, and possibly will eventually take over the regulatory powers of other self-regulatory bodies. This means that the change would involve a massive centralization of supervisory powers under the new super SIB.

In a similar way the process of centralisation of supervisory powers has occurred in China and may continue in the future. As mentioned in previous Chapters, the SCSC and the CSRC have taken direct control of China's two national stock exchanges, centralizing the regulatory powers of the local regulators in such matters as the appointment of the president and vice-president of the two stock exchanges. To adopt the type of regulatory regime, be it self-regulation or state-regulation, or mixed self-regulation and state-regulation, is a matter for each country to choose, depending upon its approach towards securities regulation and its economic, social, and legal circumstances. In China, although self-regulators have been allowed to perform certain regulatory responsibilities, their roles have been very limited. Moreover, their roles and responsibilities may be centralized by the central government regulator, as happened in the case of self-regulators of the Shanghai and Shenzhen stock exchanges. One important advantage of self-regulators is their independence and impartiality. They are to a greater extent insulated from the risk of party-political intervention, and this is just what China needs in the development of its regulatory regime.

The regulatory structure in the United Kingdom, a divided regulatory system created in the Financial Services Act 1986, is thought to be "inefficient, confusing for investors and lacks a clear allocation of responsibilities."²⁰ The same problems exist in China's regulatory structure. As was discussed in Chapter III, the institutional structure of China's securities regulation, with the SCSC and the CSRC at the centre and supplemented by various other central and regional government regulators, is one which leads to certain problems. First, responsibilities overlap between them; second, it lacks a clear allocation of responsibilities among different regulators; and third, it could result in inefficiency because many regulators share responsibilities.²¹ These problems prompted the proposal in the 1993 Securities Law of the PRC (draft) to unify various regulators into a single and strong central securities regulator, the State Securities Regulatory Commission, which was also written into the following 1994 Draft. From the investor protection point of view, the State Securities Regulatory Commission proposed by the drafts of the Securities Law of the PRC is a better solution for China's regulatory structure because it could resolve the problem mentioned above and thereby raise efficiency and reduce confusion for investors.

A strong and efficient securities regulator is important for the protection of the investor, but the costs to develop and operate such a regulator should be considered and balanced. This is important for investors because the costs will ultimately borne by savers and investors. George Staple, a former head of the Serious Fraud Office, welcomed the

²⁰ See, "Brown Ends Self-regulation," a report by Anne Segall and Helen Dunne, *The Daily Telegraph*, 21 May 1997, p. 29.

²¹ See Chapter III, in particular, section A. Securities Commissions, and section B. Government Departments.

incorporation of the Bank of England's banking supervisory function and the SROs into an enlarged SIB. He particularly pointed to increasing costs incurred by "the diversity of regulators in the City."²² In China the costs incurred by the diversity of regulators could also be high, and they too, whether from the central government or local government budget, are ultimately borne by savers and investors. Although the cost problem may present itself differently in China and the United Kingdom or other securities regimes, the nature of the problem remains the same. It is in the interest of protection of investors that the regulator should be efficient and cost-effective, and the system should reduce compliance costs and increase investor confidence in the regulatory regime.

The creation of the enlarged SIB in the United Kingdom will bring together the regulation of banking, securities, and insurance under one roof in order to bring the regulatory structure closer into line with the increasingly integrated financial markets. It is argued that "the distinctions between different types of financial institution - banks, securities firms and insurance companies - are becoming increasingly blurred. A regulatory system based on old market structures was becoming increasingly inappropriate."²³ Under the regime in the United Kingdom a bank is supervised by the Bank of England, but its stockbroking, asset management, retail financial service advisory arm and unit trusts operation are each supervised by a different agency. This, it is argued, increases the costs and reduces the effectiveness of supervision.²⁴ Under China's

²² See "Brown's Big Bang", *Gazette* (Weekly Journal of the Law Society), 94/21 29 May 1997, p. 12.

²³ See "Labour Swoops on City Sleaze," a report by Anthony Bevins et al., *The Independent*, 21 May 1997, p. 1.

²⁴ *Id.*

regulatory regime, the banking regulator, insurance regulator, and securities regulator are separate. Considering the stages of development of China's financial market, the separation seems a necessary step. But as the financial market in China becomes more open and more integrated, China may need to consider combining the regulation of banking, securities and insurance under one roof following the proposed British model.

A series of scandals badly damaged London's reputation as an international financial centre. In 1995 Barings was put into administration after a trader lost £800m, and in 1996 Deutsche Morgan Grenfell was fined for a violation of securities rules by a U.K. fund manager, to mention only a few.²⁵ This is one of the reasons which prompted the Labour government to shake-up the City's regulatory regime. As put by Chancellor Gordon Brown, he wanted "to reduce the chance of events such as the mis-selling of personal pensions happening again."²⁶ The reform plan was welcomed by the Consumers' Association and some MPs who had been concerned by the growing list of embarrassing financial scandals.²⁷ They regarded the reform as necessary to protect small savers, pensioners, and investors and to enhance the international reputation of London's financial markets. Coincidentally, one of the important reasons for the SCSC and the CSRC to tighten the control over the Shanghai and Shenzhen stock exchanges and centralize local regulatory powers is because the growing list of scandals in the securities market in China. Whether an enhanced SCSC and CSRC would reduce scandals in the securities

²⁵ For a list of more of these scandals, see the report in *The Guardian*, 14 March, 1997, p. 3.

²⁶ See "Brown Plans Overhaul of City Regulation," by Tom Stevenson and Diane Coyle, *The Independent*, 21 May 1997, p. 22.

²⁷ *Id.*

market remains to be seen, but a strong and efficient regulator could certainly help to fight against securities frauds. But it is doubtful that a strong and efficient regulator alone could effectively reduce the chance of events which damage the reputation of the securities market and harm the interests of investors. It should be emphasised that this is a complex social process which needs the combined efforts of regulators, legislators, procurators, professionals, and the investors themselves. In the international context there must be effective cross-border co-operation of securities regulators of different countries.

Concluding Remarks: Securities Regulation in China During an Era of Change

Our age is an era of change. China's economic reform which started in late 1970s is part of worldwide reforms and changes. It has transformed China from a socialist centrally planned economy to a mixed economy with market elements. China's securities market is one of the emerging securities markets of developing countries. A securities regulatory framework has been established to oversee the market and protect investors. Previous chapters have addressed some of the regulatory issues which have risen in the development of China's law of securities regulation.

A. Establishment of Comprehensive System of Securities Law in China

To establish a comprehensive national securities law is an urgent task facing China. The securities market has rapidly increased in the number of listed companies and volume of transactions in the country's two stock exchanges. Securities legislation,

however, is lagging behind the development of the securities market. The drafting work for the Securities Law of the PRC started in 1992, but the law was delayed time and again. This disappointed domestic and foreign investors who looked forward with confidence to the nation's first securities law - a law that would bring market supervision and regulation under one authority. We have examined three main reasons which have contributed to the "lagging" situation of Chinese securities laws: first, divergent views and sometimes tensions among different government regulators have in effect delayed regulatory development; second, the ideological uncertainties in such areas as property ownership have given rise to debates over the future direction of China's securities law, which has affected the speed of the establishment of the regulatory infrastructure in China; and third, there has not been enough time to create a comprehensive regulatory infrastructure to accommodate the rapid development of China's securities market. The main reason for the delay of the Securities Law of the PRC, in author's view, is the failure to resolve different views among government regulators over certain important matters and the power struggle behind the legislative process between the SCSC and the CSRC, on one hand, and the PBOC and other central and local government authorities, on the other.

