

Dancing with Wolves: Regulation and Deregulation of Foreign Investment in China's Stock Market

JiangYu Wang*

Content

Introduction

- I. Background: A Spindling Stock Market and Its Dualist Regulatory Regime
 - A. The Two-Decade Development of China's Stock Market
 - B. The Emergence of the Regulatory Framework
 - C. Opening Up to Foreign Investment and the Dualist Nature of Regulations
- II. The Current Regulations on Foreign Investment in Chinese Stock Market
 - A. The B Shares Market
 - B. Qualified Foreign Institutional Investors (QFII)
 - C. Takeover by Foreign Investors (Mergers and Acquisitions)
 - D. Foreign Participation in Securities Intermediaries Services
- III. Traps for Wolves: Analyzing the Legal Problems Facing Foreign Investors
 - A. Legal Risks Peculiar to the Chinese Stock Market

* Assistant Professor, Faculty of Law, National University of Singapore; SJD & LL.M., University of Pennsylvania; MJur, University of Oxford; Master of Laws, Peking University Law School; LL.B., China University of Political Science and Law. The author wishes to thank Dean Tan Cheng Han, Prof. M Sornarajah, and Associate Prof. Tjio Hans of the Law Faculty of National University of Singapore and Associate Professor Tan Lay Hong of the Nanyang Technology University for their very helpful comments and suggestions. Dean Tan and Prof. Sornarajah also helped polish this article to correct its typographical and grammatical errors. None of these persons are responsible for the content, conclusions and errors of this article. The author can be reached at lawwjy@nus.edu.sg.

- B. The Regulations and Regulatory Culture – Too Burdensome and Ambiguous to be Tolerable?
 - C. SOE Reform, Corruption, and Fraudulent Market Activities
 - D. Poor Corporate Governance – Listed Companies Too Dark to be Visible
 - E. Absence of Effective Judicial Protection of Minority Shareholders
- IV. Prospects for Future Liberalization and Improvement of Regulations: Analyses and Recommendations
- A. WTO Compliance
 - B. Rethinking the Role of Foreign Investors and the Pace of Liberalization
 - C. Redefining the Role of Government and Regulations, Introducing Rule of law, and Building Institutions
 - D. SOE Reform, Privatization, and Good Corporate Governance
- V. Conclusions

Abstract

China's stock market is the world's youngest one and the fastest-growing one as well. During the past decade, it has been developed with a variety of unique features, most of which are inconsistent with the concept of a viable market economy. China's dualist regulatory regime has different sets of rules for domestic participants and foreign investors. For a long period, foreign investment in the stock market was subject to severe restrictions and effectively excluded from all market activities except in the B shares market. Fundamental changes, however, have occurred following China's accession to the WTO, especially in the last two years. Now qualified foreign institutional investors (QFIIs) are allowed participate in the market, as are foreign firms that wish to acquire Chinese enterprises including listed SOEs. This article, after introducing China's existing legal rules on foreign participation in the stock market, analyzes the major legal and corporate governance obstacles facing foreign investors. It concludes that, in order to achieve the ambition to make its stock market one of the most successful in the world and to meet its WTO obligations, China needs to substantially improve its regulatory and legal framework and adjust to different regulatory philosophies, including rethinking the role of foreign investors, redefining the role and functions of government with a view to providing institutions supporting the market, and creating real good corporate governance for listed companies. To achieve this, the key is to accelerate privatization, which has picked up speed in 2003.

INTRODUCTION

Nobel laureate and economist John Hicks suggested that financial markets should be considered as one of the causes of the surge in economic growth over the past two centuries, claiming that “the Industrial Revolution would have been impossible without the concurrent development of financial markets.”¹ The World Bank, in its authoritative World Development Report, confirmed the finding of Hicks and concluded that financial development was central to economic growth and poverty reduction.²

The effective functioning of financial markets and financial systems depends upon sound financial institutions, which include banks, insurance companies, provident and pension funds, investment and pooled investment schemes (mutual funds), compulsory saving schemes, and securities markets.³ Financial institutions help facilitate private and official capital flows, channel investment and resources to their most efficient and productive uses, encourage technological innovations, and in so doing, perform the functions of shifting risk to those who are willing to bear it, as well as reducing the information costs of making transactions in market economies.⁴

¹ See HENDRIK VAN DEN BERG, *ECONOMIC GROWTH AND DEVELOPMENT* 290-91 (McGraw-Hill/Irwin 2001). The rationale was that the Industrial Revolution was characterized by a sharp rise in the use of machinery and other capital goods, which needed to be sustained by large investment. “Such Investment in turn required the mobilization of large amount of saving, which would have been impossible without the creation of liquid financial assets.” *See id.*, at 291.

² See WORLD BANK, *WORLD DEVELOPMENT REPORT 2002*, at 75-76 (online PDF version, available at <http://www.worldbank.org>) (hereinafter WDR 2002).

³ *See id.*, at 76.

⁴ *See id.*, at 75.

In addition to foreign direct investment (FDI), bank borrowing and lending and bond issuance, developing stock markets is regarded as one of the most important alternative funding sources, which is especially useful to developing countries including the People's Republic of China (China or PRC), the largest one in this group.⁵ As the World Bank has noted, "as the stock market develops and strengthens, it benefits other parts of the financial sector as well as the wider economy."⁶

The world's sixth largest and fastest growing economy,⁷ China has a relatively small stock market. However, since China's securities market is the world's youngest one as well, its pace of expansion is impressive. The Chinese stock market deserves international attention by virtue of two features: First, it is the only stock market in the world in which an overwhelming majority of listed companies are state-owned enterprises (SOEs).⁸ Second, it represents one of the world's biggest privatization movements, as China's SOEs have been gradually privatized through issuing stocks to private citizens and

⁵ See WORLD BANK, WORLD DEVELOPMENT REPORT 1999/2000, at 83 (online PDF version available at <http://www.worldbank.org>) (hereinafter WDR 2000).

⁶ See *id.*, at 84.

⁷ According to the World Development Indicators of World Bank, China's GDP in 2002 was US\$ 1,237 Billion, ranking No.6 behind USA, Japan, Germany, France, and British. See *Total GNP 2002*, Quick Reference Tables of the World Development Indicators Database (2003), available at <http://www.worldbank.org/data/quickreference/quickref.html>.

⁸ In the 1273 listed companies in China's stock markets, only about a hundred of them are privately owned. See the database of China's listed companies on the website of the China Securities Regulatory Commission (CSRC) at <http://www.csrc.gov.cn>. See also Li Yinyan, *Wang Jue: guoqi gaige reng zai gongjian* [Wang Jue says reform of SOEs is still storming fortifications], *Zhongguo Jingji Shibao* [China Economic Daily](Aug. 27, 2003), available at <http://www.szed.com/n/ca392383.htm>.

foreigners, in addition to other means. In other words, socialist China is embracing capitalism through securities markets.

China's stock market was initially launched as an effort to finance the countries ailing SOEs and to improve their performance through public listing.⁹ The Chinese population has been persuaded to commit a significant part of its savings to the securities market.¹⁰ However, like many other developing countries, China had implemented severe restrictions on foreign participation in its capital markets, not only in terms of foreign portfolio investment, but also in terms of securities-related services by foreign intermediaries. Until very recently, the Chinese practice on regulating securities markets was very restrictive, not only by comparison to OECD countries which have advanced market economies but to its Asian non-OECD neighbors as well.¹¹

It appears that the issue of foreign participation deserves a revisit in partly because China has accepted substantial commitments for trade in services upon its accession to the World Trade Organization (WTO) to expand the scope of operations permitted to foreign firms and because China has taken measures to honor those commitments. Recent efforts include the enactment of a variety of new rules allowing foreign firms to invest in the domestic shares market, which was exclusively reserved for Chinese citizens in the past, as well as to acquire and merge with domestic listed companies. In some areas relating to capital markets and securities services, China bold liberalization measures exceed its obligations undertaken under the WTO. The broader context of these efforts contains not

⁹ See OECD, CHINA IN THE WORLD ECONOMY 497 (2003).

¹⁰ See *id.*

¹¹ See *id.*, at 525.

merely WTO compliance, but also a sincere recognition of the fact that enlarged foreign participation can raise the general level of skills in the capital markets, as well as the determination of the Chinese leadership to accelerate privatization of China's SOEs and to establish a market economy based on private enterprises.

Notwithstanding the recent liberalization measures, foreign institutions are still not able to invest without limit in China's domestic equity markets.¹² In the limited areas in which foreign involvement is allowed, foreign institutions are still effectively excluded from taking full advantage of their legal rights literally granted by Chinese laws and international legal instruments such as the WTO agreements, virtually because of various barriers arising out of the swaying regulatory culture, ambiguity of laws, and poor corporate governance of many Chinese domestic listed companies.

The objective of this article is to describe and critically analyze the existing Chinese regulations on foreign participation in Chinese stock markets. In addition, it also explores the prospect of further liberalization and regulatory reform of Chinese securities regulations. Part I provides background information, introducing the basic features and the evolution of the Chinese securities regulatory framework insofar as foreign investment is concerned. Part II presents a comprehensive description of the legal framework concerning foreign participation in both portfolio investment and intermediate services. Part III examines and critically analyzes the legal barriers and de facto restrictions on foreign participation in China's stock market caused by the defects of the regulatory regime as well as the lack of good corporate governance practice in China's listed

¹² The OECD points out that in all OECD countries foreign firms are now allowed to invest without limits, although some countries make exceptions for certain "strategic" industries. *See id.*, at 526.

companies. In part IV, the article explores the prospects of further liberalization and perfection of the Chinese regulatory system. The finding of this article is that, in order to achieve the ambition to make its stock market one of the most successful in the world and to meet its WTO obligations, China needs to substantially improve its regulatory and legal framework and adjust to different regulatory philosophies, including rethinking the role of foreign investors, redefining the role and functions of government with a view to providing institutions supporting market, and creating real good corporate governance for listed companies. China will be able to establish a securities regulatory framework consistent with international practice. This, however, depends on the success of reform agenda in some key areas relating to securities and corporate law.

I. BACKGROUND: A SPINDLING STOCK MARKET AND THE DUALIST REGULATORY REGIME

A. Evolution of the Chinese Stock Market and the Regulatory Regime

Before the early 1950s China was once the home to one of Asia's largest stock markets.¹³ During the 1940s Shanghai Securities Exchange was the largest stock exchange

¹³ According to a documentary book compiled by Mr. Liu Hongru, the first head of PRC's regulatory authority on securities market in the reform era, the first stock market in China, called the Shanghai Stock Market [Shanghai Gufen Gongsuo], was created by foreign firms in 1869. In 1918, Japan set up the Shanghai Securities Branch [Shanghai Quyin Suo] of the Osaka stock exchange. Stock of Chinese enterprises was first issued in 1872 by the Shanghai General Bureau of Shipbuilding and Commerce. Two years later, in 1914, the Chinese government enacted laws to govern the Stock Exchange Market. Between 1918 and 1920, China established three large securities markets. The securities markets were interrupted for cause of Chinese-Japanese war broke out in 1930s and the World War II. In 1946 the Nationalist government set up the Shanghai Securities Exchange. See Zhongguo Zhengquan Shouce [China Securities Handbook] 513-16

in Asia and more influential and internationally supported than that of Hong Kong.¹⁴ In 1949 when the Communist Party took over the country and established the PRC, it began to institute a centrally planned economy in mainland China and finally eliminated securities activities together with any other private ownership in 1959.¹⁵ As a result, for about 30 years from the 1950s to 1980s, there was no securities market at all in China.

Reintroduction of stock companies and stock market was considered in the “Reform and Opening Up” era initiated by China’s former paramount leader Deng Xiaoping, featuring a market-oriented reform agenda of the economic system. Restructuring the economy generated more and more capital needs, which could not be met by the traditional sources – collecting funds and taxes from State-owned enterprises. In addition, fed up with the poor performance of SOEs, the Chinese leadership saw capital markets as an alternative to construct new types of corporate entities.

(Liu Hongru ed., 1992) (cited in Andrew Xuefeng Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging of Securities Regulatory Regime in China*, 12 UCLA PAC. BASIN L.J. 62, 64 & note 6-8 (1993)).

There is, however, different historical finding as to the “first” stock exchange in China. William N. Goetzmann, Andrey Ukhov and Ning Zhu of the Yale International Center for Finance (ICF) find that China’s first stock exchange, named Shanghai Share Broker’s Association, was found in 1891. See William N. Goetzmann, *China and the World Financial Markets 1870-1930: Modern Lessons from Historical Globalization*, Yale ICF Working Paper No. 00-62 (2001), at p. 7, online PDF version of the paper available at <http://papers.ssrn.com/abstract=189139>.

¹⁴ See Ann P. Vandavelde, *Realizing the Re-Emergence of the Chinese Stock Market: Fact or Fiction?* 30 Vand. J. Transnat’l L. 579, 583 (1997). It was noted that “Shanghai was then one of the most important capital markets in Asia, with a strong domestic and international banking sector and a vigorous market for domestic and foreign stocks and bonds.”

¹⁵ See Minkang Gu & Robert C. Art, *Securitization of State Ownership: Chinese Securities Law*, 18 Mich. J. Int’l L. 115, 117 (1996).

The OECD, in its recent study of the development of China's economy correctly observes that the growth of the Chinese capital markets, in which the stock market has been an indispensable part from the outset, proceeded through three stages: (i) a formative period in the late 1970s to 1980s, (ii) the emergence of more formal structures including stock exchanges and a regulatory regime in the early 1990s, and (iii) additional reforms after the 1997 Asian crisis.¹⁶ The first stage was featured with informal markets in company stocks for which initiatives, including both issuing and trading, came from enterprises themselves or from local governments without the approval of the central authority in Beijing.¹⁷ Many collective firms issued debentures and internal employee shares.¹⁸ In 1984, China officially began experimenting with the idea of establishing joint stock companies, which started in Beijing where a departmental store was given permission to issue shares to its employees.¹⁹ The capital markets evolved more rapidly than the government anticipated, as firms sought new ways to raise capital and residents to invest. Government regulation of the market activities therefore came only after the fact. At first, Beijing did not allow the bonds and stocks issued to be tradable. However, secondary markets developed underground (which is called "black-market" by the Chinese) despite the lack of official approval. Eventually the government acknowledged this

¹⁶ See OECD, *supra* note 9, at 499.

¹⁷ See *id.*

¹⁸ See *id.*

¹⁹ See SALLY A. HARPOLE, CHINA BUSINESS LAW GUIDE, ¶38-310. (1993 CCH International), and see Xiaonian Xu and Yan Wang, *Ownership Structure, Corporate Governance, and Corporate Performance: the Case of Chinese Stock Companies*, the World Bank Policy Research Working Paper No. 1794 (1997), at p. 6, available at <http://www.worldbank.org>.

practice and endorsed it with formal sanctions.²⁰ Two stock exchanges were established in the early 1990s, entering China's stock market into the second stage.²¹ This stage, at its early time, was contaminated by stock market "fever" which broke out in Southeast China in 1992,²² ignited by Deng Xiaoping's southern tour declaring that China would replace the planned economy with the market economy and encouraging people to boldly conduct economic experiments in every aspect of the economy irrespective of the socialistic or capitalistic nature of economic activities.²³ The fever was, however, short lived. The institutions, nevertheless, were gradually established in this stage. In the third stage, the

²⁰ See DANIEL A. LAPRES & ZHANG YUEJIAO, BUSINESS LAW IN CHINA (ICC Publication No. 576), 338(1997).

²¹ The Shanghai Stock Exchange was opened in December 1990 and the Shenzhen Stock Exchange in April 1991. In terms of utilizing of modern computer and telecommunication technology, the two exchanges are among the best in the world.

²² See OECD, *supra* note 9, at 499.