One guiding principle for legislative work in the economic areas in China which was advocated by Deng Xiaoping as part of his pragmatic theory of China's economic reform is that legislation should initially be brief and later gradually be supplemented by detailed rules, and that legislators should not wait to adopt for a "complete set of law." We argue that, given the fact that China is undertaking a transition from its old system to an unprecedentedly new system and rapid changes are taking place as a result of this

transition, and given the fact that China's securities market is very young, it is impossible to expect a comprehensive, stable, definitive, and detailed set of securities laws to be ready whenever the development of securities market requires such a law. But on the other hand, incomplete, uncertain, indefinite, and brief temporary regulations inevitably create uncertainty. A balance should therefore be struck between the need for rapid changes and the need to make securities laws more comprehensive, stable, definitive, and detailed.

In line with the instrumentalist nature of the Chinese legal system, China's regulations governing foreign securities investments are also a separate set of rules devised to promote foreign investment as well as to impose certain restrictions. Different disclosure regimes, for example, have been set out for domestic and foreign investors reflect the Chinese regulators' recognition that foreign investors would be unwilling to invest in Chinese companies about which they lack sufficient information. In our view that it is in the interests of domestic and foreign investors to have a consistent, coherent and comprehensive national securities law. The B-share Regulations and B-share Implementing Rules promulgated in 1995 represented a step towards a uniform set of securities law in China. The next expected goal is the unification of the regulations and rules governing A-share, B-share, H-share, N-share, and other foreign investment shares. The 1998 Securities Law of the PRC has, however, not unified separate rules governing domestic and foreign securities investments.¹ China's announcement in 1996 concerning the convertibility of Rmb held in current accounts has paved the way for the Rmb to become a freely

¹ Article 213 empowers the State Council to formulate separate measures in respect of shares of companies in China which are to be subscribed and traded in foreign currencies by foreign investors.

convertible currency. The impact of Rmb convertibility on securities regulation would be far reaching. It is possible that as the Rmb becomes freely convertible in stages, foreign investment shares would converge with domestic investment shares, and the regulatory unification of A-share, B-share, H-share, N-share, and other foreign investment shares could then be achieved.

Securities regulation in China has emphasised investor protection, which in turn has restricted the competitiveness of the securities market. This is particularly so in the financial futures market. We have examined in detail the three main grounds on which the CSRC and other government regulators justify a tightly regulated securities market in China. The first is to restrict speculative activities; the second is to protect state-owned assets; the third is to protect general public investors and maintain social stability. The view that proper regulation is essential to the protection of investors is persuasive, but excessive regulation, on the other hand, may destroy a successful and competitive market. The key lies in striking the right balance between a free securities market and a heavily regulated securities market, and the balance may vary depending on economic, legal, social, and other conditions of each country and the stages of their social and economic development. We have explored the securities regulations of Hong Kong, New York and London and strongly believe that these examples are important for China in the sense that, as a newly emerged securities market, China should learn lessons from these examples to strike a balance between the degree of regulation and the degree of freedom to ensure a healthy and competitive securities market. China should follow the practice of some countries and distinguish between professional sophisticated institutional investors and unsophisticated ordinary individual investors and accordingly draw a distinction between

systems of protection for institutional and individual investors respectively. Moreover, China should encourage new securities business, develop new securities products, and in the meantime take a cautious approach in order not to bring too wide a range of commercial business activities within the scope of securities regulation.

The development of China's securities market and regulatory regime has been influenced strongly by continuing policy changes. Preference is often given to government policies over regulatory principles and standards set down in formal laws and regulations. Regulatory provisions are constantly altered to follow changing government policies. This has created uncertainty and inconsistency, and Chinese and foreign investors are often faced with an unpredictable legal and regulatory environment. Examples have been given to illustrate the influence of policy changes on the regulation of the securities market in China. Policy stability and consistency of the regulatory regime is essential to promote the steady development of China's securities market and induce investor confidence. However, given the fact that China is now in transition from a centrally planned economy to a socialist market economy, it is arguably impossible that the securities market could expect to enjoy an environment of policy stability and consistency of regulatory regime. Constantly changing policies adopted by the government to adjust its macro-economic control over the economy and economic reform are inevitable. Equally, to achieve a certain and predicable legal and regulatory environment is arguably impossible in China also because of the practice in China that policies are treated as laws. In the Chinese socialist legal system of past decades, government policies were always treated as a legitimate legal or regulatory source to fill gaps in laws and regulations. In the long term, to build a consistent, transparent, and predictable system of securities law and regulations

in China depends not only upon policy stability, but also upon a general environment wherein the relationship between law and policy in the Chinese legal system is put in proper balance and government or Communist Party policies are not treated as a formal source of law.

The Adaptation of foreign securities law is important for China to transform its system of securities law into one which meets international standards and is thus acceptable to foreign investors. We have examined in detail the need to adapt foreign securities laws and practices: first, the need to attract foreign investors and overseas equities; second, the need to induce the confidence of foreign investors; third, the need to facilitate Chinese companies to list abroad; fourth, the need to fill the gap which exists in Chinese securities laws in order to build a comprehensive securities regulatory system in China; and fifth, the need to expand international co-operation with foreign securities authorities and create a legal environment for such co-operation. We note that the adaptation of foreign securities laws and practices should be a process of combining China's own conditions and circumstances with foreign legal concepts and practices. Two extreme views are particularly harmful to the adaptation of foreign securities laws and practices: one opposes the adaptation of foreign securities laws and practices in principle, and the other favours adaptation but without any reservations. The former view over-emphasises China's own conditions and circumstances, whereas the latter view turns a blind eye to them. People's attitudes, especially those of legislators and government officials, towards adaptation of foreign securities laws and practice in China are important. Some may support it, and some may not. But China must open up its securities market, and the Chinese securities regulatory system needs to be accepted by international

investors. Those who do not support adaptation of foreign securities laws and practice may gradually change their attitudes.

A comprehensive system of securities law does not necessarily mean automatic adequate protection for investors. The system must be properly implemented and effectively enforced. The implementation and enforcement of securities law in China have fallen behind the development of the securities market. We have examined in detail the role of the CSRC, the stock exchanges, the people's courts, and the people's procuracy in the implementation and enforcement of securities laws and analyzed some of the problems. It is our view that implementation and enforcement of securities law, just as the implementation and enforcement of any other law, is a complex social process involving different social factors and their relationships with each other. In China the complexity of this process is closely linked with economic reform and the transition China is undertaking from a socialist society to an economically and ideologically mixed society. Three factors have particularly contributed to the difficulty of implementation and enforcement of securities laws: first, the incompleteness of the legal and regulatory system; second, the social changes accompanying the economic reform and their effects; and third, people's attitudes towards law. An important and effective means to improve the implementation and enforcement of securities regulation is through education and training. However, it will take time for the general public to be aware of legal rules and comply with them, and time is necessary even for professionals and regulators to learn how the securities market works in China and how to regulate it more effectively.

Co-operation in the cross-border enforcement of securities laws has become more important along with the growing internationalisation of the investment business. The

turbulence of financial markets worldwide shows that financial turbulence could potentially bring chaotic disruption to the stability of the international financial system and the stability of the societies involved. We believe there is an urgent need to strengthen co-operation among banking and securities regulators worldwide and to promote international regulation of the financial markets. Consideration has been given to some steps which the Securities Exchange Commission of United States and the IOSCO have taken to promote initiatives for international co-operation in cross-border enforcement of securities laws. It is vitally important for China to take part in cross-border enforcement of securities laws. The question of how to improve and strengthen China's involvement in international co-operation with other securities regulators depends partly upon the improvement and strengthening of China's overall domestic legal and financial systems. Without a sound overall domestic environment, China's involvement in international co-operation in cross-border enforcement of securities laws would be significantly limited..

B. Establishment of Strong and Efficient Securities Regulator

Regulators are regarded as watchdogs in the regulation of the securities market and the protection of investors. A strong and efficient regulator is essential to deliver adequate standards of supervision and investor protection to the securities industry and the public. We have examined from a comparative perspective the reform plan proposed by the Labour Government in the United Kingdom which would introduce a single financial service regulator, an enlarged Securities and Investment Board (SIB), to regulate the financial market. The proposed change has revealed common problems faced by securities regulation generally, and the comparison undertaken is intended to illustrate what, if any,

China's securities regulator could learn for the development of China's securities regulatory regime.

The creation of the enlarged SIB in the United Kingdom would bring together the regulation of banking, securities and insurance under one authority to reflect the increasingly integrated financial markets. Under China's regulatory regime, the banking, insurance, and securities regulators are separate. We believe that considering the stages of development of China's securities and financial markets, such separation seems necessary. But as the securities and financial markets in China become more open and integrated, China may need to combine the regulation of banking, securities and insurance under one authority following the United Kingdom model.

The institutional structure of China's securities regulation, with the SCSC and the CSRC at the centre and supplemented by various central and regional government regulators, is a regulatory structure which may lead to certain problems. First, responsibilities overlap between them; second, it lacks a clear allocation of responsibilities among different regulators; and third, it may result in inefficiency because of so many regulators sharing responsibilities. We believe that, from the investor protection standpoint, a strong and efficient central securities regulator is a better solution for China's regulatory structure. This will be in some way similar to the proposed enlarged SIB in the United Kingdom.

The centralisation of supervisory powers has been underway during the past few years and seems likely to continue. The SCSC and the CSRC, for example, have taken direct control of China's two stock exchanges, centralizing the regulatory powers of local regulators in such matters as appointment of the president and vice-president of the two

stock exchanges. It is a matter of each country's own choice to determine its type of regulatory regime, be it self-regulation, state-regulation, or a mixture of the two. The choice depends upon the country's approach to the system of securities regulation and upon its general economic, social, and legal circumstances. In China, although self-regulators have been allowed to assume certain regulatory responsibilities, their roles have so far been limited. Moreover, even their limited roles and responsibilities may be centralized by the central government regulator. One important advantage of self-regulators is their independence and impartiality. To a greater extent they are insulated from the risk of party-political intervention. This is just what China, as a country with a centralised Communist Party, needs in the development of its securities regulatory regime.

A strong and efficient securities regulator is important for the protection of investors, but the costs of such a regulator should be considered and balanced. The costs will ultimately be borne by savers and investors. Although the cost problem may present itself differently in China and the United Kingdom, or in other systems of securities regime, the nature of the problem remains the same. It is in the interest of the protection of investors that the regulator should be efficient and inexpensive, and should be able to reduce compliance costs and increase investor confidence in the regulatory regime. This is another reason for the establishment of a central regulator in replace of various tiers of regulators.

A series of scandals has damaged reputation of London as an international financial centre. This has prompted the Labour Government to shake-up the City's regulatory regime. Coincidentally, one important reason for the SCSC and the CSRC to tighten control over the Shanghai and Shenzhen stock exchanges and centralize local

regulatory powers is the scandals in the securities market in China which damaged the integrity of securities market and harmed the interests of investors. While, on one hand, a strong and efficient regulator could certainly fight against securities frauds, on the other hand, it is doubtful that a strong and efficient regulator alone could effectively reduce securities frauds. This is a complex social process combining the efforts of legislators, regulators, procurators, professionals, and investors themselves to combat securities frauds. It is also necessary to strengthen cross-border co-operation among securities regulators of different countries since more and more securities frauds, especially large scale frauds, have a global nature in one way or another.

C. Further Reform on Regulation of Securities Market

As discussed in Chapter VIII, the development of China's securities market and its regulatory regime has not gone beyond the limitations of socialist ideologies in modern China. Although economic reform and the open-door policy have brought significant changes in China, the socialist ideologies of China in the past decades have restrained economic reform. It is against this background that China has developed its securities market and securities regulatory regime. On one hand, China is adapting foreign securities laws and bringing the securities regulatory regime closer to international standards, but on the other hand, the regulatory culture of China's securities market has distinctively Chinese socialist characteristics. We have considered four aspects of China's securities regulation where these characteristics are most in evidence, including ownership relationships, economic planning practices, the government role in securities regulation, and the relationship between government policies and securities law.

The reform of state-owned enterprises and the role of shares and the shareholding system have been reconciled with the ideological concern of public and private ownership of enterprises in China's economy. We reviewed first the early regulatory approach under which state-owned enterprises were permitted to raise funds through bond issues, but were not permitted to issue shares, whereas collective-owned enterprises were permitted to issue shares but not bonds. This approach was regarded by commentators as being consistent with the requirements of socialism since the state-owned enterprise bonds did not transfer ownership of property owned by the whole people. Collectively-owned enterprises stocks reflected the ownership interests of shareholders but did not entail loan commitments that the enterprises might not be able to perform. We then examined in detail two main themes which have been running throughout the development of securities regulation in China since 1987, namely, protection of the primacy of socialist ownership and limitation on foreign ownership in state-owned companies. The ideology of socialist public ownership of the means of production and the private ownership of company shares are reconciled by keeping a balance between private and public ownership of state-owned companies in favour of socialist public ownership. In line with the change in policy made at the 15th Communist Party Congress held in September 1997 the government would in future focus on 1,000 or so key state-owned enterprises, allowing the rest either to go into bankruptcy or be sold to the private sector; the CSRC adopted measures which are intended to help large and medium sized state-owned enterprises to improve their capacities and competitiveness through the issue of shares. However, it is author's view that although the policy changes announced by 15th Communist Party Congress have opened new prospects for state-owned enterprises, the ownership controversy and the problem

associated with this controversy in China's securities law need to be resolved fundamentally both in theory and in practice before state-owned enterprises can fully utilize the securities market in the future.

Central economic planning is another fundamental socialist characteristic. In the development of China's securities market a tension arises between the need to exercise planning control by the central government and the need to finance enterprises through securities in order to survive and compete in the marketplaces. This work has examined the problems associated with the quota system and other planning measures adopted by the central government to control securities issues and listings and the size of China's securities market. The quota system limits the amount of capital to be raised by provinces and municipalities and the number of companies to be listed on Shanghai and Shenzhen stock exchanges or on foreign stock exchanges. Other planning measures control annual securities issues and listings, limit the amount of capital to be raised by companies through a certain instrument, and control securities issues and listing outside state planning. It is author's view that these planning measures and the tension they created are an inevitable stage in the development of China's securities market in the period of China's transition from a planned economy to a market economy. To establish a socialist market economy in China was written into the 1992 Constitution of the Chinese Communist Party in and into the 1982 Constitution of the PRC in 1993 as the country's objective in the next decades. In our view the current quota system should be abolished with the further development of market reform; the selection of companies for the purpose of listing them on the market should not be a "State Planning Commission and the CSRC show" but a process in which investment banks, stock exchanges, accountants, and

lawyers play a more important role.