²³ Deng Xiaoping said in this tour, "We should be bolder than before in conducting reform and opening to the outside and have the courage to experiment." In responding to someone's fear of bold experiment would lead to capitalism, Deng Xiaoping said, "The chief criterion for making a judgment is should be whether it promotes the growth of productive forces in a socialist society, increases the overall strength of the socialist state and raises living standards." As to repealing of the planned economy, Deng Xiaoping said, "The proportion of planning to market forces is not the essential difference between socialism and capitalism. A planned economy is not equivalent to socialism ... a market economy is not capitalism, because there are markets under socialism too." As to securities markets, he said, "Are securities and the stock market good or bad? ...Are they peculiar to capitalism? Can socialism make use of them? We allow people to reserve their judgment, but we must try these things out." See *Excerpts from Talks given in Wuchang, Shenzhen, Zhuhai and Shanghai (January 18-February 21, 1992)*, available at <http://www.peopledaily.com.cn/english/dengxp/vol13/text/dl200.html> (visited Nov. 10, 1999).

central government's attitude towards the capital markets changed significantly in the sense that "corporatization" was regarded as a major solution to the problems created by SOEs for which other mechanisms turned out to be futile. In late 1996, the central government determined that transformation of SOEs through public issuance of equity shares as well as the stock market itself should be promoted as part of this industries restructuring programme.²⁴

The second and third stages were also featured with the construction of a formal legal and regulatory framework for the securities sectors. China did not have a special central agency to regulate securities markets until the early 1990s. At the very beginning, overlapping authorities regulating securities surprisingly co-existed for several years. Authorities such as People's Bank of China, Ministry of Finance, the State Planning Commission, the State Commission for Restructuring the Economic System, the State Administration for Industry and Commerce, and many local governments, etc., all had issued norms governing different or similar activities in the securities markets.²⁵ Confusions and conflicts thus created finally led to the creation of a centralized market regulatory body. The formation of the State Council Securities Committee (the "SCSC") and China Securities Regulatory Commission (the "CSRC") in 1992 marked the first effort to establish unified regulatory control over the market. The SCSC was charged with the primary authority for market regulation. The CSRC was designed as the SCSC's executive organ, responsible for conducting supervision and regulation of the market in accordance

²⁴ See OECD, *supra* note 9, at 499.

²⁵ See ZHU SANZHU, *SECURITIES REGULATIONS IN CHINA* 8-13 (Transnational Publishers, 2000).

with powers delegated by the SCSC.²⁶ In April 1998, pursuant to the ambitious State Council Reform Plan launched by Premier Zhu Rongji, the SCSC was repealed and the CSRC became the sole ministry under the State Council charged with the duty to supervise the securities markets. The so-called “centralized securities supervisory system” was only achieved at that time.

China has also promulgated a good body of securities laws. Since 1987, various authorities have released several hundreds of norms and regulations governing the issuance and transaction of securities.²⁷ Among those laws the most important ones are the 1993 enacted The Company Law of the People’s Republic of China (hereafter the “Company Law”), effective on January 1, 1994, and the 1998 Securities Law of the People’s Republic of China (hereafter “the Securities Law”), effective on July 1, 1999. The Company Law regulates the establishment, operation, internal management and dissolution of limited liability companies and stock companies. In terms of securities regulations, it covers the rights and obligations of shareholders, powers and responsibilities of directors, financial and accounting requirements for companies, as well as corporate termination and liquidation. The Securities Law is the primary regulation on market oversight and operation, governing registration and public issuance of shares, secondary market transactions, disclosure, insider trading, mergers and acquisitions, as well as the behavior of stock exchanges and securities firms. Supplemental to that are numerous decrees issued by the CSRC and other authorities (such as the Ministry of Finance, Ministry of Commerce,

²⁶ See CSRC, *A Brief Introduction of China Securities Regulatory Commission*, at <http://www.csrc.gov.cn/CSRCsite/eng/eabout/eintr.htm> (visited 10 November 2003).

²⁷ See Sun Jie: *Zhejianghui Zhuxi Zhou Zhengqing Fangtan [Interview with CSRC Chairman Zhou Zhengqing]*, in *Zhongguo Zhengquan Shibao [China Securities Daily]*, Dec.30, 1998, at page 1.

etc.) concerning detailed rules or specialized areas of stock market activities.

B. Special Features of China's Stock Market

The Chinese stock market is unique among dozens of its peers in the world.

Absent of the knowledge of the key characteristics of the market, it is entirely impossible to understand any aspect of the Chinese securities regulations, including those on foreign investment. A recent report of Sheldon Gao, senior director of the Dow Jones Indexes, identified fourteen key features of China's stock market using the Dow Jones Global Index and Dow Jones China Index as tools.²⁸ Some of them, because of their strong relevance to the perfection of the regulatory regime, are worth noting and discussing here.

(1) *Abnormal performance*: Since the inceptions of the two stock exchanges in the early 1990s, the Chinese stock market has delivered impressive returns in most of the years so far. The Dow Jones Report showed that, during the eight-year period from 1994 through 2001, as measured by the Dow Jones China Index consisting of 549 stocks as of 31 January 2002, China's stock market outpaced many of the world's leading indexes, including the Dow Jones STOXX 600 on European markets, Hong Kong's Hang Seng Index, Japan's Nikkei 225, as well as the Dow Jones World Emerging Markets Index covering eleven emerging markets around the world.²⁹ The performance, however, could only be characterized as "abnormal" because it is not based on the performance of the listed companies and the Chinese economy as well.³⁰

²⁸ *China Stock Market in Global Perspective*, Dow Jones Indexes, September 2003 (Research report by Sheldon Gao, senior director, Dow Jones Indexes) (Hereinafter the Dow Jones Report).

²⁹ See the Dow Jones Report, *supra* note 28, at 6.

³⁰ See *id.* A vivid evidence is that since 2001, the Chinese stock market has been grim despite that China's economy has been experiencing explosive GDP growth.

(2) *Insulated market*: As this article will discuss in the following part, China's stock market divides its shares into a variety of types.³¹ "Class A shares" are restricted to domestic investors. Foreign investors originally were only allowed to buy and trade (with restrictions) the so-called "B shares." Only recently, a small number of investors in the two markets have been allowed to participate in both markets.³² It is alleged that market segregation plus the foreign exchange control regime helped China to protect its economy against foreign harassment during the Asian financial crisis of 1997.³³ However, in recent years, the segregation is increasingly viewed as a barrier between China's capital markets and international investors.

(3) *Substantial government ownership and low float ratio*: Free float ratio, representing a stock market's liquidity and investability, refers to the proportion of freely tradable shares available to investors.³⁴ Due to widespread state ownership, the float ratio in China's stock market, close to 30 percent since 1993, appears to be extremely slow.³⁵ Although things have been changing due to recent regulatory relaxations allowing foreign investors to have greater participation in SOEs,³⁶ in most listed companies which were converted from SOEs, only one-third of the company's shares are typically issued to the public, with the rest remaining in the hands of the government, the company itself, or other

³¹ See *infra*, part I(C)(1) of this article.

³² See *id.*

³³ See The Dow Jones Report, *supra* note 28, at 12.

³⁴ See *id.*, at 14.

³⁵ One can appreciate the extremity of China's stock market in float ratio by contrasting it with that of other markets: the ratio in the U.S. is 93.9%, in Europe 78.7%, and in Japan 79.6%. See *id.*, at 14-15.

³⁶ See *infra*, part II of this article.

state-owned companies.³⁷ According to a Dow Jones survey, the average government ownership in China's stock market was 45 percent, as of 31 January 2002, with a maximum of 89 percent. Such a high percentage of state ownership does not exist in any other stock market in the world.³⁸

(4) *Irregular expansion primarily through IPOs* The size of a stock market expands through either external expansion, which refers to the issuance of new shares such as IPOs, secondary offerings and follow-up offerings, or internal growth, which is the appreciation of existing shares.³⁹ While in most other places in the world stock markets expand through internal growth,⁴⁰ in China the opposite has been true. Since the early 1990s, the total market value grew at an annual rate of 47.4 percent, only 16.9 percent was contributed by an increase in the value of the existing stocks.⁴¹ In other words, almost two thirds of the market growth was the result of external expansion. The significance is that the return on existing stocks is substantially weakened despite the amazing expansion of market size.

(5) *Typical characteristics of emerging market embodied by confused and restrictive regulations:* Due to lack of regulatory experience, rule of law, and of fully developed market economy, China's stock market possesses many of the features that are characteristics of emerging markets. First, there are too many types of shares to confuse

³⁷ See The Dow Jones Report, *supra* note 28, at 15.

³⁸ See *id.*, at 16.

³⁹ See *id.*, at 17.

⁴⁰ For instance, during the years from 1993 to 2001, 84% of the market growth was the result of internal growth while only 16% came from new issuance of stocks in the U.S. stock market. See *id.*, at 18.

⁴¹ See *id.*

investors. In addition to the well-known “A shares” and “B shares”, there are several additional classes available to global investors and denominated in free exchangeable currencies, such as the H, N, L, and S shares listed in Hong Kong, New York, London and Singapore, respectively.⁴² Secondly, initial public offerings (IPOs) are strictly regulated in China. China is identified by the Dow Jones report as “the only country in which the government completely controls the size of the stock market, the pace of issue and the allocation of resources.”⁴³ Thirdly, the market is predominated by small-cap stocks rather than blue-chip companies, in both absolute size and in relation to the rest of the world, due to the fact that most of China’s blue-chips are listed only on overseas exchanges and are not available to domestic investors.⁴⁴ Fourthly, the market is dominated by retail investors.⁴⁵ Institutional investors are underdeveloped in China’s stock market. Finally, contrary to the global trend of consolidating multi exchanges of a single jurisdiction into a single-exchange structure, China has two stock exchanges of similar size, performing virtually the same functions on every aspect.⁴⁶

(6) *Pyramid structure and unusual “core”*: A matured stock market is supported by a group of blue-chip companies that acts as the “core” or backbone of the market structure.⁴⁷ Such a market “is generally shaped like a top-heavy gyroscope or funnel – a few of these blue-chip companies may easily represent a huge chunk of the market or

⁴² *See id.*, at 21.

⁴³ *See id.*, at 22.

⁴⁴ *See id.*, at 22.

⁴⁵ *See id.*, at 22.

⁴⁶ *See id.*, at 23.

⁴⁷ *See id.*, at 24.

dominate the benchmark index's movement.”⁴⁸ The numerous small cap companies, at the bottom of the market structure, are relatively insignificant. But in China, the stock market lacks real blue-chip stocks with high profitability and, as such, investors are overwhelmed with small-caps.⁴⁹

(7) *Incredible speculation:* In a developed stock market, because investors have more confidence in the long-term economic prospects and the steady growth of corporate profits, the turnover level, which represents the frequency of trading or the length of holding period, is generally lower.⁵⁰ Data demonstrates that the average turnover in China's stock market was 500 percent, indicating that an individual stock changed hands five times a year on average.⁵¹ The average holding period is two months. By contrast, in a mature market, the normal holding period for a stock is about two years.⁵² This suggests that the spirit of speculation is extremely strong and widespread. As the Dow Jones report observes, “The fundamental truth is that the investing environment of China's stock market simply does not encourage long-term investment strategies.”⁵³

(8) *Disappointing earnings of companies and low dividend yield:* The phenomenon of incredible speculation could be explained by the lack of “core” blue-chip

⁴⁸ See *id.*, at 24-25.

⁴⁹ For instance, the Dow Jones report identified only one company listed in China as a large stock – Shenzhen Development Bank, and 130 companies as mid-cap stocks. The remaining over 1,000 companies are classified as small-cap or micro-cap companies. See *id.*, at 22.

⁵⁰ See *id.*, at 36.

⁵¹ See *id.*

⁵² See *id.*

⁵³ See *id.*, at 37.

companies in the market as well as by the poor performance of listed companies in terms of making profits and distributing dividends. The fact that most companies posted low earnings, despite the abnormal performance of the market, leads to the recognition of the size of the bubble in China's stock market.⁵⁴ At least, it is indisputable that most stocks are seriously overvalued.⁵⁵ Cash dividend distribution, which plays a crucial role in long-term investment, appears not to be so important in the Chinese stock market, albeit the law requires that no company could make a follow-up or secondary offering unless it pays a cash dividend (which helps the market's payout percentage to stay within a reasonable range). However, China's dividend yield (0.75 percent only) is terribly low in comparison with the rest of the world as well as with other investment vehicles in China including the CD rate and bond rate.⁵⁶ To be sure, the low payout percentage and dividend yield are rooted in the poor earnings of listed companies.⁵⁷

In brief, as demonstrated by the above discussions, the current plight of the Chinese stock market is marked by a number of structural flaws, of which the most important ones are the pyramid structure⁵⁸ and confusions in regulatory policies. These special features certainly have a tremendous impact on foreign participation in China's stock market.

C. Opening Up of China's Stock Market and the Dualist Regulatory Regime

As noted previously, the original goal of the Chinese government for developing securities markets was two-fold: (1) to mobilize private saving in order to finance SOEs,

⁵⁴ *See id.*, at 40.

⁵⁵ *See id.*

⁵⁶ *See id.*, at 45.

⁵⁷ *See id.*, at 46.

⁵⁸ *See id.*, at 47.

and (2) to improve SOE performance through public participation.⁵⁹ Seemingly, foreign participation was not conceived as needed at the outset of the development of China's stock market. Desires for international participation, which came from both Chinese domestic enterprises in certain sectors that were in dire need of both foreign investment and the legal status as listed companies and foreign investors who wished to participate in China's capital markets, pressed the government to create a room for foreign participation in the stock market in the early 1990s. The opening up of the Chinese stock market started with creating a domestic B shares market that until very recently was only available to foreigners, followed by the construction of a parallel regulatory framework for foreign portfolio investment, mergers and acquisitions with foreign companies, and market access to foreign intermediaries business.

1. Chinese Classification of Stocks – All Shares Are Not Created Equal

Though both the Company Law and the Securities Law are curiously silent on the classification of corporate stocks, it remains the most distinctive feature of Chinese securities markets: the stock, in addition to its universal classification as common stock, preferred stock, etc, is also defined by the status and nationality of the shareholders.⁶⁰

⁵⁹ See OECD, *supra* note 9, at 497.

⁶⁰ In a developed capitalist market the idea is that “all shares are equal”. Nevertheless, there are also different types of stocks which are, most commonly, common and preferred shares. The distinction between this two classes arises as a result of the investors' dividend expectations, voting rights and priority in liquidation. Apart from these differences, shareholders of each class of shares are entitled to equal rights and equal benefits, irrespective of their origin and citizenship. See William I. Friedman, *One Country, Two Systems: The Inherent Conflict between China's Communist Politics and Capitalist Securities Market*, 27 Brook. J. Int'l L. 477, 495 (2002).

There are four classes of shares in China's stock market, which include state shares, legal person shares, A shares tradable by domestic individuals, and foreign capital shares (B shares). The basic rationale under the class distinction is chiefly ideology-based, for the primary purpose of controlling the transferability of different types of shares and maintaining the leading role of government in the economy.

(1) *State Shares (Guojia gu)*: State shares refers to shares held by central governmental agencies, local governments, or authorized institutions on behalf of the State. According to relevant regulations, it shall include: (i) the shares converted from the net assets of SOEs which have been transformed into stock companies, (ii) shares initially issued by various companies and purchased by the central or local governmental departments investing on behalf of the State, and (3) shares initially issued by companies and purchased by the investment companies, assets management companies, and economic entities authorized to make investments on behalf of the State.⁶¹ State shares are not allowed for trading on open markets such as a stock exchange or an OTC market. Nevertheless, they can be transferred upon approval of the CSRC and the State Assets Supervision and Administration Commission (SASAC). Sales of state shares to foreign investors have been allowed recently as a result of a post-WTO reform programme.⁶²

(2) *Legal Person Shares (Faren gu)*: Referring to shares of a stock company owned by another company or organization with a "legal person" status,⁶³ the legal person

⁶¹ FANG Liu Fang, *China's Corporation Experiment*, 5 Duke J. Comp. & Int'l L. 149, 203 (1995).

⁶² See *infra*, part II (C) of this article.

⁶³ Like many other civilian jurisdictions, legal persons, under the Chinese law, are collective organizations considered by the law as having a legal personality distinct from the natural individuals who make them up. They are subject to the law with the attribution of legal capacity and may possess both rights and duties.

shares can be indirectly held by the State if the shareholders are State-owned companies.⁶⁴ Basically, this class includes shares held by domestic entities in which the state is the majority owner but has not the entire ownership.⁶⁵ There are four types of ownership for legal person shares, namely, state-owned legal person shares, collective enterprise legal person shares, private enterprise legal person shares, foreign invested enterprise legal person shares, and institutional legal person shares.⁶⁶ Trading of legal person shares through stock exchanges is prohibited, albeit this can be done upon case-by case approval from relevant authorities. Like state shares, legal person shares can be sold to foreigners according to several laws issued after China's accession to the WTO.⁶⁷

(3) *A Shares or individual shares (Geren gu)*: Individual shares, with an official recognized nickname of “A shares”, refer to shares that may only be owned by Chinese residents (including domestic institutions). A shares have the full function born by classic stock, and can be freely traded and transferred in domestic markets. For a long time until very recently, these shares were the only type of equity that were traded among domestic investors at the two stock exchanges and were not accessible to foreign investors.⁶⁸

(4) *B Shares or Foreign Capital Shares (Waizi gu)*: Foreign capital shares include B shares and overseas listing shares. B shares are shares which were originally offered

Companies, public or private entities or public bodies can become legal persons through appropriate registration under the law.