In China official approvals are penetrating every aspect of economic activities. The securities industry is not exception. Thus approval procedures are required in every stage of corporate and securities activities, ranging from incorporation of companies, issuance of shares, listing of shares, to trading of shares. On the positive side, approval procedures may ensure the quality of applicant companies, promote the integrity of the securities market, and provide additional comfort to investors. We acknowledge these and other justifications for government examination and approval of corporate and securities activities. However, we have also examined a number of problems associated with governmental examination and approval. First, the CSRC has taken more roles than it should take as a regulator; second, the criteria which determine which companies are allowed to issue shares and be listed on the market are not always commercial criteria, and government priorities and political considerations are often as relevant; third, the approval procedures often involve various authorities and separate approvals, and as a result different regulators may have divergent views on the same question and applicant companies have to clear all the hurdles to obtain necessary approvals for their applications. This may be a lengthy and unpredictable process; fourth, companies are subject to an exceedingly large number of approvals compared with other countries under a free market economic system. The government has recognised that it is handling many affairs it should not handle and cannot handle well. In early 1998 a radical reform was implemented which reduced substantially the number of ministries of the central government and its civil servants. We anticipate that this official recognition and the reform programme will bring further changes to the functions of government agencies,

including government securities regulators.

One aim of economic reform in China is to promote the use of legal and market rather than administrative means to regulate economic activities and markets. However, government intervention in the securities market through administrative means remains a problem in China. Having examined administrative intervention measures introduced by the CSRC in the regulation of China's securities market, this work argues that given the fact that China's present securities market is marked by numerous individual investors and a high level of speculation, proper government intervention in the securities market at this stage is necessary for the purpose of leading the market from being a highly speculative arena to a sensible investment forum. But it is further argued that although temporary intervention administrative measures are necessary, the permanent solution to the problems of China's securities market lies in further reform of the market economy and further improvement of the regulatory regime. From a regulatory point of view, what the government should not be doing is to intervene in the market excessively through administrative measures, which will inevitably damage the healthy development of the securities market in China.

D. Further Opening Up of China's Securities Market

The liberalization process in the financial services sector in China is an important part of the wider economic reform programme which has been closely linked with the negotiation of China's entry into the World Trade Organization since the 1990s. We have looked at the steps which were taken to accelerate this liberalization process. First, more cities have been allowed to open up to foreign banks, which may set up joint ventures

with Chinese partners; second, the scope of business has been enlarged and in certain cities Chinese currency (Rmb) banking business has been opened to foreign financial institutions; and third, preparations are underway to allow foreign financial institutions to participate in China's insurance and securities markets. A pilot scheme in Shanghai opened up Rmb business to foreign financial institutions as an example of liberalization. However, there also are arguments against the full-scale entrance of foreign financial institutions into China. It is expected that the full scale engagement of foreign financial institutions in the domestic Rmb business is some time away and foreign financial institutions will have to confront significant regulatory hurdles before they can develop the full range of Rmb financial services in the banking and securities sectors.

An important step was taken in 1996 to liberalize foreign exchange control when China announced that its Rmb currency would be convertible in current accounts as of December 1996. This step opened a new dimension for foreign financial institutions to participate in China's banking and securities business. Although the convertibility of Rmb in current accounts is a major step in the process of liberalization of the financial services sector in China, the securities market will be open substantially to foreign investors only when the complete convertibility of the Rmb is realized. While there are indications to show that China is moving towards a more open and liberated regulatory environment to encourage foreign investors to participate in China's securities market, there are difficulties in the liberalization process. Progress, for example, has been made in improving transparency, about which foreign investors have complained; but on the other hand, such progress is but limited progress.

The discussion of the relationship between China and Hong Kong in respect of the

securities market and regulatory system is an important part of the equation. Hong Kong has returned to become a Special Administrative Region (SAR) of China. This is significant in that it brought prospects for the integration and convergence of the securities market and regulatory system of the two sides. It opens up a new era of development for the securities market and regulatory system of mainland China and Hong Kong in that the return of Hong Kong will have an overwhelming effect on the future direction of the Hong Kong securities market, and China's securities market will be affected by the Hong Kong securities market as a better regulated, more developed, and more open market. Interface between securities regulation in mainland China and Hong Kong will be inevitable. It is beneficial for both systems of securities law if they move towards harmonisation. Examples have been cited of regulatory harmonisation in Europe and the United States to argue that China and Hong Kong could learn from these models in order to build a harmonised regulatory regime as those in Europe and the United States.

The Basic Law of Hong Kong reserved the existing common law in the Hong Kong SAR. We believe that the Hong Kong government decision to invite two serving Law Lords from the United Kingdom to be available to sit on the Hong Kong Court of Final Appeal will not only promote the quality of justice and independence of the judiciary of Hong Kong, but also create a safeguard to ensure that the common law tradition continues to remain a cornerstone of the legal system of Hong Kong. A proposal to establish a Bilingual Legal System Committee has been put forward by the Hong Kong government as a permanent institutional establishment to strengthen judicial co-operation between mainland China and Hong Kong. In addition, efforts have been made to translate Hong Kong laws into Chinese and provide a fully bilingual legal environment for the use

of Chinese in the judicial process. It is author's view that all these developments will affect the relationship of securities market and regulatory regime between mainland China and Hong Kong and promote the integration and convergence of securities regulation of the two sides.

E. Challenge in the 21st Century

The reforms and changes worldwide in past decades have provided a historic opportunity for China to develop its securities market. The establishment of China's securities market and securities regulatory regime is a natural result of China's economic reform and open-door policy, which in turn followed the trend of reforms and changes worldwide. As the world moves into the 21st century, it is witnessing a growing globalization and competition. Regional securities markets and regulatory regimes are becoming increasingly linked with each other in international contexts. Deregulation of global financial services will open up world markets in banking, insurance, asset management and brokerage in the years to come.² These developments will compel China to make continuing efforts to keep up with the worldwide trend of globalization and competition. The level of China's securities market and securities law must approximate other international financial centres; otherwise, China will isolate itself from the international community. China has promised to take further steps to liberalise the

² See, the World Trade Organisation (WTO) talk on the liberation of communication and financial services which produced the Geneva agreement of the 132 WTO members on deregulation of global financial services. Source: China News Digest, <http://www.cnd.org>, 18 December 1997.

regulation of foreign banks and foreign insurance companies in China.³ This and other moves signalled that China is taking serious steps to follow the worldwide trend and is preparing itself for the challenge of the 21st century.

³ *id.*, China made an offer at the WTO on 5 December 1997 to grant national treatment to foreign banks in terms of registered capital and guaranteed funds, and allow foreign insurance companies to set up wholly-owned subsidiaries. Foreign banks will be allowed to handle local currency business in Shanghai first, and in five special economic zones two years after China joins the WTO.

Chapter XI

The Latest Developments: 1998 Securities Law of the People's Republic of China

At the time when I began to write this work in 1994, the drafting work on the Securities Law of the PRC had already been underway for nearly two years. The Company Law of the PRC was adopted at the end of 1993. There was then a high expectation among academics and practitioners that this would be followed by the Securities Law of the PRC. The year 1994 saw another round of drafting and discussion without passing the law and the hope was moved on to the year 1995. Under these circumstances, I delayed completing the Thesis to wait for the adoption of this law, but realised later that I could not wait for it any longer. I then proceeded the Thesis on the basis of first two drafts of the law and all the other regulations promulgated both before and after 1993.

After all these years of drafting and discussion, the law was finally adopted by the Standing Committee of the NPC on 29 December 1998 and became effective 1 July 1999. It is the first securities law of the PRC and its significance could, in a loose sense, be described as that of the Securities Act 1933 in the United States and the Financial

Services Act 1986 in the United Kingdom. It contains 12 chapters and 214 articles, covering securities issue, securities trading, take-over of listed companies, stock exchange, securities firm, services relating to securities activities, government regulatory and self-regulatory bodies, and legal responsibility.