⁶⁴ See FANG, *supra* note 61, at 204.

⁶⁵ See Xu & Wang, *supra* note 19, at . 7. See also OECD, *supra* note 9, at 512.

⁶⁶ See FANG, *supra* note 61, at 204.

⁶⁷ See *infra*, part II(C) of this article.

⁶⁸ See *infra*, part II (A) of this article.

exclusively to international investors. Like other shares, they are denominated in RMB, but Chinese citizens until 2001 were not permitted to own or trade in B Shares.⁶⁹

(5) *Overseas listing shares*: Overseas listing shares are shares issued by Chinese companies listed on securities markets outside mainland China. Though subject to CSRC regulations insofar as initial approval is needed for the companies to go abroad, they are not part of the Chinese securities market but rather components of the stock markets in which they are listed and traded. They currently include H shares, N shares, L shares and S shares. H shares are offered by Chinese companies listed on the Hong Kong Stock Exchange. They are subscribed for and traded in Hong Kong Dollars, and denominated in RMB. They can only be purchased and traded by Hong Kong local investors or international investors.⁷⁰ N shares are issued to foreign investors on US stock exchanges. Some of them are issued through IPOs but many others are denominated in RMB and subscribed for in US dollar. Dividends are declared in RMB but paid in US dollars. As such, many N shares are not traded directly on stock exchanges but were issued by way of ADRs(American Depository Receipts).⁷¹ L shares are issued on the London Stock Exchange according a memorandum of understanding signed between U.K and China's relevant authorities on October 7, 1996.⁷² S shares are offered on the Singapore Stock Exchange.

A typical domestically listed Chinese company normally has a mixed ownership structure, in which each of the three major groups (state, legal persons, and individuals)

⁶⁹ See *infra* note 89 and the accompanying text.

⁷⁰ See I. A. TOKLEY & TINA RAVN, COMPANY AND SECURITIES LAW IN CHINA 71 (1998).

⁷¹ *Id.*, at 72.

⁷² *Id.*

holds about one third of total outstanding shares.⁷³ The structure becomes more complex as many companies now also issue B shares to foreigners and Chinese residents. Normally those overseas listed Chinese companies have not yet entered into the stock market of their home country. In any case, only one-third of the shares in state-owned companies are tradable according to law.

2. The Dualist Regulatory System

Insulated markets, class distinctions of shares and different treatment of ownership naturally lead to different sets of regulations on foreign and domestic investors. Since the creation of B shares, China has promulgated numerous statutes for the separate regulation of foreign participation in the capital markets, while domestic investors and institutions are subject to another set of laws. Laws solely governing foreign investment will be discussed in the following parts of this article in detail.

It is not entirely clear whether foreign investment is also subject to the various laws supposed to be promulgated for domestic companies and transactions. In essence, the Securities Law applies to the issuing and trading of shares, corporate bonds and other securities “as lawfully recognized by the State Council within China.”⁷⁴ Conceivably, the law governs foreign investment-related securities such as B shares since they are “lawfully recognized” by the central government. However, it has also to be made clear that “specific measures in respect of shares of companies in China which are to be subscribed and traded in foreign currencies by persons and institutions outside China shall be

⁷³ See Xu & Wang, *supra* note 19, at 8.

⁷⁴ Securities Law, art. 2.

separately formulated by the State Council.”⁷⁵ The implication is not that shares of Chinese companies reserved for foreign investment (B shares) and overseas listing shares (H shares or N shares) are to be governed entirely by a separate set of regulations made by the State Council. Instead, regulations on foreign investment are regarded as “specific”, “special”, or even “exceptional” measures on foreign participation, supplemental to the major laws on securities as an entirety. For instance, the specific law on B shares promulgated by the State Council in 1995 states clearly that the rules of the law “are formulated in accordance with the relevant provisions of the Company Law of the People’s Republic of China,”⁷⁶ implicating that it is still within, rather than separate from, the framework of the Company Law. Another example is the rules concerning mergers and acquisitions. In 2002 and 2003, China has promulgated a variety of laws regulating merger and acquisition, with a special emphasis on takeovers of Chinese companies by foreign investors. Of the five major laws promulgated by various ministries, four are concerned with foreign takeovers and the other two contain rules regarding takeovers and disclosure in general, without making specific reference to purely domestic or foreign-related transactions. However, one provision of a leading law on foreign takeover stipulates that “transferring state shares and legal person shares to foreign investors shall

⁷⁵ *Id.*, art. 213.

⁷⁶ *See* Guowuyuan guanyu gufen youxian gongsi jingnei shangshi waizi gu de guiding [Regulations of the State Council on Domestically Listed Foreign Capital Shares of Stock Companies], adopted at the 37th Executive Meeting of the State Council on Nov. 2, 1995 and promulgated by Decree No. 189 of the State Council of the People’s Republic of China on December 25, 1995 (hereinafter the B Shares Regulations), art.1.

also comply with relevant CSRC rules on takeovers, disclosure, etc.”,⁷⁷ thus indicating that foreign-related transactions are subject to those general laws.

To summarize, although it is not explicitly established in the relevant laws, the dualist nature of the Chinese securities regulatory framework shall be understood as such, namely that regulations on foreign investment in China’s stock market serve as “special” laws to the general framework, whose provisions shall take precedent to relevant provisions of general laws in cases in which there is overlapping or conflict. For matters not stipulated in foreign investment-specific laws, the provisions of general laws (such as the *Securities Law* or the *Takeover Measures*⁷⁸) shall be followed.

II. CURRENT REGULATIONS ON FOREIGN PARTICIPATION IN CHINA’S STOCK MARKET

As noted previously, China’s equity markets are connected to the international markets through a variety of channels. Originally it was the B shares market accessible to global investors. In recent years, as a result of China’s WTO commitments and compliance efforts, foreigners have gained larger room in the capital markets as well as in the securities services business. Recent movements include the allowance of foreign institutional investors to buy and trade in A shares, more flexibility for takeovers of Chinese companies by foreigners, as well as greater market access for foreign securities business.⁷⁹

⁷⁷ See the *Foreign Acquisition Rules*, *infra* note 118, art. 4.

⁷⁸ See the *Takeover Measures*, *infra* note 115.

⁷⁹ Until very recently (Mid-2002), there had been severe limitations on foreign participation of any kind in the Chinese capital markets. See OECD, *supra* note 9, at 525-526.

A. The B Shares Market

Coming into existence in 1991,⁸⁰ the B shares market perfectly reflected the Chinese leadership's mixed feeling regarding the internationalization of securities markets, namely, making use of foreign capital without shaking socialist public ownership. B shares are governed by mainly two regulations promulgated by the State Council and the CSRC, respectively. One is *The Regulations of the State Council on Domestically Listed Foreign Capital Shares of Stock Companies* (hereinafter "the B Shares Regulations")⁸¹, and the other is the *Implementing Rules of the Regulations of the State Council on Domestically Listed Foreign Capital Shares of Stock Companies* (hereinafter "B Shares Implementing Rules").⁸² Pursuant to the two laws, B shares present the following features (as opposed to A shares which are similar in terms of functions to common stocks in a Western stock company).

First, B shares are denominated in Chinese currency (Renminbi), but are subscribed for, bought and sold in foreign currency, and listed and traded on securities exchanges in China.⁸³ Dividends and other payments by the issuing company shall be calculated and

⁸⁰ See ZHU, *supra* note 25, at 127. At the inception they were officially referred to as "Renminbi tezhong gupiao"[Renminbi special shares], nicknamed as "B shares." See *id.* With the enactment of the 1995 B Shares Regulations, both "B shares" and "jingnei shangshi waizi gu" ["domestically listed foreign capital shares"] were used in official documents.

⁸¹ Title in Chinese Pinxin see *supra* note 76.

⁸² Title in Chinese Pinxiin: Gufen youxian gongsi jingnei shangshi waizi gu de guiding de shishi xize.

⁸³ The B Shares Regulations, art. 2.

declared in Renminbi but paid in foreign currency.⁸⁴ Second, B shares could only be issued to overseas investors, which, according to the Chinese definition, shall include foreigners, natural and legal persons from Taiwan, Hong Kong and Macao, and Chinese citizens that are residing abroad.⁸⁵ Chinese in the mainland of China were not allowed to buy and trade in B shares. Third, dividends and capital gains from B shares can be sent abroad freely despite China's strict foreign exchange control.⁸⁶ Fourth, foreign securities firm can serve as dealers of B shares while they were not allowed to do the business of A shares. The two stock exchanges could enact rules to stipulate the requirements for foreign securities firms to enter into agency agreements with Chinese partners or to act as dealers in trading B shares.⁸⁷ The first foreign securities firm invading China's securities markets was Morgan Stanley & Company, which established a joint venture entitled China International Capital Corporation with China Construction Bank and several other partners in 1995.⁸⁸

Until early 2001, the B shares market was off-limits to individual and institutional Chinese investors. This policy was changed then by a new government decree released on 21 February 2001 which allows domestic individual investors to buy and trade B shares.⁸⁹

⁸⁴ *Id.*, art. 25. Accordingly, a foreign exchange rate should be stated in the prospectus of the issuing company, or decided by a resolution of shareholders' meeting. *See* the B Shares Implementing Rules, art. 41.

⁸⁵ The B Shares Regulations, art. 4.

⁸⁶ *Id.*, art. 5

⁸⁷ B Shares Implementing Rules, art. 33.

⁸⁸ *See* Dave Lindorff, *In Beijing, the Long March is just Starting*, *Bus. Wk.*, Feb. 12, 1996, at 68.

⁸⁹ *See* Zhongguo zhengquan jiandu guanli weiyuanhui, guojia waihui guanli ju, guanyu jingnei jumin geren touzi jingnei shangshi waizi gu ruogan wenti de tongzhi [Circular of the China Securities Regulatory

Nevertheless, B shares are still only subscribed in foreign currency and, as such, Chinese investors have to use the foreign exchange reserve in their banking accounts to buy those shares.⁹⁰

The original purpose for the creation of the B shares market was to open “two windows” for the Chinese capital markets. One window was designed as a channel to help a small number of Chinese SOEs obtain scarce foreign currency, and the other was expected to demonstrate to foreigners China’s resolve to open up its economy.⁹¹ Despite the poor performance of the B shares market, Chinese regulators have used many measures to boost the market, of which the most recent one was to channel the foreign currencies holdings of private citizens into the market. This move, unexpectedly, destructed the original purpose underpinning the B shares regime. In fact, the B shares market has been significantly marginalized: in the three years following the end of 2001, no single company was approved to issue B stock in the market.⁹² More telling is the size of the market.

Commission and the State Administration of Foreign Exchange on Questions Regarding Investment in the B Shares Market by Chinese Residents], CSRC Decree No. 22 (2001) (hereinafter the B Shares Circular on Chinese Investors).

⁹⁰ *See id.*, art. 2.

⁹¹ *See* CHAO Kejian et.al, *Huifu rongzi gongneng, zhengxing B gu shichang* [Restore the Financing Functions of and Boost the B Shares Market], in *Shanghai Zhengquan Bao* [Shanghai Securities Daily] (October 31, 2003), available at <http://business.sohu.com/77/72/article215027277.shtml>.

⁹² In November 2003, Shanggong Stock Company obtained the approval of the CSRC to issue B shares to 14 foreign institutions. This was the first approval of issuance since the end of 2001. *See, shanggong gufen youxian gongsi faxing jingnei shangshi waizi gu (B gu) zhaogu shuoming shu zhaiyao* [Prospect of Shanggong Stock Company for the Issuance of B Shares], Nov. 5, 2003, in *Shanghai Zhengquan Bao* (Shanghai Securities Daily), available at <http://www.stocknews.com.cn>. See also ZHU Jinfu, Shanggong B

Despite many years of development, the B shares market remains small in terms of both the number of listed companies and market capitalization.⁹³ The listed companies were also regarded as too small and too risky.

In light of the fact that the A shares market is being opened to foreign investors (albeit under limitations)⁹⁴ and many Chinese companies now go directly abroad to raise foreign capital, the logic of having a separate B shares market would be called into question. Future priorities for development of China's capital market should include merging the A shares and B Shares and eliminating the class distinctions among different types of stock.

B. Qualified Foreign Institutional Investors (QFII)

It is said that Asian countries' liberalization of capital markets normally has gone through three or four stages, including mainly initial permission of limited entry of foreign capital into the market, then opening the domestic markets to foreign institutional investors, and finally the overall liberalization of capital markets.⁹⁵ Chinese regulators seemed suddenly to spot this experience shortly after the nation joined the WTO.

The experience mainly came from Taiwan. Since 1990, in efforts to liberalize its

gu qiaokai rongzi zhi men, B gu shichang mianlian chongxin dingwei [Shanggong B Shares Opened the Doors for Financing; B Shares Market Needs Reposition Itself], in *Zhongguo Jingying Bao* [China Business Operation Daily] (Sept. 30, 2003), available at <http://finance.sina.com.cn/k/20030930/0935462053.shtml>.

⁹³ See CSRC database on B shares market at <http://www.csrc.gov.cn>.

⁹⁴ See *infra* part II of this article.

⁹⁵ See, Cao Fengqi Tan Dalu Ziben Shichang Touzi Guoji Hua Zhanlue Yu Duice [Cao Fengqi on strategies for the globalization of China's Capital Market], statement by Prof. Cao Fengqi in the 2003 Advanced Forum on the Globalization of China's Capital Market (October 11, 2003), available at <http://news.sohu.com>.

stock market for access to foreigners, Taiwan has begun to permit qualified foreign institutional investors (QFIIs) to directly buy and trade in Taiwan-listed securities.⁹⁶ Under the QFII regime, foreign banks, insurance companies and fund management institutions were allowed to invest directly in securities listed in the Taiwan Securities Exchange (TSE). QFIIs must meet certain threshold requirements, including longevity, experience and asset.⁹⁷ There were also strict requirements as to inward remittance of foreign capital, profit repatriation, and percentage limits on QFIIs' investment in target companies.⁹⁸

In November 2002, roughly one year before Taiwan abolished the QFII regime,⁹⁹ the CSRC and People's Bank of China (PBC), the two regulators on China's financial markets, jointly introduced the mainland's QFII system in a decree titled *Provisional Rules on Administration of Domestic Securities Investment of Qualified Foreign Institutional Investors (QFII)* (hereinafter the QFII Rules).¹⁰⁰ Effective December 1, 2002, foreign financial institutions could apply to invest directly in China's domestic A shares market. The two stock exchanges both released their "Implementing Rules" regarding the

⁹⁶ See Jeffrey H. Chen & Jack J. T. Huang, *Taiwan's Evolving Stock Market: Policy and Regulatory Trends*, 12 UCLA Pac. Basin L. J. 34, 40-41 (1993).

⁹⁷ *Id.*

⁹⁸ *Id.*, at 42-44.

⁹⁹ Taiwan's Ministry of Finance formally abandoned the QFII system on October 2, 2003. See, *Taiwan Abandons QFII System*, available at <http://www.china-ready.com/news/Oct03/TaiwanAbandonsQFIISystem100303.html> (visited Nov. 17, 2003).

¹⁰⁰ See Hege jingwai jigou touzizhe jingnei zhengquan touzi guanli zanxing banfa [Provisional Rules on Administration of Domestic Securities Investment of Qualified Foreign Institutional Investors (QFII)], Joint Decree No. 12 of the CSRC and PBC, Nov. 5, 2003.

application of QFII Rules in the effective date of December 1, 2002.¹⁰¹

The QFII Rules define “QFIIs” as “overseas asset management institutions, insurance companies, securities companies, and other asset management institutions” approved by the CSRC and granted foreign exchange quota for the State Administration of Foreign Exchange (SAFE).¹⁰² Curiously enough, foreign banks are not included in the definition, although commercial banks are mentioned in an article of the Rules concerning asset size. In addition, it is widely understood that banks can operate in China’s QFII system through their asset management subsidiaries.

Compared with the Taiwan QFII system, the threshold access standard for foreign institutions is rather high in terms of their experience, asset requirements, and business longevity. To be qualified as QFII in China, a fund management company must have conducted fund management business for at least five years, managing asset size no less than US\$ 10 billion in the past year; an insurance company shall have conducted insurance business for over 30 years, with actual paid-up capital of no less than US\$ 1 billion and securities assets managed in the latest fiscal year of no less than US\$ 10 billion; a securities firm shall have conducted securities business for over 30 years, with actual paid-up capital of no less than US\$ 1 billion and securities assets managed in the latest fiscal year of no less than US\$ 10 billion, and a commercial bank shall have its total assets ranked among the top 100 in the world in the latest fiscal year and securities assets

¹⁰¹ Texts of the implementing rules passed by the two stock exchanges can be found at their website at <http://www.sse.com.cn> (Shanghai) and <http://www.sse.org.cn> (Shenzhen).