The adoption of the 1998 Securities Law of the PRC marked a new stage of China's securities regulation. Since 1992, when the drafting work on the Securities Law of the PRC started, more than 200 national and local securities regulations were promulgated. In addition, the Shanghai and Shenzhen stock exchanges were established in 1990 and 1991 respectively, and this was followed by the establishment of the SCSC and the CSRC in 1992. All these developments moved China's securities market and its corresponding regulatory framework from one stage to another, from a primitive towards a more sophisticated framework. There is no doubt that the 1998 Securities Law of the PRC has opened up a new stage in the development of China's law of securities regulation. The following provides a brief account of the law in order to reflect this latest development in the law of securities regulation in China. The discussion focuses on the four aspects, namely, the scope of the law, the securities commission and self-regulatory bodies, the regulation of the primary securities market, and the regulation of the secondary securities market.

A. Scope of the Law

Article 2 of 1998 Securities Law states that “the Law applies to the issue and trading in China of shares, company bonds, and other securities defined by the State Council” and “the issue and trading of government securities shall be regulated separately by law and

regulations.” In effect, this Article provides expressly that share (*gupiao*), corporate bond (*gongsi zaiquan*), and the issue and trading thereof are governed by this law. As far as other forms of securities are concerned, the State Council has a delegated power to determine in the future whether they shall be covered by this law. It is also noticeable that Article 2 effectively, first, excludes implicitly commodity and financial futures products from the scope of this law; second, separates government debt securities from corporate debt securities; and third, separates the securities that are open to domestic investors from the securities that are open to foreign investors.¹ Throughout the 1998 Securities Law, there is no definition of share and corporate bond, nor is there a separate chapter or section that provides further interpretation of the terms used in the law.

Compared with the positions proposed in 1993 and 1994 Securities Law (drafts) regarding the scope of regulation, the approach adopted in 1998 Securities Law is more like that of the 1994 Draft rather than 1993 Draft. In fact, if one compares the wording of Article 2 of the 1998 Securities Law with Article 2 of 1994 Draft, these two Articles are almost identical. Both are in a general and brief form, leaving the gap to be filled by the State Council. On the other hand, the approach adopted by the 1993 Draft was to provide a detailed statutory scope of regulation. Apart from the provision regarding the scope of the law in Article 2, Article 6 of 1993 Draft further listed, in the form of an interpretation of the term “securities”, various forms of “securities” that were to be governed by 1993 Draft. It was pointed out in Chapter II that, in terms of legislative technique and style, the approach taken by the 1993 Draft was closer to those of foreign

¹ Article 213 stipulates that the State Council shall adopt separate implementing rules for the regulation of shares open to foreign investors for purchase and trading.

securities legislation whereas the approach taken by the 1994 Draft was closer to Chinese legislation in that there was no special section nor schedule devoted to definition or interpretation and additionally provisions are all in a general and brief format.

To exclude commodity and financial futures products from the scope of the law means that these products and their markets have to be regulated under separate regulations. The State Council has promulgated the 1999 Provisional Regulations on Administration of Futures Trading,² which, at the moment, is the national regulation dealing with futures markets. It remains to be seen whether it will be upgraded into a separate law on its own or will be incorporated in the 1998 Securities Law of the PRC through amendments. To separate commodity and financial products from shares and corporate bonds and other forms of securities shows the hesitation of the government to promote futures markets in China because of a fear that these markets may have a devastating effect on social and political stability. To separate government debt securities from corporate debt securities confirms the practice adopted so far, that government debt securities are better left to be administrated separately by the PBOC as a channel for government budgetary finance. Similarly, to separate securities open to domestic investors from those open to foreign investors confirms the practice adopted so far that two markets and two sets of rules are necessary to control foreign investment in securities industry in China.

The approach taken by the 1998 Securities Law may bring about the following problems. First, such brief statutory scope may create the problem of uncertainty. It is

² It was promulgated on 15 June 1999 and effective as of the same day.

obvious that people need to know for certain whether a given form of securities or securities business is governed by the law. They turn to the text but have no answer. They then consult the implementing regulations, and if there are no such regulations, they must wait for an answer from the State Council or securities regulatory authorities. The 1998 Securities Law further provides that “where this law does not stipulate, the provisions of 1993 the Company Law of the PRC and other laws and regulations shall apply”.³ In practice, the application of the 1993 Company Law and “other laws and regulations” may cause problems.

Second, it remains to be seen how the State Council or its securities authority will exercise its discretionary power in relation to the selection of securities that are to be governed by the 1998 Securities Law. Before the adoption of the 1998 Securities Law, the State Council was the authority which decided the scope of securities regulation. It could include any security within the scope of securities regulation and also exclude any security. The 1998 Securities Law now establishes the statutory scope of securities regulation, but also gives the State Council a delegated power to define what securities should be governed by the law. As far as the State Council authority is concerned, there is no difference between the position before and after the 1998 Securities Law except that such authority has now received statutory recognition. In general, it is necessary to delegate a discretionary power to a body to enlarge or restrict the scope of the regulation. But the power delegated to the State Council by the 1998 Securities Law may lead to a situation where the State Council exercises the power against the intention of the Standing

³ Article 2.

Committee of the National People's Congress and thus enlarges or restricts the scope of the regulation in a way which was not intended by the legislative body. If, on the other hand, the primary 1998 Securities Law provides a more detailed regulation, thus problem could be avoided to a great extent.

Third, additional difficulties may arise due to the absence of a definition of “securities business” in the 1998 Securities Law. Such omission also existed in 1994 Draft. In contrast 1993 Draft provided a definition of “securities business” in the form of an interpretation of the term. The approach taken by the 1993 Draft, from a comparative perspective, is similar to United Kingdom 1986 Financial Services Act, which defines what businesses are to be governed by the Act as a “securities business”. In the absence of such definition in the 1998 Securities Law, it would be difficult to ascertain whether a given form of business activity falls under the scope of the law. This in turn may lead to a situation where “innocent” commercial activities are unwittingly caught by the breadth of the interpreting power of the State Council or its securities authority as discussed in Chapter II above.

B. Securities Commission and Self-regulatory Organisation

Article 7 of the 1998 Securities Law stipulates that the State Council Securities Regulatory Authority (*guwuyuan zhengquan jiandu guanli jigou*) is to exercise centralised and unified supervision and regulation over the securities market of China. Article 8 stipulates that centralised and unified state regulation shall be supplemented by self-regulation through the Securities Industry Association (*zhengquanye xiehui*), a self-regulatory organisation. These two Articles set the basic tone of the Law with regard to

the regulatory structure China is preparing to pursue, that is, strong state regulation supplemented by limited self-regulation. This basic approach was actually reflected in the 1993 and 1994 Drafts and proposed throughout the entire drafting process. The difference between the approach adopted by the 1998 Securities Law and that contained in the 1993 and 1994 Drafts is a matter of degree. In general, the previous drafts tended to confer more powers and functions on self-regulatory organisations, whereas the 1998 Securities Law has actually limited their powers and functions.

To promote self-regulatory organisations and adopt the concept of self-regulation (*ziluxing guanli*) in the previous drafts and the final version of the 1998 Securities Law is an example which shows that China has made attempts to draw on foreign securities legislation for China's law of securities regulation. As argued in previous chapters, self-regulatory concepts and practice in China is only form but not substance. This is mainly for the the following two reasons. First, the role played by self-regulatory organisations is very limited. If one looks at the provisions of the 1998 Securities Law regarding the Securities Industry Association,⁴ one sees that the functions and responsibility conferred on the Securities Industry Association by the law are only related to routine matters and welfare issues regarding its member securities firms, including among others matters relating to services and training in member firms, to members' suggestions and requests which are to be reported to government regulators, and to mediation of disputes among member firms. Such important matters as approval powers for the establishment of securities firms are left to the government regulators.

⁴ Chapter 9, Articles 162-165.

Second, self-regulatory organisations are subject to tight control by the government regulator. This is particularly the case regarding the control of stock exchanges. Article 100 of the 1998 Securities Law stipulates that the general manager of stock exchanges is to be appointed and dismissed by the State Council Securities Regulatory Authority. In contrast, the 1994 Draft proposed that the general manager of stock exchanges be appointed and dismissed by the board meeting of the stock exchange concerned.⁵ In the same vein, Article 96 of 1998 Securities Law stipulates that the articles of association of stock exchanges and amendments thereof must be approved by the State Council Securities Regulatory Authority. This approval power was also originally proposed to be held by the members' general meeting of stock exchanges under the 1994 Draft.⁶ In this sense one can hardly say that stock exchanges are still regarded as a self-regulatory organisation, a position proposed by both the 1993 and 1994 Drafts. In fact, the 1998 Securities Law does not explicitly recognise stock exchanges as a self-regulatory organisation.

To strengthen the power of the State Council Securities Regulatory Authority is one of the main themes of the 1998 Securities Law. Article 168, for example, provides that the State Council Securities Regulatory Authority, in carrying out its functions, has the power to enter the premises of the person or institution concerned to take evidence, interrogate the person or institution concerned, read and copy trading records, accounts, registers, and other relevant materials, seize relevant documents and materials which are

⁵ Article 98.

⁶ *Id.*

in danger of being moved or concealed, and apply to the court for freezing relevant accounts or funds. Although a provision conferring similar powers on the State Council Securities Regulatory Authority was proposed in the 1993 and 1994 drafts of the Securities Law, it was not as strong as Article 168 of the 1998 Securities Law in that some of these powers were not proposed. Moreover, both the 1993 and 1994 Drafts provided safeguards in order to prevent abuse of these powers by the government regulator. Article 143 of 1993 Draft, after listing the powers that the government regulator could have in relation to their investigative power, emphasized that such investigation should be limited to the "necessary scope" and should "follow relevant legal procedures". These words, however, are not included in Article 168 of the Securities Law 1998. It is arguable that there is a danger of these powers being abused by the government regulator. It is necessary, on one hand, to strengthen the power of the government regulator and give it teeth, but on the other hand, it is also necessary to restrain such powers in order to prevent them being abused by the government regulator. In this respect the 1998 Securities Law leans too much on one side and ignores the other. This, in the long term, may damage the strong securities regulator that the 1998 Securities Law actually intends to create.

C. Regulation of Public Offering of Securities

Chapter 2 of the 1998 Securities Law deals with the public offering of securities, including Articles 10-29. Throughout the chapter, the main theme is that of government approval for applications for public offerings of securities. Article 2 stipulates that a public offering of securities must comply with the conditions set out by the provisions of

relevant laws and regulations and must be submitted for approval to the State Council Securities Regulatory Authority or the government department with an approval power delegated by the State Council. No institution or individual may offer securities to the public without such an approval. Based on this general principle, the law sets out further requirements regarding the procedures and documentation at different stages of the approval process. The State Council Securities Authority or other relevant government departments are delegated to promulgate further detailed rules regarding these procedures and documentation. Legal responsibility is accordingly imposed on those who violate the law by offering securities publicly without approvals of relevant authorities.⁷

Public offerings of securities through a tightly-controlled government approval regime, on one hand, could guarantee the quality of securities and companies to be put on the market for public subscription and thus provide comfort to investors, but on the other hand, as previous chapters noted, could lead to a series of problems, such as bureaucracy, political influence, and distortion of fair competition. To a certain degree, some of these problems created by the government approval process could be reduced or avoided thanks to a system established by the 1998 Securities Law under which a statutory Issue Examination Committee (*faxing shenhe weiyuanhui*) shall be formally set up to undertake approval work. Article 14 stipulates that Issue Examination Committee shall consist of expertise from the State Council Securities Regulatory Authority and professional experts appointed from outside. The Committee shall decide upon the application for public

⁷ Article 175 stipulates that those who issue securities publicly without approval shall be ordered to stop the issue, return the capital raised together with interest, and be fined between 1% to 5% of the capital raised. Those who are directly responsible for the violation of the law shall be cautioned and fined between Rmb 30,000 to 3000,000. Where criminal offenses are committed, they shall be investigated.

offering through a voting system to ensure that the approval process is fair and transparent. This system and the Issue Examination Committee were actually proposed and put into practice several years ago. The 1998 Securities Law confirms this practice on a statutory footing, which confirms the determination of the government to create a fair and open approval procedure with regard to public offerings of securities. But it remains to be seen whether the Committee can really exercise its professional judgment or merely serve as a "rubber stamp" of the government regulator in the process of approving public offering applications.

As far as individual members of the Committee are concerned, they are not allowed to accept presents from issuing applicants, to hold shares of the applicants whom they have approved, and contact the applicants privately.⁸ Obviously, the aim of these strict restrictions is to promote a clean Issue Examination Committee and attract the confidence of issuing applicants as well as of general public investors. Article 205 provides that if the committee member of the Issue Examination of Committee do not perform their duty in accordance with the law, they are subject to administrative penalties and where criminal offenses are committed, they shall be investigated and charged. This Article, together with relevant provisions of the 1997 Criminal Law of the PRC and relevant regulations regarding administrative penalties, puts pressure on committee members in order that they abide by the rules and perform their duties in accordance with the law.

Although various campaigns in China have achieved relatively successful results in fighting against corruption, bribery, and other forms of illegal activities within the

⁸ Article 15.

government administration, official corruption is still a serious problem. It is significant under these circumstances that the 1998 Securities Law sets out these strict requirements to fight against official corruption in the securities industry. It may be difficult to implement them in the real world, but at least they will have an impact on the members of the Issue Examination Committee.

Apart from the government regulator, professional intermediaries such as accounting firms, law firms, asset valuers, sponsors, and lead managers are all playing an increasingly important role in the public offering of securities. One focus of the 1998 Securities Law is to recognise the importance of these intermediaries and increases their roles accordingly. In the past twenty years of economic reform, professional firms have developed rapidly in law, accountancy, investment and other commercial areas. As far as the securities market is concerned, these professional firms are an inseparable part of it. They need the market, and the market needs them. The 1998 Securities Law reflects these developments by putting these intermediaries in an appropriate place and holding them responsible for any false, misleading, and incomplete information they prepared for the issuing applicants. This will help increase the confidence of the general public and protect their investment interests. But on the other hand, whether issuing applicants can or can not come to the market still depends largely if not entirely upon the approval of government regulator, and not upon the advice or assessment of these professional intermediaries. This is a limitation China can not go beyond at a time when it is still a country where tight government control of or intervention in the securities market is still taken as granted.