¹⁰² See the QFII Rules, *supra* note 100, art. 2.

managed of no less than US\$ 10 billion.¹⁰³ In addition, the applicants for QFII shall have sound corporate governance structure and internal control system, and their home jurisdiction shall have signed Memorandum of Understanding with the CSRC for cross-border regulatory cooperation.¹⁰⁴

A QFII can invest in A shares (but not B shares), listed government bonds, convertible bonds, corporate bonds, and other financial instruments as approved by the CSRC.¹⁰⁵ However, any investment amount must not exceed the quota granted by the SAFE.¹⁰⁶ In addition, Shares held by each QFII in one listed company should not exceed ten percent of total outstanding shares of the company, and total shares held by all QFIIs in one listed company should not exceed twenty percent of total outstanding shares of the company.¹⁰⁷ QFIIs are also required to comply with the “Guidelines to Foreign

¹⁰³ See the QFII Rules, art. 7. In contrast, when Taiwan implemented the QFII regime in 1991, it only required that, in order to be approved for QFII, a commercial bank should have total assets among the top 500 in the world, with securities asset managed in the size no less than US\$ 300 million; an insurance company should have conducted insurance business for over 10 years, managing securities assets in the size no less than US\$ 500 million; and a fund management company should have been in the business for five years with the size of managed asset no less than US\$ 500 million. See, *Tai Zhengquan Zhuanjia: Neidi QFII Menkan Yuan Gaoyu Taiwan Shuiping* [Taiwan securities experts: Mainland’s QFII threshold is far high than that of Taiwan], in *Nanfang Ribao* [Nanfang Daily] (December 9, 2002), available at <http://www.china.com.cn/chinese/zhuanti/243938.htm>.

¹⁰⁴ See QFII Rules, art. 6 (3) and art. 6(4).

¹⁰⁵ *Id.*, art. 18.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*, art. 20.

Investment” issued by the State Council once a year.¹⁰⁸

Like the Taiwanese system, one of the most prominent features of the mainland QFII is the strict control of inflow and outflow of capital. Each QFII may only apply to remit an amount within the quota assigned by the SAFE, which ranges from US\$ 50 million to 800 million.¹⁰⁹ However, it is not clear how many times a QFII can apply each year.¹¹⁰ For capital outflow, the Rules stipulate that the principal investment shall stay in

¹⁰⁸ According to the current Guidelines for Foreign Investment, foreign investment projects are divided into four categories: encouraged, permitted, restricted, and prohibited. Foreign investment is not allowed (prohibited) in projects jeopardizing national security, polluting the environment and harming human health, occupying large tracks of land, retarding military facilities, and employing technologies peculiar to China. It is restricted in areas that use backward technologies, that are detrimental to the ecological environment, that involve exploration of protected minerals, and that belong to industries that the state only allows gradual openness. All the other areas are either encouraged or permitted. *See zhidao waishang touzi fangxiao guiding* [Guidelines for Foreign Investment], promulgated by the State Council on Feb. 11, 2002 and effective April 1, 2002. The Guidelines are state regulations, following which, the state ministries concern jointly issue a Foreign Investment Catalogue to implement the Guidelines. The current effective Catalogue was released on March 2002.

¹⁰⁹ *See Hege jingwai jigou touzizhe jingnei zhengquan touzi waihui guanli zanxing guiding* [Provisional Rules on the Administration of Foreign Exchange Issues for QFII], released by the State Administration of Foreign Exchange of China on Nov.29, 2002, art. 8 (hereinafter QFII Rules on Foreign Exchange).

¹¹⁰ As of this writing, UBS Warburg, the first approved QFII in China, has used up its first approved quota of US\$ 500 million and is applying for a second quota for US\$ 300 million. The two applications were certainly submitted within a year. HSBC has also applied to increase its quota. *See, Haiwai touzizhe kanhao A gu shichang, QFII fen shenqing zengjia e’du* [Overseas investor optimistic at the A shares market: QFIIs are rushing to apply for increase in quota amount], in *Zhengquan Ribao* [Securities Daily](Nov. 4, 2003), available at <http://www.china.com.cn/chinese/FI-c/435182.htm>.

China for three years until it is allowed to repatriate only by installments.¹¹¹ Restrictive as it is, this provision effectively forces the investors to stay in the market, irrespective of their market judgment. The rationale is, obviously, to limit the detrimental effect of international “hot money” which was alleged to cause the 1997 Asian Financial Crisis.

C. Takeover by Foreign Companies (Mergers and Acquisitions)

Permission of foreign access to the mergers and acquisitions (M&A) market is regarded as the boldest movement of the Chinese government in opening up its capital markets and restructuring the SOEs. Out of the concern for sovereign control over the national economy, China’s government had been very hostile toward foreign takeover of Chinese companies, be it hostile or friendly mergers or acquisitions. The two earliest foreign takeovers of PRC companies occurred in May 1995. One involves the acquisition of 25 percent of the shares of Beilu Co. by two Japanese companies, and the other was the purchase of 20 percent of the shares of Jiangling Automobile Company by Ford Motor Company.¹¹² The two takeovers triggered tremendous volatility in China’s stock market and attracted the attention of Chinese regulators immediately. One month later, the Chinese authority issued a “notice” mandating that “no unit shall be allowed to transfer state shares and legal person shares to foreign investors until the state promulgated laws allowing this”, although the two takeovers that had already taken place were

¹¹¹ See QFII Rules, art. 26.

¹¹² See, *Binggou hui jizhong zai naxie hangye?* [On what areas will foreign mergers and acquisitions focus?], in Beijing Chenbao [Beijing Morning News](Nov. 5, 2002), available at <http://202.84.17.28/csnews/20021105/295748.asp>.

grandfathered.¹¹³

WTO accession – and the anticipation of it – has led to dramatic changes in Chinese regulators’ attitude towards foreign invasion into the Chinese economy through M&As. On the contrary, as this article will discuss later on, they might now view that as an effective way to reform China’s struggling SOEs. Since 2001, a number of regulations and rules have been released to liberalize takeovers by foreign investors of Chinese companies, including, mainly, SOEs. The laws include:

Several Opinions concerning Foreign Investment in Listed Companies,¹¹⁴ issued by the CSRC and Ministry of Foreign Trade and Economic Cooperation (the predecessor of Ministry of Commerce), November 2001 (hereinafter *Several Opinions*);

Administrative Measures on the Takeovers of Listed Companies,¹¹⁵ issued by the CSRC, September 2002 (hereinafter *Takeover Measures*);

Circular on the Transfer of State Shares and Legal Person Shares to Foreign Investors,¹¹⁶ issued by the CSRC, Ministry of Finance, and State Commission on Economy and Trade, November 2002 (hereafter the *State Shares Circular*);

¹¹³ See Guowuyuan bangongting guanyu zhuanfa guowuyuan zhengquan weiyuanhui guanyu zanting jiang shangshi gongsi guojiagu he farengu zhuanrang gei waishang qingshi de tongzhi [Notice of the State Council on the Transmission of the Request of the State Council Securities Commission Asking for Suspending the Transfer of State Shares and Legal Person Shares to Foreign Investors], September 23, 1995, art. 1.

¹¹⁴ Title in Chinese pinxin: Guanyu shangshi gongsi sheji waishang touzi youguan wenti de ruogan yijian.

¹¹⁵ Title in Chinese pinxin: Shangshi gongsi shougou guanli banfa.

¹¹⁶ Title in Chinese pinxin: Guanyu xiang waishang zhuanrang shangshi gongsi guoyougu he farengu youguan wenti de tongzhi.

Provisional Rules on Restructuring SOEs by Utilizing Foreign Investment,¹¹⁷

issued by Ministry of Finance, State Administration on Foreign Exchange, State Industrial Administration, and State Commission on Economy and Trade, November 2002 (hereinafter *SOE Restructuring Rules*);

Provisional Rules on the Acquisition of Domestic Enterprises by Foreign Investors,¹¹⁸ issued by the Ministry of Foreign Trade and Economic Cooperation, the State General Administration of Taxation, the State General Administration of Industry and Commerce, and the State Administration of Foreign Exchange, March 2003 (hereinafter *Foreign Acquisition Rules*), and

Administrative Measures on the Disclosure of Change in Share Holding of Shareholders,¹¹⁹ issued by the CSRC, September 2002 (hereinafter the *Disclosure Measures*).

The above laws, together with a number of other decrees and rules concerning IPOs, disclosure, and foreign exchange control with regard to foreign takeovers, are so confusing that even a China law expert may have difficulties to sort them out. The basic logic is that the *Rules on Foreign Acquisition* and *Rules on Transfer of State and Legal Person Shares* are the two main laws particularly with regard to foreign takeovers, with the rest being supplemental only. As previously noted, the laws on M&A demonstrate strongly the dualist nature of Chinese securities regulations.¹²⁰

Compared with previous M&A rules which are either prohibitive or very restrictive,

¹¹⁷ Title in Chinese pinxin: Liyong waizi gaizu guoyou qiye zanxing guiding.

¹¹⁸ Title in Chinese pinyin: Waiguo touzizhe binggou jingnei qiye zanxing guiding.

¹¹⁹ Title in Chinese pinxin: Shangshi gongsi gudong chigu biandong xinxi pilu guanli banfa.

¹²⁰ See *supra* note 77, 78, and the accompanying text.

the recently enacted regulations are rather liberal. Yet they still show strong Chinese characteristics which are worth noting here.

First, national treatment to foreign investors is established. Foreigners can directly buy shares of domestic firms from domestic shareholders or from new issuances of the firms (so-called “equity interest M&A”). Alternatively, they can conduct “assets M&A” by setting up foreign invested enterprises (FIEs) and use the FIEs to buy assets from domestic firms, or by buying assets from domestic firms and then using the assets to set up FIEs.¹²¹ There is no percentage limitation on a foreigner’s shareholding in the target company or new company. In addition, the laws do not differentiate foreign or domestic M&As in terms of rules on information disclosure and takeover procedures.¹²² Accordingly, a domestic firm acquired by foreign investors is not deemed as FIE and does not enjoy the normal preferential treatments afforded to FIEs according to the three major FIE laws.¹²³

Second, in M&A foreign investors still need to comply with China’s state policies regarding the directions of foreign investment embodied in the Guidelines on Foreign

¹²¹ See, *Foreign Acquisition Rules*, art.2.

¹²² See, *State Shares Rules*, art. 4. See also FENG Henian, *Waizi shougou shangshi gongsi guoyougu he farengu de xiangguan fagui he anli* [Rules and cases concerning foreign acquisition of state shares and legal person shares], speech made by Mr. Feng, Deputy Director of the Legal Department of the CSRC, in the 2003 Advanced Forum on Foreign Acquisitions of Domestic Enterprises (August 20, 2003), available at <http://business.sohu.com>.

¹²³ See, *State Shares Rules*, art. 9. The three major FIE laws are, respectively, *Zhonghua renmin gongheguo zhongwai hezi qiye fa* [The Law of PRC on Chinese-Foreign Equity Joint Ventures], *Zhonghua renmin gonghe guo zhongwai hezuo qiye fa* [The Law of PRC on Chinese-Foreign Contractual Joint Ventures], and *Waishang duzi qiye fa* [The Law of PRC on Wholly Foreign Owned Enterprises].

Investment and the Foreign Investment Catalogue. The Guidelines and Catalogue prohibits foreign investment in certain sectors such as production and research of transgenic plant seeds, exploration and mining of radioactive minerals, production of certain traditional Chinese medicines, and a variety of service areas.¹²⁴ In some other areas, such as transport by water and railway, telecommunication, distribution services, etc., foreign control is restricted to less than 50 percent.¹²⁵

Third, the rules encourage and even require mid- and long-term investment. Foreign investors can only transfer their acquired shareholding twelve months after they have paid up “in full” the consideration for M&A.¹²⁶ The purpose of this provision, as stated in the leading principles of the *Foreign Acquisition Rules*, is to “attract mid- and long- term investment, prevent short-term speculation, and maintain due order in the securities market.”¹²⁷

Fourth, the price of state shares and legal person shares shall be determined by way of open tender.¹²⁸ More specifically, in a takeover process involving foreigners, although the parties generally can agree on the price, the *Foreign Acquisitions Rules* require that the parties shall base the trading price on the valuation made by assets valuation institutions.¹²⁹ Curiously and confusingly, the *Rules* say that the parties “may by agreement choose asset

¹²⁴ See Foreign Investment Catalogue, *supra* note 108.

¹²⁵ *Id.*

¹²⁶ See, *State Shares Rules*, art. 7.

¹²⁷ See *id.*, art. 1(4).

¹²⁸ *Id.*, art. 3, para. 2.

¹²⁹ *Id.*, art. 8, para. 1.

valuation institutions incorporated in China.”¹³⁰ What causes confusion is the word “may.” It is surely not clear whether the parties can agree otherwise as “may” is normally understood as non-mandatory. However, practitioners who do M& A legal work in China understood the rules as “to require valuation by PRC valuation institution.”¹³¹ The law also explicitly prohibits transfer or sale of shares at a price “manifestly lower” than valuation which is deemed as “transfer of assets abroad in disguised form.”¹³²

Fifth, employees of the target company shall be taken care of. Contrary to the Anglo-American style of takeover which deems the matters relating to the unemployment of the workers of the target company an issue total irrelevant to securities regulations, China’s M&A rules impose a social responsibility on the acquiring foreign company in this regard. In order for the authorities to approve a deal, an “employee arrangement scheme” with regard to the workers of the target shall be submitted as part of application package.¹³³

The most interesting part of the recent M&A laws is probably the antitrust provisions, in which China asserts both domestic and extraterritorial jurisdiction over takeover activities. In the case of domestic M&As, the foreign investor must submit a report to the Ministry of Commerce (MOC) and the State Administration of Industry and Commerce (SAIC) if (1) one of the parties to the deal has a business turnover exceeding

¹³⁰ *Id.*

¹³¹ This can be seen from a seminar given by Thomas E. Jones on the topic *Buying into China: New Avenues for M&A Transactions*, on Nov. 7, 2003 in Singapore. Mr. Jones a partner of the China Practice Group of the Hong Kong Office of Freshfields Bruchhaus Deringer. The PowerPoint slides for the seminar are on file with the author and can certainly be obtained from Mr. Jones himself.

¹³² *State Shares Rules*, art. 8.

¹³³ *Id.*, art. 12 and 15.

RMB1.5 billion (about US\$ 181 million) in China, (2) the aggregate number of M&As of domestic companies in the relevant industry of China within one year exceeds ten, (3) the China market share of a party to the M&A has reached 20 percent, or (4) the M&A will result in the share of the China market of a party to the M&A reaching 25 percent.¹³⁴

China also asserts jurisdiction over global M&As if they have economic interests in China.

Briefly, the parties to an offshore transaction shall submit a report to the MOC and SAIC for approval if any of the following triggers is met: (1) one of the parties to the offshore M&A has assets exceeding RMB three billion (about US\$ 362 million) in China, (2) a party's business turnover in China exceeds RMB 1.5 billion in the current year, (3) share of the China market of a party and its affiliates has reached 20 percent, (4) the M&A will result in the share of the China market of a party and its affiliates reaching 25 percent, and (5) as a result of the offshore M&A, a party to the deal will directly or indirectly hold equity in more than 15 FIEs in the relevant industry in China.¹³⁵ According to a practitioner, these provisions, having worldwide transactional implications, are likely to make China the third major antitrust jurisdictions after the United States and EU.¹³⁶

D. Foreign Participation in Securities Intermediaries Services

Foreign participation in China's securities business was once heavily restricted in China. The OECD, in one of its reports on China's capital market in 2002, depicted the situation as the following:

China's restrictions on foreign participation are very severe In the domestic

¹³⁴ *Id.*, art. 19.

¹³⁵ *Id.*, art. 21.

¹³⁶ *See Jones, supra* note 130.