D. Regulation of Secondary Securities Market

The regulation of the secondary securities market is the centre part of the 1998 Securities Law. It is an area where the final version of the law has departed substantially from the early drafts of the law. While the early 1993 and 1994 Drafts tended to give more power and freedom to the market and allow the market to regulate itself, the 1998 Securities Law adopts an approach which promotes strong government intervention in market trading activities. One important underlying reason for this approach is that the Asia financial crisis which occurred in 1997 left unforgettable marks not only on those Asian countries which were directly affected by it but also on China, though it was not directly affected. After the crisis, China's authorities, including the government, securities regulator, and legislative body, all took the event very seriously and their attitudes profoundly influenced the 1998 Securities Law. Throughout the provisions regarding the secondary market, one can find that government control over stock exchanges has been significantly tightened⁹ and a range of trading activities has been barred as prohibited trading activities.¹⁰

The strengthening of government control over stock exchanges under the 1998 Securities Law has been achieved by shifting powers from the stock exchanges to the State Council Securities Regulatory Authority in two main areas, namely, rule-making and appointment. Some rules of stock exchanges are formulated by the stock exchanges but approved by the State Council Securities Regulatory Authority. These include the articles

⁹ Chapter IV: Stock Exchange, including Articles 95-116.

¹⁰ Chapter III, Section iv, "Prohibited Trading Activities", including Articles 67-77.

of association of the stock exchange,¹¹ the rules relating to trading carried out in the stock exchange,¹² and the rules relating to members of stock exchanges and their code of conduct.¹³ Other rules of stock exchanges are formulated not by the stock exchange but by the State Council Securities Regulatory Authority either on its own or in conjunction with other government departments. These include the rules relating to suspension and termination of listed companies,¹⁴ and the rules relating to operation of the risk fund required under the 1998 Securities Law and set up by stock exchanges .

As far as the appointment power is concerned, the general manager of stock exchanges is appointed and removed by the State Council Securities Regulatory Authority.¹⁵ The law is silent as to whether the State Council Securities Regulatory Authority has the power to appoint and dismiss other senior staff of stock exchanges, but it could be assumed that the government regulator will have direct influence on these matters either through the general manager appointed by the government or through government approval of the articles of association or other relevant rules of stock exchanges.

The section of the 1998 Securities Law on "prohibited trading activities" (*jingzhi jiaoyi xingwei*) has codified previous regulations relating to insider dealing, manipulation of the market, and other illegal trading activities. In relation to this section, Chapter XI of the

¹¹ Article 96.

¹² Article 113.

¹³ *Id.*

¹⁴ Article 108.

¹⁵ Article 100. See also the discussion about this power in the context of self-regulatory bodies at p. 281.

1998 Securities Law, "legal responsibility", includes several articles which create legal responsibility regarding a violation of the law on prohibited trading activities. Together the section on "prohibited trading activities" and the relevant articles in Chapter XI have built a bridge between the 1998 Securities Law on one side, and the 1997 Criminal Law and the 1993 Company Law, on the other. These three laws form a strong legal framework to fight against insider trading, manipulation of the market, and other illegal activities, including among others defaulting investors and the fabricating and spreading of false information.

There are however several apparent problems about the approach the government has taken to formulate the 1998 Securities Law in relation to the regulation of the secondary securities market. First, to shift powers from stock exchanges to the State Council Securities Regulatory Authority has actually paved the way for strong government intervention in the market. Second, to strengthen government control over trading activities and prohibit some of them as prohibited trading activities may in fact stop certain normal trading activities. For example, to bar state-owned enterprises from taking part in speculation in securities may prevent these enterprises from carrying out normal trading activities for hedging purposes. Third, there is an inconsistency between the 1998 Securities Law and the 1997 Criminal Law with regard to criminal responsibility and punishment. For example, the 1998 Securities Law expressly categorises the people working as government regulators as a special group of people and they would be punished severely if they violate securities laws and regulations. The 1997 Criminal Law, however, does not have such an express provision to separate the people working as securities regulators from other groups of people for the purpose of punishment.

E. 1998 Securities Law and Future Development of Securities Regulation in China

The 1998 Securities Law of the PRC, the first ever securities law of the People's Republic of China, has no doubt brought the regulation of the securities market in China into a new stage. It is a law which has codified the regulatory practices China implemented during past years in its securities market. It has also reflected the new development of China's securities regulation which has taken place in recent years, especially after the Asian financial crisis. There are, however, several areas regarding which the 1998 Securities Law has not provided any statutory provision. These can be roughly divided into two groups. One is the group which involves certain fundamental socialist ideological issues, and the other is the group which involves some securities market practices which China has not yet fully implemented and thus has not gained enough experience in past years.

There are, for example, no provisions in the 1998 Securities Law regarding the trading of state-owned shares, nor any regarding the merges of the A-share and B-share markets, about which there has been heated debates among both academics and practitioners. The reason why there are no provisions concerning these two areas is that they involve socialist public ownership, an issue which has not been resolved satisfactorily by the Chinese government. Similarly, there are no provisions in the 1998 Securities Law regarding, for example, investment funds, an area which China wants to develop fully but is cautious due to, among other reasons, a lack of experience.

The drafting of the 1998 Securities Law actually has been a process in which China has tried to fit capitalist securities market practices into China's own conditions without fundamentally changing its present system, and also a process in which China has tried

to acquire capital securities market experience in order to create a similar but not identical securities market in China. At the beginning of this work, it was stated that China's emerging securities market is part of worldwide reforms and changes. It is predictable that, based on the developments China has promoted to regulate its securities market, China will continue to follow the worldwide trend of reform and change to develop the 1998 Securities Law. This process could be slow and could be fast, depending directly upon China's overall economic reform and indirectly upon the process of China's future political and social reforms.

Glossary of Chinese Terms

Chinese-English Index

B gu	B-股	B-share
Caiwu gongsi	股份公司	Finance company
Caiwu kuaiji baogao	财务会计 报告	Financial accounting report
Congshi zhengquan yewu	从事 证券业务	To carry on securities business
Difang	地方	Local
Difang zhengquan faqui	地方 证券法规	Local securities regulations
Faren gu	法人 股	Legal person-owned share
Faqi chengli	发起 成立	Incorporation through the method of promotion
Faxing shenhe weiyuanhui	发行 审核委员会	The Share Issue Examination Committee
Gaizu/Gaijian	改组·改建	Restructure
Geren gu	个人 股	Individual-owned share
Gongsi faren	公司 法人	Corporate legal person
Gongsi zaiquan	公司 债券	Corporate bond
Gongzhong gu	公众 股	Shares for public
Gufen	股份	Shares
Gufen youxian gongsi	股份 有限公司	Joint stock company
Gupiao	股票	Share certificate

Guizhang	规章	Administrative rules
Guojia gu	国家股	State-owned share
Guojia zhengquan guanli weiyuanhui	国家证券管理委员会	The State Securities Regulatory Commission
Guoku quan	国库券	Treasury bond
Guoyou duzi gongsi	国有独资公司	Wholly state-owned company
Guoyou qiye	国有企业	State-owned enterprise
Guozai qihuo	国债期货	Treasury bond futures
Jiejian	借鉴	Adaptation through borrowing
Jimin gupiao	记名股票	Registered share
Jingji ren	经纪人	Broker
Jingnei	境内	Inside the territory of China
Jingnei shangshi waizi gu	境内上市外资股	Domestically-listed foreign investment share
Jingrong qihuo	金融期货	Financial futures
Jingrong qihuo gongsi	金融期货公司	Financial futures firm
Jingwai	境外	Outside the territory of China
Jingwai shangshi waizi gu	境外上市外资股	Overseas listed foreign investment share
Kezhuanhuan zaiquan	可转换债券	Convertible bond
Konggu	控股	Controlling share
Muji chengli	募集成立	Incorporation through the method of public issue
Neibu zhigong gu	内部职工股	Internal employees share
Neimu jiaoyi	内幕交易	Insider dealing
Neimu ren yuan	内幕人员	Insiders
Neimu xinxi	内幕信息	Inside information
Neizi gu	内资股	Domestic investment share
Nianzhong baogao	年终报告	Annual report
Qiye zaiquan	企业债券	Enterprise bond