*capital market, foreign institutions are now effectively excluded from virtually all activities involving Chinese domestic investors. Foreign intermediaries cannot deal with Chinese investors in domestic primary offerings, engage in secondary market trading of A -shares, and may not form investment funds or other institutional savings products that are marketed to Chinese residents. Foreign intuitions are limited to soliciting orders for B-shares from non-residents, with a Chinese partner required to complete the trade on the exchange.*¹³⁷

China's WTO accession fundamentally changed the situation. On June 1, 2002, half a year after joined the world trading system, the CSRC released two laws allowing foreign participation in securities firms and fund management business: the *Rules for Establishing Foreign-Invested Fund management Companies* (hereinafter the *Fund Rules*),¹³⁸ and the *Rules for Establishing Foreign-Invested Securities Companies* (hereinafter *Securities Companies Rules*).¹³⁹

According to the *Fund Rules*, foreign companies can establish fund management joint ventures either through purchasing shares of existing domestic fund management companies or co-establish new joint ventures with Chinese partners, both in the form of limited liability companies.¹⁴⁰ A foreign party in the joint venture shall be a financial institution with good records (meaning it has not been seriously punished by the regulatory or judicial authority of its home jurisdiction in the recent three years) and with a paid-up capital no less than RMB 300 million (about US\$ 36 million), in addition to any other

¹³⁷ See OECD, *supra* note 9, at 525-26.

¹³⁸ Title in Chinese pinyin: Waizi cangu jijin guanli gongsi sheli guize.

¹³⁹ Title in Chinese pinxin: Waizi cangu zhengquan gongsi sheli guize.

¹⁴⁰ See the *Fund Rules*, art. 2.

prudential requirement that might be raised by the CSRC. It shall also come from a jurisdiction which has signed a “memorandum of understanding” (MOU) with the CSRC.¹⁴¹

The *Rules* also stipulate the percentage limit on the shareholding of foreign investors in the joint ventures. In line with China’s WTO commitments, the foreign partner is limited to a 33 percent stake initially, but foreign ownership will be allowed to rise to 49 percent three years after China’s accession to the WTO.¹⁴²

The *Securities Companies Rules* have similar provisions allowing foreigners to buy shares from a domestic securities company or jointly establish a new company with a domestic partner (not limited to domestic securities firms) in the form of limited liability companies.¹⁴³ The foreign partner, being a financial institution which has engaged in financial business for more than ten years with good records, shall also have good internal control system as well as good reputation and business performance in international securities markets.¹⁴⁴ Needless to say, this kind of soft “requirements” place great discretion in the hands of Chinese bureaucrats in charge of the approving process. The share percentage of the foreign partner in the joint venture is limited to one-third.¹⁴⁵

A foreign invested securities firm is allowed to engage in a broad range of securities services, including underwriting of stock (for both A shares and B shares) and bonds (government and corporate bonds), brokerage of B shares, brokerage and self-

¹⁴¹ *Id.*, art. 6.

¹⁴² *Id.*, art. 8.

¹⁴³ *See the Securities Companies Rules*, art. 2.

¹⁴⁴ *Id.*, art. 7.

¹⁴⁵ *Id.*, art. 10.

operation of bonds, as well as other businesses as may be approved by the CSRC.¹⁴⁶

Compared with domestic securities firms, they are not allowed to provide brokerage services for A shares, and to engage in securities custody, buying and selling stocks for their own account, as well as in consulting services.

III. TRAPS FOR WOLVES: THE LEGAL PROBLEMS FACING FOREIGN INVESTORS

A. Legal Risks Peculiar to the Chinese Stock Market

Investment risks exist in almost every capital market. Entering into the Chinese market (and any market), foreigners are prepared to accept commercial and market risks such as price fluctuations, mistakes in corporate decision-making, change of fashion, economic recession due to cycles, as well as other uncertainties which are inherent in the nature of doing business. These risks are not the subject of this article. There are also legal and policy risks in a market that are to be incurred as a result of changes in governmental policies and regulations. Legal (and policy) risks are normal in a mature market insofar as they are created in an environment in which the government merely play the role of regulator and nothing else (such as a significant shareholder), and the regulatory culture is consistent and coherent with a viable framework of rule of law.

Setting foot in China's stock market, foreign investors wish to profit either from trading stocks or from directly participating in the management of Chinese companies through mergers and acquisition. The special features of China's stock market have caused a variety of legal and policy risks which shall be characterized as systemic problems peculiar to China. As previously noted, the stock market comprises substantial state

¹⁴⁶ *Id.*, art. 5.

ownership, with SOEs constituting the majority of listed companies. In addition, two-thirds of the shares are non-tradable. In such a context, regulators of the stock market often face the “identity” problem, namely, whether they shall act as regulators of the market, for which they should treat all the parties equally, or as owner of state shares, for which their first priority is to ensure the realization of the multiple objectives of the government in terms of both maximizing of state assets and maintaining social stability even at the expense of the economic interest of other shareholders. As a matter of fact, most paradoxes in China’s stock market are closely tied to SOEs. The vivid characteristics of emerging markets also present problems in connection to rule of law, corruption, poor corporate governance, and lack of a credit system. In addition, the current laws place tremendous power on the part of majority shareholders while provide little protection for minority shareholders. Judicial remedies, while only emerging in this current year, are quite limited as well as restrictive. As foreign investors will still only be able to hold minority shares in many cases due to various constraints, protection of minority will be a major concern.

The B Shares market can be used to illustrate some of the problems facing foreign investors. Notwithstanding the many efforts used by Chinese regulators to boost it, the market is still far from attractive and has performed poorly so far. Notorious problems in the market include the lack of liquidity, restrictions on foreign securities firms, lack of proper disclosure of information, and uncertainty of B shareholders’ rights with respect to the issuers. First, under the B Shares Regulations, information disclosure documents of the issuers for B shares shall be prepared in Chinese.¹⁴⁷ Although the laws state that foreign

¹⁴⁷ See B Shares Regulations, art. 17.

language version documents can be provided when needed, it is not required.¹⁴⁸ This could be justified to the extent that investors should not expect documents in a language other than Chinese as they choose to invest in Chinese companies. However, as the investors originally targeted are solely foreigners, provision of documents in a language they are familiar with should reasonably be the requirement; otherwise, it would result in inadequate disclosure because of language barriers. Investors also lack trust in China's accounting system. While the B Shares Regulations insincerely stipulate that the issuing company may provide financial reports adjusted according to the International Accounting Standards or the accounting standards of the place outside China where the offer is conducted, reports produced are still unreliable because the overall reports of the company produced are based on China's Enterprise Accounting Standards which do not inspire popular confidence so far. In terms of shareholder's rights, the B Shares Regulations explicitly offer the same rights to foreigners as their domestic counterparts.¹⁴⁹ In addition, a foreign shareholder may entrust a proxy with exercising his shareholder's rights on his or her behalf.¹⁵⁰ However, this provision may not be meaningful because the regulations did not grant shareholders the right to pursue derivative action. The absence of such a provision means that shareholders may not have a legal basis to sue directors and officers who have violated their fiduciary duties.¹⁵¹ Moreover, shareholders who intend to control a Chinese company through trading of B shares may be frustrated, because they are not

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*, art. 5.

¹⁵⁰ *Id.*, art. 21.

¹⁵¹ See Jay Zhe Zhang, *Securities Markets and Securities Regulations in China*, 22 N.C. J. Int'l L. & Com Reg. 557, at 615 (1997).

allowed to buy A shares which generally constitute the majority of total shares in a company. All these serve as obstacles to bar the further development of the B shares markets.

B. The Regulations and Regulatory Culture: Too Burdensome and Ambiguous to be Tolerable?

Any investor must face regulations and regulators, which jointly form the regulatory regime. Regulators are tough and regulations burdensome – this is probably a worldwide phenomenon. However, in advanced stock markets there is always a boundary, namely, regulators normally play the role of watchdog for the marketplace, providing rule of law and maintaining a fair, orderly, and transparent market. For example, the main duty of the U.S. Securities and Exchange Commission (SEC) is to ensure the implementation of federal rules regarding disclosure, and in no case is it expected to be a guarantor of corporate profits.¹⁵² The uniqueness of the Chinese regulators (especially the chief regulator CSRC) is that they are designed to play multiple roles, in which being watchdog is the minor. Briefly speaking, the CSRC is chiefly equipped with two tasks, including “developing” as well as “regulating” the capital market, and is expected to do both well.¹⁵³ In addition, as a state agency, the CSRC and other regulators concerned (such as the PBC) are more or less considered as representatives for the state in taking care of state assets.

Conflict of interests and ambiguous identity caused by multiple roles of the

¹⁵² See Donald C. Clarke, *Corporate Governance in China: An Overview*, in *China Economic Review* (forthcoming 2003), available at <http://papers.ssrn.com/abstract=424885>.

¹⁵³ See Zhao Wenguang, *Gushi fazhan xuyao “liangzhi shou” tuidong* [The growth of the stock market needs push from “two hands”], in *Zhengquan Shichang Zhoukan* [Securities Market Weekly] (Sep. 22, 2003), available at <http://news.sohu.com>.

regulators, in conjunction with lack of experience, have led to both under-regulation and over-regulation, as well as ambiguous laws. In one sense, the CSRC is probably the most powerful regulator in the world, and China is the most heavily-regulated market.¹⁵⁴ Contrary to the belief of free market theory in most developed capital markets, China's IPO market is dominated by the mentality of plan economy in which the government directly controls the IPO process as well as any follow-up issuance, determining which enterprise is able to issue shares. In fact, the CSRC views this market access authority as its main duty. In addition, the CSRC is in charge of issuing licenses to intermediaries service providers including securities companies, accounting firms, brokers, fund managers, and securities consultants. Even newspapers and magazines must have obtained licenses from the CSRC in order to publish statements of listed or prospective listed companies. For a long period before 2003, lawyers needed to obtain licenses from the CSRC in order to provide legal opinions for companies with regard to securities. Most of those licenses only have one-year duration so the CSRC is always able to kick anybody out of the market by withdrawing or refusing to renew license.¹⁵⁵

Regulations in China's stock market often go to ridiculously detail and specific. For instance, before the launch of an IPO, the CSRC sends personnel (called "preliminary interviewer") to the company seeking listing to check its qualifications. The preliminary interview decides all the material issues relating to IPO, including, among others, number

¹⁵⁴ See SHAO Yingbo, *Guodu guanzhi dao zhi de cuo che – Fang Liufang jiexi zhongguo zhengquan shichang* [Frustration caused by over-regulation – Fang Liufang on China's securities market], in *Jingji Guan cha Bao* [Economic Watch Daily](Dec. 6, 2001), available at <http://news.sohu.com/17/39/news147363917.shtml>.

¹⁵⁵ See *id.*

of shares, price, timing of issuance, as well as choosing the stock exchange to list.¹⁵⁶

When intermediaries are involved, the CSRC has detailed provisions as to how the underwriters shall proceed to “educate” their clients, the kinds of lawyers a company shall hire, which accounting firms shall be retained by listed companies conducting financial business ... so on and so forth.¹⁵⁷ Furthermore, self-regulation is almost non-existent as all NGOs in China’s securities market are de facto inferior subsidiaries of the CSRC. For example, the two stock exchanges are no more than two departments of the CSRC, at least in the sense that their heads are appointed and their internal rules approved by the regulator.¹⁵⁸

As noted by Prof. Fang Liufang of the China University of Political Science and Law, “*guanzhi guodu*” (over-regulation) is the major problem in China’s securities market. A direct result of it is that capital flow out of China to escape burdensome domestic restrictions through the setting up of offshore companies.¹⁵⁹ Indeed, since 1990s, the amount of capital flowing out of China has been larger than China’s receipt of oversea capital.¹⁶⁰ Ironically, although it is equipped with over-reaching regulatory power, the

¹⁵⁶ *See id.*

¹⁵⁷ *See id.*

¹⁵⁸ *See id.* The paternal relationship is so strong that Mr. Gao Xiqing, the formal Executive Vice President of the CSRC, had to ask the securities associations to “speak against” the CSRC when it was necessary. *See, Gao Xiqing: Zhengquan ye xiehui keyi dui zhengjianhui shuo “bu”* [Gao Xiqing: securities business associations could say no to the CSRC], in *Renmin Ribao* [People’s Daily](July 4, 2002), available at <http://business.sohu.com/90/47/article201994790.shtml>.

¹⁵⁹ *See* SHAO, *supra* note 154.

¹⁶⁰ *Id.*

CSRC has no accountability to shareholders. The official Xinhua News Agency recently claimed that the CSRC “should be responsible for the listing of unqualified companies, the falsification of financial statements by listed companies, joint trading of listed companies with their controlling shareholders, excessive speculation and insider manipulation.”¹⁶¹ Certainly neither the CSRC as an agency nor any of its individual officer has been pursued for responsibility.

Another risk resulting from conflicting multi-objectives of the regulators is the swaying and often unpredictable regulatory culture due to a change of the person in charge. The swaying culture is most prominent in recent years in the sense that certain chiefs of the CSRC prefer to play a larger role in “regulating” while others like to help “develop” the stock market with certain tolerance of fraudulent activities. In February 2000, liberal-minded Zhou Xiaochuan ascended to the chairmanship of CSRC. With the assistance of Executive Vice President Mr. Gao Xiqing who was basically an America-trained lawyer,¹⁶² he began to transform substantially the Commission into a regulatory machine, with a view to establishing a “clean” market subject to clear rules and transparency and a powerful regulatory framework modeled after the SEC of the United States. For Zhou, the major task for the CSRC was to establish its role as an independent regulator rather than the representative of state ownership.¹⁶³ Using the metaphor of football games, he stressed

¹⁶¹ See Gordon G. Chang, *China's Equity Markets: Floating With Helium*, in CATO Institution's China's Brief, Vol. 2, Issue 9, Apr. 25, 2002.

¹⁶² Mr. Gao graduated from Duke University Law School with a JD degree in 1986. He became the CSRC's Vice President in 1999.

¹⁶³ See, Zhou Xiaochuan, *Zhongguo ziben shichang de zuzhi jigou* [The structure of China's capital markets], speech made in the China's Capital Forum 2002(Dec.5, 2002), available at <http://www.csrc.gov.cn>.

that the regulator should act as a judge for all players, never attempting to go down to the greenfield to play itself.¹⁶⁴ Zhou's commission focused its work mainly on enacting and enforcing disclosure rules. In 2001 along, the CSRC introduced 51 new regulations and disciplined more than 81 listed companies and 10 intermediaries, including law firms and accounting firms, for violations for securities laws.¹⁶⁵ The result was more than obvious: China's stock market entered into the longest bear period since the beginning of 2001, and has not recovered so far. According to the statistics provided by the CSRC, from the middle of 2001 to the end of 2002, the stock market suffered a loss of RMB638 billion (about US\$77 billion).¹⁶⁶

The Zhou-Gao's regulatory style, emphasizing on supervision and compliance, certainly irritated many persons who have stakes only in a bull market and even incurred the blame of many investors for their losses. In addition, although supported by Premier Zhu Rongji, they had actually less friends among officials. In a 2002 stock market seminar, four former CSRC chairman coincidentally made speeches saying the development of the market should be priority under any circumstance.¹⁶⁷ In December 2002, Zhou was moved to the position of the president of the People's Bank of China (PRC's central bank) and succeeded by Mr. Shang Fulin, a former veteran from the army. Shortly after his takeover

¹⁶⁴ *Id.*

¹⁶⁵ See, Feiwen Rong, *Chinese Investors Dislike Market Regulation*, at <http://journalism.berkeley.edu/projects/greaterchina/story-stock.html> (visited Nov. 21, 2003).

¹⁶⁶ See the database provided on the CSRC's website at <http://www.csrc.gov.cn>. In July 2001, the total capitalization of tradable shares China's stock market was RMB1886.6 billion, which became RMB1248.4 in December 2002.

¹⁶⁷ See Rong, *supra* note 165.

of the CSRC, Mr. Shang made it very clear that all the problems “are part of the development and shall be solved through development,”¹⁶⁸ and requiring a “correct solution to the relationship among reform, development, and stability.”¹⁶⁹ Needless to say, investors see another shift in regulatory culture, without being able to know the orientation of the next personality in charge of the CSRC.

Mr. Zhou’s perspective for establishing a clean market is certainly correct insofar as normal, developed stock markets are concerned. The Chinese market’s uniqueness renders his efforts to model the SEC futile. However, denying the positive role of Zhou still cannot solve the existing dilemma in China’s stock market: the absence of a set of clear and transparent rules and effective enforcement. Failing such an achievement, fraud as the main theme of the market is unlikely to be changed irrespective of how big China’s stock market is “developed” to.

C. SOE Reform, Corruption, and Fraudulent Activities in the Market

In the words of Prof. Fang Liufang, “in theory, China’s Securities Law, Company Law, and the regulatory framework are strict enough to prevent any market fraud activity.”¹⁷⁰ The reality, however, is very different. Due to the structural flaws of the

¹⁶⁸ See SHANG Fulin, *Tuijin ziben shichang gaige kaifang he weiding fazhan* [To push the reform, opening up, and stable development of the capital markets], in *Guoji Jinrong Bao*[International Finance Daily], April 21, 2002, at p.8, available at <http://www.people.com.cn>. See also Shang Fulin, *Jiji tuijin ziben shichang gaige kaifang he weiding fazhan* [Actively push for the reform, opening up, and stable development of the stable market], speech made at the “2003 Forum for China’s Financial Reform and Development”, Apr. 20, 2003.

¹⁶⁹ *Id.*

¹⁷⁰ See SHAO, *supra* note 154.

market arising out of initial design, massive fraudulent activities exist in both the first (IPO or new issuance) and the secondary (exchange) markets. In 2001, Wu Jinglian, one of China's most prestigious economists, proclaimed in a program of China's Central TV Station that China's stock market "is just like a casino, but worse than that," because "even casinos have rules so that you can't look at other people's cards. But in our stock market, many people can peer at the cards of others, can cheat, can practice fraud. [In brief], market manipulation and insider trading have reached their extremity."¹⁷¹

The root of the problem rests with China's struggling SOE reform. To reinvigorate its cumbersome SOEs, China has tried several approaches. In the early 1990s, concurrently with the drafting and passage of the Company Law, the government launched a new approach – "corporatization", one aspect of which is to transform SOEs into listed stock companies. As a programmatic document of the Communist Party of China (CPC) stated, "The joint stock system is a form of capital organization of modern enterprises, which is favorable for separating ownership from management and raising the efficiency of operation of enterprises and capital."¹⁷² From the government's view, this approach presents several benefits. First, it expands the fund-raising channel for SOEs. Second, SOEs can transform their operational mechanisms in compliance with the requirements of

¹⁷¹ See *Wu Jinglian nuchi gushi heizhuang* [Wu Jinglian scolds fraudulent institutions in the stock market], interview of Wu Jinglian by the "Economy 30 Minutes" of the CCTV (Jan. 15, 2001), transcript available at <http://www.people.com.cn/GB/jinji/35/159/20010115/378998.html> [hereinafter "Wu's interview"].

¹⁷² Jiang Ze Min, *Hold High the Great Banner of Deng Xiaoping Theory for an All-Round Advancement of the Cause of Building Socialism with Chinese Characteristics into the 21 Century – Report Delivered at the National Congress of the Communist Party of China* on September 12, 1997.

modern enterprises. Thirdly, it helps to allocate financial resources to benefit SOEs.¹⁷³

These optimistic predictions, if not complete daydreams, at least turn out to be one-sided wishes in some sense.

The name of many (and probably most) transformed stock companies fall short of their substance. They have merely the corporate cloak of Western-style stock companies, but are still being run in the old way of administrative control.¹⁷⁴ For many SOEs, the main benefit from the transformation into joint stock company is not the opportunities to “restructure itself into a modern enterprises”, but rather to raise capital to alleviate financial difficulties.¹⁷⁵ In order to obtain approval from the CSRC for IPO, they disclose false figures of profits or even forge financial reports.¹⁷⁶ As stated by Prof. Fang in an interview,

When a SOE obtains a quota for IPO, even though it has suffered loss in the past three years [which hence cannot meet the initial legal requirement for IPO], it can immediately have profit earnings in the past three consecutive years simply by requesting those “securities accountants” to cook accounting statements for them, of course with extra high pay to those accountants. ... The issuer’s “make-up” fee is eventually absorbed by the “issuance cost”, which shall be deducted from the capital contribution paid by

¹⁷³ *Id.*

¹⁷⁴ See HE QING LIAN, XIANDAIHUA DE XIANJING – ZHONGGUO ZHI WENTI [THE TRAP OF MODERNIZATION – CHINA’S PROBLEMS] (1998, Zhongguo Xiandai Chubanshe [China Today Press]), p. 24.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

*investors purchasing the shares. SOEs made-up – intermediaries provide make-up service – investors pay the bill: this is the entire process of the game.*¹⁷⁷

Because each SOE has a supervising body which is either an agency of the central government or local governments and which has a tremendous stake in the company's going-public, the listing process is highly politicized, involving enormous rent-seeking activities and corruption. The 2002-litigated "Macat case" is a telling one. Macat Co. obtained approval from the CSRC and launched IPO in August 2000. In November 2000 the CSRC identified that Macat falsified hundreds of millions of dollars of profit and revenue in its financial statements. According to the disclosed CSRC report and court judgment for this case, not only the company, a small entity without any substantial assets, purposely cheated the public, all the intermediaries, including an accounting firm, an asset valuation institution, a law firm, and a securities company, helped fabricate the false statements.¹⁷⁸ The case was characterized as involving a "sophisticated production line for producing false accounting reports and numbers in the securities market."¹⁷⁹ Eventually a dozen managers and professionals were prosecuted for violating the criminal law.¹⁸⁰

¹⁷⁷ See SHAO, *supra* note 154.

¹⁷⁸ See Yu Ming, Wang Shuo & Ling Huawei, *Maikete e'meng – yitiao kongqian wanzheng de zhengquan shichang zaojia liushuixian de wanzheng baoguang* [Macat's nightmare – a whole production line making falsified reports in the securities market is exposed to sun], in *Caijing Magazine*, March 20, 2002, 2002 Issue 6 (general issue no. 56), available at <http://business.sohu.com/39/60/article200406039.shtml> and <http://www.caijing.com.cn>.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

According to a commentator, the massive accounting fraud perpetrated on the market in the Macat case was rather a phenomenon than an individual case.¹⁸¹ For both foreign and domestic investors, the quality of listed companies shall always be thought twice, as the disclosure reports provided by various intermediary service providers, which are supposed to serve as the “soft” regulatory infrastructure, cannot be trusted outright.

D. Poor Corporate Governance: Listed Companies Too Dark to Be Visible

Corporate governance was suddenly brought into the landscape of China’s securities market in 2001 by the famous YinGuangXia case.¹⁸² Since then, this issue, becoming a high profile topic, has been placed at the very top of the regulator’s agenda and mentioned frequently in all the recent keynote speeches by the Chinese, ranging from the Premier to university professors.¹⁸³

Poor corporate governance is still a problem caused by the inherent paradox of SOEs which constitute the majority of listed companies. Because the government restricts the sale of tradable shares to investors, normally in any listed SOE the state owns at least two third of the shares (including state shares and legal person shares), which are not tradable (and thus transferable to private investors by any means) as a matter of law. This one-third privatization naturally leads to the prominent “one shareholder (the state shareholder) too dominating” problem. Owners of the one-third tradable shares, composed mainly of dispersed individual investors, have no meaningful influence on the decision-

¹⁸¹ See LI Shuguang, *Gusi zhili de shengtai weiji* [Ecological crisis in corporate governance], in *Caijing Magazine*, March 20, 2002, 2000 Issue 6 (general issue no. 56), available at <http://www.caijing.com.cn>.

¹⁸² See, *Standard & Poors Country Governance Study – Corporate Governance in China*, Nov. 2003, at 1, available at <http://www.standardandpoors.com> (hereinafter the S&P Study).

¹⁸³ *Id.*

making process in the listed SOEs.¹⁸⁴ In addition, China's corporate and securities laws, understandably in the sense that they were made to protect state assets, place very strong power on the majority shareholder with respect to voting rights and corporate management.

The state is, after all, an abstract owner. It must exercise its ownership through human agents. Clarke thus correctly observed that "State-owned enterprises were thus always controlled, both at the enterprise level and at the level of the administrative body in charge of them, by human beings who did not own the enterprise."¹⁸⁵ Due to the absence of the effective ultimate owner (the state), power to control the SOEs rests in the hands of appointed managers, which can only be monitored by competent government agencies. When serious violations of securities laws or infringements of state assets are discovered, it is not uncommon to find that the state agencies either lacked the necessary supervisory capability or simply conspired (through corrupt officials) with the directors and managers of the listed companies to steal the shareholders' property.

¹⁸⁴ And this shall be supplemented by another problem, namely, China's investors have little sense of responsibility as shareholders. Popular interest in purchasing stock has been overwhelmingly motivated by the prospect of rapid appreciation in market value, rather than by long-term analysis of the fundamentals of the company. It is a well-known fact that 99% of private investors are oriented towards speculative profits. Investors rarely inquire into the stock issuer's economic condition, operations, or future prospects, apparently assuming that the government will not allow an enterprise to fail. Dividends do not enter into the analysis and attention is directed solely to short-term fluctuations in price. A report by Guangzhou East Market Research Firms indicated that, in a poll about shareholders sense of Guangzhou, about 50.6% of those investors stated that they had little or no knowledge of the operation of their companies. 43.7% stated that they never had the sense of a shareholder. See HE, *supra* note 174, at 27.

¹⁸⁵ See Clarke, *supra* note 152, at 6.

The YinGuangXia case is the most influential one of this kind involving severe losses to thousands of minority shareholders due to almost non-existent corporate governance. In May 2002, the CSRC issued a penalty report finding that, from 1998 to 2001, YinGuangXia Co. fabricated sales receipts and disclosed false information about various production facilities that actually never existed. The company lied to the market concerning RMB1 billion (about 120 million) in revenue and RMB771 million in profit.¹⁸⁶ With this bright spot in the financial statements it led investors to believe it was the long-expected “blue chip” in China’s stock market. The sole purpose of all the misrepresentation was to induce investors to buy its follow-up issuance. According to the investigation of the official Xinhua News Agency, since 1994 to 2001, YinGuangXia made three follow-up offerings and collected RMB574 million from the market, resulting the severe losses to thousands of small investors.¹⁸⁷

One of the major reasons causing the YinGuangXia scandal was the virtual non-existence of corporate governance in this literally state-owned listed company. According to the Xinhua investigation, the meetings of the board of directors had always been done perfunctorily, with decisions decided by “core” people without transparency.¹⁸⁸ The fraudulent activities were conducted by the CEO of YinGuangXia Tianji Inc. which was a

¹⁸⁶ See, *Zhengjianhui xiada chufa jue ding, ST YinGuangXia jiang zanting shangshi* [CSRC issues penalty and trading of YinGuangxia shares will be suspended], in *Zhengquan Shibao* [Securities Time] (May 16, 2002), available at <http://www.people.com.cn/GB/jinji/35/159/20020516/729584.html>.

¹⁸⁷ See Xinhua News Agency, *YinGuangXia zhuizong: 7.7 yi yuan de paomo shi zenyang chuida de?* [Tracing YinGuangXia: how was the bubble of 770 million profit made?], by reporter He Jinsong and Han Zhenjun, May 26, 2002, available at <http://www.xinhuanet.com>.

¹⁸⁸ *Id.*

wholly owned subsidiary of YinGuangXia and was the major revenue source of the listed company. As noted by Prof. Li Weian, the Dean of the International Business School of Nankai University of China (in the city of Tianjin), the board of directors completely failed in certain aspects of corporate governance, including governance of its subsidiary and the corporate management. In addition, non-state shareholders were entirely deprived of the right to monitor the board and the management.¹⁸⁹

In the foreseeable future, foreigners still have to face the problem of poor corporate governance and the predominance of the “legal representative” of the state shareholder. Needless to say, their keenness in participating in China’s stock market, which the Chinese regulators see as an opportunity to restructure its SOEs and national economy, will be limited if the poor corporate problem is not solved.

E. Absence of Effective Judicial Protection of Minority Investors

Despite the enormous number of securities disputes regarding frauds, judicial involvement is so far limited and self-constrained on the part of Chinese courts. When the YinGuangXia scandal and another fraudulent case (Yorkpoint Science and Technology Co.) occurred in 2001, hundreds of investors rushed to courts for help, and they were frustrated by the judiciary’s reluctance to process securities litigation. On September 21, the Supreme Court of China released a notice requiring all the lower courts temporarily not to accept securities lawsuits concerning insider trading, fraud, market manipulation, etc, on

¹⁸⁹ See, *Gongsi dongshihui nanci qijiu: Jingjixue jia tan YinGuangXia shijian* [Economist on YinGuangxia: the board of directors is liable], in *Shenzhen Tequ Bao* [Shenzhen Special Administrative Region Daily](Aug. 27, 2001), available at <http://business.sohu.com/20010827/file/0092,023,100050.html>.

the ground of the “constraints created by the current legislative and judicial conditions.”¹⁹⁰ A shock to investors, professionals and scholars (and certainly a comfort to some others), it fueled a debate on the rule of law and judicial role for the development of the securities market. Yet if one’s thinking came down to earth the Court’s decision appeared reasonable and understandable, at least according to Mr. LI Guoguang, the then Vice President of the Supreme Court.¹⁹¹ First, there was an issue of lack of judicial coordination. As investors would initiate different lawsuits against the same defendants in many domestic jurisdictions, different lower courts would render conflicting rulings due to the absence of coherent criteria. This would jeopardize the reputation and credibility of the legal system. Secondly, the concern was about the overloading of the entire court system by individual securities lawsuits. Thirdly, judicial capability was frankly admitted, especially the lack of prior experience of judges, and the absence of national uniform standards as regards evidential rules and damage determination would only make things worse. Finally, the concern was about the protection of state assets. As indicated by Justice LI, “if there were to be numerous lawsuits against all these listed firms and if the private plaintiffs were awarded the rightfully deserved relief, it would lead to major losses

¹⁹⁰ See Zuigao Renmin Fayuan Guanyu She Zhengquan Minshi Peichang Anjian Zanbu Shouli de Tongzhi [Notice of the Supreme People’s Court on the Temporary Ban on Private Securities Lawsuits], FaMingChuan (2001) 406 Hao [Doc. 406 (2001) of the Court](September 21, 2001), text *available at* <http://www.court.gov.cn>.

¹⁹¹ See Zhiwu Chen, *Capital Markets and Legal Development*, Yale School of Management working paper (Sep. 12, 2003), *available at* <http://icf.som.yale.edu/research/china-intiative.shtml>.

of state assets (since the listed companies are mostly state-controlled).”¹⁹² Clearly, the socialist ideology of state ownership prevailed over justice for individual rights.

Four months later, a second notice came from the Supreme Court allowing Chinese courts to accept private securities cases concerning misrepresentation.¹⁹³ It set up relevant judicial standards and definition for “misrepresentation”,¹⁹⁴ but confines courts’ jurisdiction only to this type of claims. In addition, it preconditioned judicial acceptance of these cases on the prior penalty report of the CSRC establishing the facts and evidence.¹⁹⁵ Arguably, this breached the principle of judicial independence guaranteed by the PRC Constitution and was alleged to be a re-writing of the Securities Law enacted by the country’s top legislature, the National People’s Congress (NPC).¹⁹⁶ Nevertheless, a wave of lawsuits flooded the courts after the promulgation of this notice.¹⁹⁷

The most comprehensive judicial interpretation, *Provisions concerning Civil Securities Litigation on Misrepresentation Cases* [hereinafter the *CSL Provisions*],¹⁹⁸ was

¹⁹² *Id.*

¹⁹³ See Zuogao Renmin Fayuan Guanyu Shouli Zhengquan Shichang Yin Xujia Chenchu Yinfa de Minshi Qinquan Jiufen Anjian Youguan Wenti de Tongzhi [Notice of the Supreme People’s Court on accepting civil tort disputes arising out of misrepresentation in securities markets] (Jan. 15, 2002), text available at <http://www.court.gov.cn>.

¹⁹⁴ See *id.*, art. 1.

¹⁹⁵ *Id.*, art.2.

¹⁹⁶ See Chen, *supra* note 191.

¹⁹⁷ *Id.*

¹⁹⁸ Chinese title: Zuigao Renmin Fayuan Guanyu Shenli Zhenquan Shichang Yin Xujia Chenshu Yinfa de Minshi Peichang Anjian de Ruogan Guiding, promulgated on 2 January 2003 and effective as of 1 February 2003, text available at <http://www.court.gov.cn>.

released in January 9, 2003, obviously as a response to outcries of lower courts for more detailed procedural and substantive rules. The *CSL Provisions* make no change to the confinement of private securities litigation only to misrepresentation cases, and affirm the requirement of preconditioning private lawsuits on the prior investigation and administrative decisions of the CSRC and other state ministries. Investors in China's securities market still have no judicial recourse for cases concerning insider trading, market manipulation, and other fraudulent activities, and they have to sue in the courts of the places where the defendants are headquartered and where local protectionism is a prevailing concern.