Quanguo	全国	National
Quanguo zhengquan fagui	全国证券法规	National securities regulations
Renmibi tezhong gupiao	人民币特种股票	Renminbi special share
Shangping qihuo	商品期货	Commodity futures
Shangping qihuo gongsi	商品期货公司	Commodity futures firm
Shangshi gongsi	上市公司	Listed company
Sifa shencha	司法审查	Judicial review
Siyou hua	私有化	Privatization
Touzi jijing gongsi	投资基金公司	Investment fund management company
Waihui qihuo	外汇期货	Foreign exchange futures
Waizi gu	外资股	Foreign-owned investment share
Wu jimin gupiao	无记名股票	Bare share
Xishou	吸收	Reception
Xinzheng fuyi	行政复议	Administrative review
Yizhi	移植	Transplant
Yinhang	银行	Bank
Youjia zhengquan	有价证券	Negotiable instrument
Youxian zheren gongsi	有限责任公司	Limited liability company
Zaiquan	债券	Bond
Zhaogu shu	招股书	Prospectus
Zhenquan	证券	Securities
Zhengquan congye ren yuan	证券从业人员	Those who carry on securities business
Zhengquan fagui	证券法规	Securities regulations
Zhengquan falu yewu	证券法律业务	Legal services relating to securities business
Zhengquan faxing	证券发行	Securities issuing
Zhengquan fuwu jigou	证券服务机构	Securities services institution
Zhengquan fuwu yewu	证券服务业务	Securities services business

Zhengquan hua 证券化	Securitization
Zhengquan jigou 证券机构	Securities institution
Zhengquan jiaoyi 证券交易	Securities trading
Zhengquan jingying jigou 证券交易机构	Securities firms/Securities management institution
Zhengquan jingying yewu 证券经营业务	Securities management business
Zhengquan gongsi 证券公司	Securities firm
Zhengquan shichang 证券市场	Securities market
Zhengquan yewu 证券业务	Securities business
Zhengquanye zhongcai weiyuanhui 证券业仲裁委员会	The Securities Arbitration Commission
Zhongda shijian 重大事件	Major event
Zhongjie jigou 中介机构	Intermediaries
Zhongqi baogao 中期报告	Interim report
Ziben zhengquan 资本证券	capital instrument
Ziluxing zuzhi 自律性组织	Self-regulatory organisation

English-Chinese Index

Administrative rules	Guizhang 规章
Administrative review	Xinzheng fuyi 行政复议
Adaptation through borrowing	Jiejian 借鉴
Annual report	Nianzhong baogao 年终报告
B-share	B gu B-股
Bank	Yinhang 银行
Bare share	Wu jimin gupiao 无记名股票
Bond	Zaiquan 债券
Broker	Jingji ren 经纪人
Capital instrument	Ziben zhengquan 资本证券
Commodity futures	Shangping qihuo 商品期货

Commodity futures firm	Shangping qihuo gongsi 商品期货公司
Controlling share	Konggu 控股
Convertible bond	Kezhuanhuan zaiquan 可转换债券
Corporate legal person	Gongsi faren 公司法人
Corporate bond	Gongsi zaiquan 公司债券
Domestic investment share	Neizi gu 内资股
Domestically-listed foreign investment share	Jingnei shangshi waizi gu 境内上市外资股
Enterprise bond	Qiye zaiquan 企业债券
Finance company	Caiwu gongsi 财务公司
Financial futures	Jingrong qihuo 金融期货
Financial accounting report	Caiwu kuaiji baogao 财务报告
Financial futures firm	Jingrong qihuo gongsi 金融期货公司
Foreign exchange futures	Waihui qihuo 外汇期货
Foreign-owned investment share	Waizi gu 外资股
Incorporation through the method of public issue	Muji chengli 募集成立
Incorporation through the method of promotion	Faqi chengli 发起成立
Individual-owned share	Geren gu 个人股
Inside information	Neimu xinxi 内幕信息
Inside the territory of China	Jingnei 境内
Insider dealing	Neimu jiaoyi 内幕交易
Insiders	Neimu ren yuan 内幕人员
Interim report	Zhongqi baogao 中期报告
Intermediaries	Zhongjie jigou 中介机构
Internal employees share	Neibu zhigong gu 内部职工股
Investment fund management company	Touzi jijing gongsi 投资基金公司
Joint stock company	Gufen youxian gongsi 股份有限公司
Judicial review	Sifa shencha 司法审查
Legal services relating to securities business	Zhengquan falu yewu 证券法律业务
Legal person-owned share	Faren gu 法人股

Glossary of Chinese Terms

Limited liability company	Youxian zheren gongsi 有 限 责 任 公 司
Listed company	Shangshi gongsi 上 市 公 司
Local securities regulations	Difang zhengquan faqui 地 方 证 券 法 规
Local	Difang 地 方
Major event	Zhongda shijian 重 大 事 件
National securities regulations	Quanguo zhengquan fagui 全 国 证 券 法 规
National	Quanguo 全 国
Negotiable instrument	Youjia zhengquan 有 价 证 券
Outside the territory of China	Jingwai 境 外
Overseas listed foreign investment share	Jingwai shangshi waizi gu 境 外 上 市 外 资 股
Privatization	Siyou hua 私 有 化
Prospectus	Zhaogu shu 招 股 书
Reception	Xishou 吸 收
Registered share	Jimin gupiao 记 名 股 票
Renminbi special share	Renmibi tezhong gupiao 人 民 币 特 种 股 票
Restructure	Gaizu/Gaijian 改 组 ， 改 建
State-owned enterprise	Guoyou qiye 国 有 企 业
Securities regulations	Zhengquan fagui 证 券 法 规
Securities trading	Zhengquan jiaoyi 证 券 交 易
Securities institution	Zhengquan jigou 证 券 机 构
Securities services business	Zhengquan fuwu yewu 证 券 服 务 业 务
Securities issuing	Zhengquan faxing 证 券 发 行
Securities services institution	Zhengquan fuwu jigou 证 券 服 务 机 构
Securities market	Zhengquan shichang 证 券 市 场
Securities business	Zhengquan yewu 证 券 业 务
Securities firm	Zhengquan gongsi 证 券 公 司
Securities management business	Zhengquan jingying yewu 证 券 经 营 业 务
Securities firms/Securities management institution	Zhengquan jingying jigou 证 券 经 营 机 构

Glossary of Chinese Terms

Securities	Zhenquan 证券
Securitization	Zhengquan hua 证券化
Self-regulatory organisation	Ziluxing zuzhi 自律性组织
Share certificate	Gupiao 股票
Shares for public	Gongzhong gu 公众股
Shares	Gufen 股份
State-owned share	Guojia gu 国家股
The Securities Arbitration Commission	Zhengquanye zhongcai weiyuanhui 证券仲裁委员会
The State Securities Regulatory Commission	Guojia zhengquan guanli weiyuanhui 国家证券管 理委员会
The Securities Issue Examination Committee	Faxing shenhe weiyuanhui 发行审核委员会
Those who carry on securities business	Zhengquan congye renyuan 证券从业人员
To carry on securities business	Congshi zhengquan yewu 从事证券业务
Transplant	Yizhi 移植
Treasury bond	Guoku quan 国库券
Treasury bond futures	Guozai qihuo 国债期货
Wholly state-owned company	Guoyou duzi gongsi 国有独资公司

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