IV. PROSPECTS FOR FURTHER LIBERALIZATION AND IMPROVEMENT OF THE REGULATIONS: ANALYSES AND RECOMMENDATIONS

Having described the state of regulatory affairs of China's stock market with respect to foreign investment and analyzed the legal problems facing foreign investors, the next step, logically, is to explore the prospects for the future of China's securities regulations in this regard. As noted by many commentators, there will be no future for China's securities markets – and accordingly no future for the success of foreign participation in the markets – if those structural flaws and systemic problems are not solved.¹⁹⁹ Given the strong paternalism in China's securities markets, viable securities

¹⁹⁹ In recent years, there is a common recognition among Chinese commentators that China's securities markets have been marginalized in terms of playing a meaningful role in the economic development. In fact, in an ongoing debate on the problems of the stock market, the meaningfulness of having such a distorted market has been put on doubt. See, eg., YI Xianrong, *Guonei gushi weihe bianyuan hua?* [Why the stock

regulations should play a significant role in shaping a sound environment for the development of the market. However, the perfection of China's securities regulations with regard to foreign investment depends on China's determination to honor its WTO obligations, a reflection of the role of foreign investors, repositioning the government in economic development, the advance of privatization of Chinese economy and, most importantly, rule of law and institutions building for the market economy.

A. WTO Compliance

A Member of the WTO, China is expected to comply with all the obligations under the General Agreement on Trade in Services (GATS)²⁰⁰ in terms of financial services and has so far obtained mixed evaluations with regard to its performance. As a WTO member who had struggled 15 years to join the multilateral trading institution largely due to the stern demands on market access from other GATT/WTO members and whose foreign economic relations are now primarily governed by WTO agreements, China's compliance with WTO obligations constitutes the most important aspect of its bilateral and multilateral engagements with other countries.

market is marginalized?], and YU Li, *Quanshang zhi huan: Shoudu Jingmao Daxue Liu JiPeng Jiaoshou Zhuan Fang* [Worries of the securities business – interview of Prof. Liu Jipeng of the Capital Economic and Trade University], both in *Nanfang Zhoumo* [Nanfang Weekly] (Sep. 11, 2003), available at <http://www.nanfangdaily.com.cn/zm>, and <http://news.sohu.com>. In the second article, Prof. Liu stated: “It can basically be concluded that the capital market is in its most difficult, grim period since its inception 11 years ago. The grim situation does not lie in the fact that it is fundamentally a bear market. More severely, we don't know what's the future of China's capital market, and we are at loss, not knowing where it is heading to.” *See id.*

²⁰⁰ See General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization [hereinafter WTO Agreement], Annex 1B [hereinafter GATS].

GATS, part (and Annex 1B) of the Agreement Establishing the World Trade Organization, contains two components: the first is the framework agreement setting the basic rules and the second a schedule recording each country's specific commitments and a list of most favored nation exemptions. Pursuant to GATS as well as China's WTO accession agreements, China undertakes the following three general obligations:

(1) *Most favored-nation treatment*: Members are required to "accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favorable than that it accords to like services and service suppliers of any other country."²⁰¹ The objective of this provision is to ensure a WTO Member treats other members on a non-discrimination basis. In China's Accession Protocol it agrees to accord to foreign individuals and enterprises as well as foreign-funded enterprises "treatment no less favorable than that accorded to other individuals and enterprises in respect of (a) the procurement of inputs and goods and services necessary for production and the conditions under which their goods are produced, marketed or sold, in the domestic market and for export; and (b) the prices and availability of goods and services supplied by national and sub-national authorities and public or state enterprises, in areas including transportation, energy, basic telecommunications, other utilities and factors of production."²⁰² Apparently, financial services, including securities services, are embedded in this commitment. However, pursuant to GATS Art. II(2) which authorizes Members to make deviations from

²⁰¹ *Id.*, art. II.

²⁰² See Protocol on the Accession of the People's Republic of China, Nov. 10, 2001, Accession of the People's Republic of China, WT/L/432, Part I(3) [hereinafter the Protocol].

MFN obligation, China can accord particular countries less than MFN treatment as long as it has listed these deviations (called MFN exemptions) in its GATS Art. II Schedule.²⁰³

(2) *Transparency*: Art III of GATS provides that each Member shall “publish promptly” all relevant domestic measures of general application which pertain to or affect the operation of GATS as well as international agreements pertaining to or affecting trade in services to which the Member is a signatory.²⁰⁴ According to its commitments with respect to transparency, China undertakes only to enforce laws that are published. In addition, it agrees to provide to WTO Members, upon request, all laws affecting trade in services, and establish an official journal and entry point which make Chinese laws readily available to any individual, enterprise or WTO Member.²⁰⁵

(3) *Fair application of laws*: Art. VI of GATS requires WTO Members to ensure that “measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner.”²⁰⁶ This article is intended to prevent Members from denying, nullifying, or impairing GATS benefits to other Members through the use of onerous domestic administrative measures. In this regard, China commits itself to “apply and administer in a uniform, impartial and reasonable manner all its laws, regulations and other measures of the central government as well as local regulations, rules and other measures issued or applied at the sub-national level pertaining to or affecting trade in ... services ...”²⁰⁷

²⁰³ See GATS, art. II(2).

²⁰⁴ See GATS, art. III.

²⁰⁵ See the Protocol, *supra* note 203, Part I(2)(C).

²⁰⁶ See GATS, art. VI.

²⁰⁷ See the Protocol, *supra* note 203, Part I(2)(A)(2).

The above principles, covering all aspects of regulatory and administrative measures affecting trade in services, form the kind of general obligations that apply almost without qualification to all financial services activities, including securities services. China has also given a variety of specific commitments with regard to securities services. Those commitments, although fully binding and embodying the principle of market access and national treatment, apply to a Member only to the extent that the country has made an affirmative commitment in their Schedule to be bound (the so-called “positive list”).²⁰⁸ Specifically, China allows foreign securities institutions to engage directly (without Chinese intermediaries) in B Shares business. They may also become Special Members of all Chinese stock exchanges. Foreigners are permitted to establish joint ventures with foreign investment up to 33 percent within three years after China’s accession and 49 percent thereafter. From 2005, they can also establish joint ventures in China in the underwriting of A shares and in underwriting and trading of B shares and H shares as well as government and corporate bonds.²⁰⁹

Part II of the article can demonstrate that, according to “the law on paper”, China has enacted laws fully consistent with its WTO obligations.²¹⁰ There is little doubt that the

²⁰⁸ See GATS, art. 16, 17 and 18.

²⁰⁹ See WTO, Report of the Working Party on the Accession of China, Addendum, Schedule CLII – The People’s Republic of China, Part II – Schedule of Specific Commitments on Services on Service (and) List of Article II MFN Exemptions, 1 October 2001, WT/ACC/CHN/49/Add.2 (hereinafter China’s Service Commitments).

²¹⁰ It shall be noted that China’s commitments do not contain obligations relating to opening up China’s domestic capital markets to foreigners. They merely apply to measures allowing service market access and

“law in reality” will be significantly different as China’s policies are also exposed to interest groups politics, in which the lobbying power of international financial capitalists who have enormous stake in China’s honoring of its commitments plays a substantial role. The crucial question is that WTO has pose challenges to China’s traditional thinking on socialist ideology of property ownership, country governance, relationship between the government and private citizens, as well as economic integration and globalization. In essence, WTO accession and compliance provides the momentum for constructing the rule of law and civil society in China as well as reducing state ownership to the minimum (through privatization) insofar as social stability and controlling capacity of the ruling party are threatened. The following sections will discuss the impact of WTO on China in these areas.

B. Rethinking the Role of Foreign Investors and Pace of Financial

Liberalization

Policy makers and regulators in China are often obsessed with sovereign concern on the control of the national economy. While they long for foreign investment and have successfully made the country among the largest recipients of foreign capital in the past decade,²¹¹ they have also taken tremendous precautionary measures preventing foreign control in Chinese companies, except in a limited, selected body of enterprises.

Fortunately, this mentality, faced with challenges posed by both poor performance of a

MFN and NT treatment, when obligated, to foreign service suppliers. For example, permitting foreign enterprises to takeover Chinese SOEs is not included in China GATS obligations.

²¹¹ In 1993 China became the second largest recipient of foreign direct investment (FDI) after the United States. In 2002, largely thanks to the “9.11” event which frustrated the confidence of international investors on the U.S., China replaced the U.S. as the largest destination of FDI.

substantial number of domestic SOEs and economic globalization has been changing particularly in recent years. Yet it might still be a very subtle issue in the sense that domestic sovereign and financial stability are legitimate concerns among the many nations of the world, and this is especially true in the context that it is often alleged that short-term-profit-oriented international investors contributed to the 1997-98 Asian Financial Crisis.

Embracing foreign investors, however, is a global trend. The OECD, in comparing the situation with China, notes that “All OECD countries have accepted the principle that foreign investors should be allowed to invest without limit in their domestic equity markets, although some countries make exceptions for certain ‘strategic’ industries.”²¹² Foreign investors, especially foreign institutional investors, can not only enlarge the investor base, but also contribute to the financial innovation in the domestic market. They help the formation of good corporate governance culture by introducing “international expectations concerning disclosure governance and profitability into markets and so encourage listed companies to adhere to global standards.”²¹³

One may argue that, literally, “international expectations” or global best practice, as mentioned above, might not be necessarily desirable. However, in this particular context, there are at least two counter-arguments to refute this. First, global capital flow, necessary for the development of any economy, is very sensitive as regards international standards

²¹² See OECD, *supra* note 9, at 526.

²¹³ *Id.*

and more likely to float to the place where global best practice is adopted.²¹⁴ Secondly, the content of global best practice per se is sufficient to instill confidence in the mind of international investors – namely, it dictates that “shareholder value is becoming an accepted standard by which corporate performance is assessed throughout the world.”²¹⁵ The World Bank describes the overall benefits of foreign participation in developing countries’ stock market as the following:

*Opening stock markets to foreign participation increases liquidity by deepening the pool of buyers and sellers. Price earning ratios rise as liquidity increases, making the market a far more attractive source of equity financing. As the stock market develops and strengthens, it benefits other parts of the financial sector as well as the widereconomy – foreign direct investment accompanies stock market purchases, for instance. Stock market development and banking development have a strong positive relationship, as do stock market liquidity and economic growth.*²¹⁶

There is still a crucial question of making a subtle balance because of the risks associated with global capital flow. Financial crises in recent years suggest that foreign portfolio investors can play a key role in contagion of crises by quick shifts in capital flows, making the host economies more susceptible to volatility and sometimes causing their collapses.²¹⁷ The 1997 Asian Financial Crisis was a vivid example. Ironically, China

²¹⁴ See Jeong Yeon Lee, *The Role of Foreign Investors in Dept Market Development: Conceptual Frameworks and Policy Issues*, World Bank Policy Research Working Paper, No. 2428 (August 2000), available at <http://www.worldbank.org>. See also, WDR 2000, *supra* note 5, at 84.

²¹⁵ See OECD, *supra* note 9, at 526.

²¹⁶ See WDR 2000, *supra* note 5, at 84.

²¹⁷ See Lee, *supra* note 214.

escaped the crisis largely thanks to the fact that its financial system was less liberalized than most of its Asian neighbors. As noted by Nicholas R. Lardy of the Institute for International Economics, “China’s experience in the Asian financial crisis supports the view that premature capital account liberalization increases a country’s vulnerability to a currency crisis.”²¹⁸

There is little doubt that China will promote the orderly flow of foreign investment in its securities markets. It is, however, important to stress that improvement and reform does not necessarily mean unfettered liberalization. A financial crisis caused by over-speculative capital markets is more detrimental and even dangerous to both the Chinese and world economy. China’s problem is that its financial regulators (when regulating the capital markets) and its trade negotiators (when giving concessions for trade in services) could not easily locate the right point of balance between liberalization and restrictive regulation. Probably for that reason, they are extremely conservative in certain aspects, such as allowing foreign investors to invest in China’s equity market, while tending to adopt bold liberalization measures in other aspects, such as a sudden acceptance of foreign takeover of SOEs without first solving a variety of problems (such as the proper valuation and pricing of state assets) which are prerequisite to the reform of SOEs. China’s external commitments in services were also not a result of deliberation of the country’s “national condition”, a phrase Chinese officials often assert when faced with challenges with regard to policy legitimacy, but rather part of a liberalization package which has incorporated

²¹⁸ See Nicholas R. Lardy, *The Case of China*, January 2003, paper for the Conference on Comparative Study of Financial Liberalization in Asia, East-West Center (September 22-23, 1999), available at <http://www.brookings.edu>.

many social, political, and self-interest oriented factors. As observed by Lardy, “In its WTO negotiations, China’s Moftec negotiators made commitments in services without sufficiently consulting with the relevant domestic regulators.”²¹⁹

China should continue to encourage foreign portfolio equity investment without undermining efforts in attracting foreign direct investment. The distinction between A and B shares, which generates pricing distortions, should be abandoned. However, there is no need for China to rush to capital account liberalization until a general environment that will have appeal to foreign investors is established. As a World Bank research correctly noted, “in sequencing capital account liberalization, the greatest danger is removal of most restrictions on capital account transactions before major problems in the domestic financial system are addressed. Countries in which these problems are severe, but that choose to suddenly and fully open the capital account, run the risk of incurring a crisis.”²²⁰

It is fair to say that China has acted very prudentially and appropriately in many regulatory aspects. For instance, it enhances the stability and controllability of the domestic stock market by requiring QFIIs not to repatriate their principal within a period (according to Chinese law it is three years) and foreign companies not to transfer their shares within one year after their takeover of a Chinese company.²²¹ However, China can safely advance further liberalization on two fronts.

First, foreign institutional investors should be given more flexibility and larger freedom for portfolio investment. While the QFII regime is a good start, the access

²¹⁹ See Nicholas R. Lardy, *Problems on the Road to Liberalization*, in *Financial Times*, March 15, 2002.

²²⁰ See Lee, *supra* note 214.

²²¹ See *supra* note 103 and the accompanying text.

requirements are just too high and excessively cautious. For instance, the business experience requirement (up to 30 years) and paid-up capital (US\$1 billion) and managed assets (up to US\$10 billion) requirement are higher than that initially taken by Taiwan, the pioneer of the QFII system.²²² Tremendous amount of middle and small institutional investment firms, while equipped with excellent management experience, know-how, and dedicated enthusiasm in emerging markets, are excluded from China's stock market. In addition, the requirement that each QFII is only allowed to invest up to US\$800 million will make the aggregate investment of institutional investors a tiny part of the total capitalization of China's stock market.

Secondly, greater market access should be given to foreign financial service suppliers, including securities firms, investment banks, and fund management companies. While the number of China's own securities firms (Chinese banks are prohibited to participate in securities business due to a Glass-Steagall style restriction) has exceeded a hundred, which, in theory, could form a basis for fair competition, no best practice has been established due to massive fraudulent activities as well as the cheating culture. Gao Xiqing, when he was the Executive Vice President of the CSRC, once indicated that every Chinese stock was manipulated by Chinese institutions, indicating that almost all securities firms and other institutions played a negative role in standardizing the market order.²²³ In another occasion, Gao said again that if he could exercise his free will, he would hire no Chinese fund management companies to manage China's social securities funds and the

²²² *See id.*

²²³ *See, Gao Xiqing renwei, gushi muqian wugu buzhuang* [Gao Xiqing takes the view that "no stock is not manipulated by institutions"], Sohu Business, May 24, 2001, at <http://business.sohu.com/44/52/article13745244.shtml>.

only reason preventing him from doing so was that the existing state laws did not allow this.²²⁴ His views on Chinese intermediaries were affirmed by CHEN Siwei, another senior Chinese official who said recently that violation of laws by securities firms was one of the major problems in the implementation of China's Securities Law.²²⁵ One of the many pieces of evidence was that in the Macat cases discussed previously, almost all the intermediaries conducted serious frauds by helping to falsify documents.²²⁶ Given that most Chinese intermediaries are not so reliable, there is a solid reason to introduce into the landscape foreign competitors who implement international best practice in supplying securities services.

C. Redefining the Role of Government and Regulations, and Introducing Rule of Law and Institutions Building

In the days of the plan economy, Chinese government agencies used to control every aspect of the society, including the development of economy. This tradition, together with the mentality underlying it, has persisted into contemporary days which could be characterized as a transition period towards a market economy. As the country advances from plan to market, the role of the government shall also be transformed from

²²⁴ See Ming Hao, *Shebao jijin luzhan lubai* [Social security funds repeatedly make loss], in 21 Shiji Jingji Baodao [21st Century Economic Report] (Aug. 20, 2003), available at <http://www.nanfangdaily.com.cn/jj/20030821/cj/200308200606.asp>.

²²⁵ See, *Cheng Siwei: Zhengquan fa shishi zhong cunzai de wenti burong hushi* [Cheng Siwei says that the major problems in the implementation of the Securities Law should not be ignored], Renmin Ribao [People's Daily](Nov. 19, 2003), available at <http://www.people.com.cn>.

²²⁶ See *supra* note 178 and the accompanying text.

the “instrument of the ruling class”, as the Communist ideology suggests, to a functional institution that provides good governance. According to the World Bank,

*Good governance includes the creation, protection, and enforcement of property rights, without which the scope of market transactions is limited. It includes the provision of a regulatory regime that works with the market to promote competition. And it includes the provision of sound macroeconomic policies that create a stable environment for market activity. Good governance also means the absence of corruption, which can subvert the goal of policy and undermine the legitimacy of the public institutions that support market.*²²⁷

In China’s transition to a market economy, the government’s chief task is to provide institutions supporting the market through regulatory reforms. Regulatory powers are centered on the system of law.²²⁸ “The foundation of a rule of law is built from respect by both government and citizens for the legitimacy of regulation, from high-quality regulations, from openness and clarity in the regulatory system, and from processes by which regulators can be held accountable for the contents of rules.”²²⁹ As a general matter, the government has the mission to provide a functional and enforceable legal and regulatory framework which meet the following objectives as regards financial and capital markets:²³⁰

²²⁷ See WDR 2002, *supra* note 2, at 99.

²²⁸ See OECD, *supra* note 9, at 368.

²²⁹ See *id.*

²³⁰ For reference to the regulatory and legal model of mature markets, see *e.g.*, Financial Services and Markets Act 2000 of the United Kingdom, chapter c. 8. The following points were excerpted from the author’s assignment paper in Professor Philip R. Wood’s class “Global Comparative Financial Law” when he

- (1) To establish viable, predictable, and flexible commercial rules for the financial market and financial transactions. In any event, private financial transactions should be the focus of financial law, simply because they constitute the foundation of financial markets. Without prosperous and growing commercial transactions, all public/regulatory regimes would lose their sense and justification for existence. The commercial rules include those on contract, agency, tort, property, and many others.
- (2) To protect investors and finance consumers (banking clients, securities investors, insurance policy holders) against the failure (insolvency/bankruptcy) of the service providers, against bad selling or advisory practices, often caused by conflicts of interests, and against risky products. The underlying philosophy is that those investors are just like normal consumers, who are part of the public and should therefore be protected. In addition, the damage caused to them because of failure or bad practice of service providers is usually more severe than normal consumer loss in any other commercial/consumer transactions.
- (3) To prevent or minimize contagion or systemic risk of the financial market. It has become a common phenomenon that, because of the enhanced linkages across national and international financial markets, the volatility of capital flows and the potential for concentrated disturbance are more easily and broadly transmitted across institutional groups or markets, thus triggering inter-market contagion and causing systemic collapse. In the end, that will lead to financial and economic

was studying at Oxford in 2002-03. The author acknowledges tremendous thanks to Prof. Wood for the enlightening discussions with him on the topic of “goals of financial law.”

crises, like those that happened in Mexico and East Asia. Frankly, systemic risk has provided a major incentive for financial regulation.

- (4) To safeguard the proper functions of markets and maintain investors' confidence, including the smooth operation of markets, price transparency and proper information supply, mainly being the prevention of market abuses or manipulation and insider dealing. A related point is the provision of adequate clearing and settlement and custody facilities.
- (5) To regulate financial intermediaries (service providers) as regards their conduct of business, integration, and sound reputation. This is essential for financial laws to work as those intermediaries are presently the pillars of markets. A related point is to create a fair competition environment for those institutions by creating a level playing field for them and preventing monopolies amongst those intermediaries in the financial services.

As repeatedly stressed in this article, China's regulatory dilemma is that, on the one hand, regulations are overreaching, overly-complex, multi-layered, often arbitrary and very interventionist, which lead to excessively high transaction costs; but on the other hand, many sectors of the market also suffer from substantial under-regulation, poor enforcement, and under-institutionalization, which lead to insufficient confidence in markets by consumers and investors. In addition, the regulators, in particular the CSRC, undertake dual tasks, one of which is developing the market. Especially in these days when the stock market has been undergoing the longest bear period, CSRC is under enormous pressure to "save the life of the market" (*jiushi*) by powerful interest groups including the many Chinese securities firms. It, however, should realize that, using a Chinese idiom, "*yin zhen*

zhi ke” (drinking position to quench thirst) provides no solution to the problem. For the regulators, there is no alternative to the safeguard of a general environment which ensures the reasonably accurate disclosure of information and a good corporate governance structure. Regulatory “forbearance” might be inevitable in many cases due to the limitation of regulatory capacity; however, the regulators should by no means become accomplice of market manipulators, insiders, and other law-breakers.

Chinese regulators should also bear in mind that they are not omnipotent. Regulations should place increasing responsibility on market participants, emphasizing internal compliance, in-house risk management and governance systems and industry standards. It is within the broader framework of institutions building to have private firms, industry associations and self-regulatory organizations (SROs) to undertake greater responsibility for the elaboration of standards. In order to accomplish this, the key is to establish clear rules with strong incentives for market participants to positively play their roles.

A viable stock market, to establish institutions which serve as checks and balances against abuse of public powers and instill confidence in international and domestic investors, should have an effective judiciary to ensure the proper application of the rule of law, rights of administrative procedure, and efficient dispute resolution regimes. In China, the judiciary is rather weak and self-constrained in providing protection to investors. Within and without China, the consensus is that China needs a strong judicial system to safeguard the stock market and provide adequate dispute settlement mechanisms. The gap of between different opinions lies in different views regarding Chinese judiciary’s capacity as well as socialist ideology (especially when the concept of “preventing the loss of state

assets” is concerned). While the first concern could be solved as the experience and resources of the judiciary expands, the second can possibly remain in place for a rather long period until full-pledged protection for private property is established. In addition, judicial reform, by nature, should be best focused on the creating of politically independent, difficult-to-intimate judges, and this can only be accomplished within the context of social responsibility. Given the nature of China’s transitional political structure, it has a long way to go before true judicial independence is established. Nevertheless, it is still possible to establish a judiciary which is keen on providing equal protection to both state and private property, as social ideology is indeed diminishing due to recent reform movements initiated by the Chinese Communist Party with regard to SOEs and state-owned assets.

D. SOE Reform, Privatization, and Good Corporate Governance

It is repeatedly emphasized that a well-functioning stock market depends on two factors: a reasonably accurate information disclosure system and good corporate governance structure. Corporate governance is centered on the idea that companies are governed with the aim of providing investors with a reasonable financial return and operators of the companies, acting within institutional constraints, manage them with integrity and responsibility.

Since corporate governance became a high profile issue at the end of the 1990s, China has made important strides attacking the problems during the last few years. As mentioned earlier, the root of poor corporate governance lies in the intrinsic flaws of the SOEs management system, stemming from their complex, multi-layer ownership and control structures, dominating corporate management and shunning protection to minority shareholders, conflicting objectives, as well as from the ambiguous identity of the state as

an owner (shareholder) and regulator. To enhance corporate governance, there is no alternative to the reform of SOEs.

For a long period in the reform era, the officially proclaimed guideline of China's SOEs reform was "separating State ownership from corporate management", with the intention to preserve state dominance and government control in the national economy.²³¹ According to the blueprint on SOEs reform issued by the ruling party, the SOE managers should not be ideologically and politically qualified, be law-abiding, and have a deep sense of responsibility. In addition, they should be familiar with the business they engage in and armed with modern knowledge of business management and even finance, science and technology, and laws.²³² Indeed, the party was seeking angels falling to Earth (specifically China) from Heaven. However, in many cases the quality of the persons they appointed fell far short, as evidenced by the numerous cases concerning management corruption and embezzlement of corporate property (thus causing the loss of asset in listed companies). Agency problems lead to heavy loss of the wealth of both the state and domestic and foreign investors.²³³ With the retreat of the State from management of enterprises, the

²³¹ See Jiang Ze Min, *Hold High the Great Banner of Deng Xiaoping Theory for an All-Round Advancement of the Cause of Building Socialism with Chinese Characteristics into the 21 Century – Report Delivered at the National Congress of the Communist Party of China* on September 12, 1997.

²³² The CPC Central Committee's Decision on Major Issues Concerning the Reform and Development of State owned Enterprises (Adopted at the 4th Plenum of the 15th CPC Central Committee on September 22, 1999).

²³³ See e.g, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, *Journal of Financial Economics*, Vol. 3, No.4, 305-360 (1976); Frank Eastbrook, *Two Agency Cost Explanations of Dividends*, *American Economic Review*, Vol. 74, 650-659

State supervision of the management withdraws as well. Some managers have treated State assets like their own private property. Corruption thus rampantly emerged and received incentives from the absence of an effective ultimate owner. Obviously, the major problems are caused by the ambiguity of the state-enterprise property relationship. Clear ownership rights are fundamental to the market economy. It can provide important incentives to use assets productively. As Demsetz so stated, “property rights derive their significance from the fact that they help a man form those expectations which he can reasonably hold in dealing with others. Without those expectations, people are unable to predict whether they will have a given set of assets at their disposal and are thus less likely to make the most efficient use of those assets. At a minimum, then, a system must parcel out some (or most) of the constituent rights of ownership into a bundle of rights which are clearly defined and legally protected.”²³⁴ However, clear ownership by itself is not sufficient for establishing good corporate governance. Insofar as ownership is concerned, an enterprise has what are known as “residual risk holders”. In order for these risk holders to be willing to accept risk, they must (1) be compensated for holding that risk by being the owner (and therefore having control over the enterprise's operations and profit and loss distribution) or (2) be able to escape the risk by selling the right to hold it. The existence

(1984); and Eugene F. Fama, *Agency Problems and the Theory of the Firm*, *The Journal of Political Economy*, Vol. 88, NO. 2, 288-307 (1980).

²³⁴ Deborah Kay Johns, *The State-Enterprise Property Relationship In The People's Republic Of China: The Corporatization Of State-Owned Enterprises*, 16 *Mich. J. Int'l L.* 911, 923. (quoting Harold Demsetz, *Toward a Theory of Property Rights*, 57 *Am. Econ. Rev.* 347, 348 (1967)).

of either of these two conditions could lead to that the owners of the enterprise behave efficiently.²³⁵

Under the ownership structure of SOEs, the State legally owns all the assets of SOEs, and SOE managers are entrusted by the State to operate the enterprise. This formula, however, rarely has the chance to achieve success. First, the managers have no or little incentive to behave efficiently and to make profits for the enterprise because, at least literally under China's current employment system, a manager's compensation has little to do with his/her performance in managing the company. Second, the managers have no or little responsibility for the failure or loss of profit of the company because the current system does not pursue a manager's personal liability in case of failure of a company. In fact, it is neither feasible nor fair to place such a heavy liability on managers given the low pay they receive as opposed to the normal income of private owners of enterprises. The managers must be subject to effective external supervisions. In a free economy, the shareholders are responsible for selecting managers of a company and those managers are accountable to them. This formula, however, does not currently work in China, partly because the State is not well equipped with the necessary capability to supervise the management of every company, and partly because minority shareholders otherwise than the State are somehow consciously excluded from supervising management.

The key to solving this dilemma is to gradually privatize the SOEs and relinquish government control over them. In a society based on private ownership, misappropriation of corporate assets seldom happens, and the corporate managers have both the financial and personal incentives to behave efficiently. The Chinese government and the ruling

²³⁵ *Id.* at 924.

party CCP have realized that the privatization approach might be their last but nevertheless the best resort to solve the SOE problems. On the 4th Plenum of the 15th CPC Central Committee on September 22, 1999, the CPC issued the *Decisions on Major Issues Concerning the Reform and Development of State-Owned Enterprise*, which, though does not contain the word “privatization”, implied the Party’s strong interest in this regard. According to the 1999 *Decisions*, the State will control only those industries relating to national security, public utility and natural monopolies, while withdrawing from other commercial industries. It also calls for the development of non-public ownership that refers to the de facto private sector. More revolutionary was that it allows the transfer of small and medium-sized SOEs (SMEs) to private citizens through merger, leasing, or sales. Finally, it mandates that failed SOEs must be diminished through bankruptcy and closure. A much bolder move (called as “radical break” by the Washington Post²³⁶) has been taken in October 2003. In the “third plenum” meeting of the Communist Party’s Central Committee, the ruling party passed a resolution with the most explicit language ever regarding opening greater door to private business²³⁷. Significant to the reform of SOEs and the development of capital markets are two decisions that are likely to fundamentally change the landscape of China’s corporate ownership structure. First, the socialist ideology on ownership should be virtually diminished. In addition to the call to give private business equal treatment and legal protection, it redefines “socialist public ownership” as “shareholders’ ownership” (*Gufenzhi*), saying this is the primary form of

²³⁶ See John Pomfret, *Chinese Leaders Endorse Property Rights*, Washington Post, Oct. 15, 2003, at A17.

²³⁷ See Several Decisions of the CCP Central Committee on the Perfection of Socialist Market Economy, adopted by the CCP Central Committee in its third plenum meetings (Oct. 14, 2003), available at <http://www.people.com.cn> (hereinafter CCP Decisions 2003).

public ownership. It also calls for a “mixed ownership” (*hunhe suoyouzhi*) which is characterized as owned by “diversified owners” (*duoyuanhuo touzi zhuti*) who can trade their ownership in a property market according to the “modern property system” (*xiandai chanquan zhidu*) proposed by the *Decisions*.²³⁸ Affirming the previously established principle that state ownership shall exist only in areas that “are vital to national security and economic lifelines, the *Decisions* explicitly permit private capital to invest in the areas of infrastructure, utilities, and other industries so long as no law prohibits its entry.²³⁹ The implication is that not only state-owned SMEs can be privatized, big SOEs, especially those under the direct control of the central government, could also be sold to the private sector through “corporatization”.²⁴⁰ The second significant aspect is that it clarifies the different roles of the state as shareholder and regulator. The recently established State-owned Asset Supervision and Administration Commission (SASAC) is authorized to perform the function of the state owner, representing the state as shareholder in a company. Furthermore, the *Decisions* provide that the law should safeguard “the equal legal status and development rights” of all market participants, including the state owner.²⁴¹ Conceivably, government agencies with regulatory powers like the CSRC should act only as regulators, treating public and private owners equally.

²³⁸ *See id.*

²³⁹ *See id.*

²⁴⁰ *See* TAN Xinpeng, *Guoxi gaige: zou qiye duoyuanhua daolu – fang GuowuyuanFfazhan YanjiuZhongxin fu suozhang ZHANG Wenkui* [Reforming SOEs: the road is diversification of shareholdings – interview with Mr. ZHANG Wenkui, the Deputy Director of the Center for Development and Research of the State Council],

²⁴¹ *See* the CCP Decisions 2003, *supra* note 243.

As stressed by Wu Jinglian, effective corporate governance for China's listed companies could be established only after the predominance of state ownership is eliminated.²⁴² The *CCP Decisions 2003* certainly attempts to solve the problem. The prospect is bright in the sense that the major obstacle in the past was the socialist ideology that mandated state ownership as a "forbidden area", untouchable to the private sectors. To confirm this, the Minister of the SASAC stated recently that "very, very few enterprises" would remain wholly state-owned and predicted the country would enter a "peak period of mergers and acquisitions" because his agency and local governments have been granted the authority to dispose of SOEs.²⁴³ Apparently, orthodox socialism is going to leave China very soon as the wave of mass privatization has been heralded.

CONCLUDING REMARKS

International investors play a key role in major world capital markets. China, never hiding its ambition to make its stock market one of the most successful on the globe, has recognized this in recent years. To turn recognition into results, China has taken a variety of measures, featured with fancy terms such as B shares, QFII, and M&A, to attract international portfolio investment. It had advanced very cautiously until very recently in 2003, when it opened the door of the stock market boldly and widely to foreigners as well

²⁴² See, Wu Jinglian: "yigu dada" rengshi gongsi zhili de zhuyao wenti [Wu Jinglian says that "predominance of single state shareholder" is still the major problem in corporate governance], China News Agency (May 12, 2002), available at <http://www.Chinanews.com.cn>.

²⁴³ See, Guowuyuan xinwen ban zhaokai "Binggou Chongzu Guoji Gaofeng Luntan" Jizhe Zhaodaihui: Li Rong, Huang Shuhe da jizhe wen [Press conference of the State Council News Office on "International Merger & Acquisition Summit Beijing 2003": Interviews of Li Rongrong and Huang Shuhe by reporters](Nov. 11, 2003), available at <http://www.sasac.gov.cn> and <http://www.China.com.cn>.

as to domestic citizens. The objective is clear: China is seen as striving to swallow more global capital to excite its domestic market and to finance and privatize its ailing SOEs.

To achieve this objective, the key is to enhance the regulatory framework which, based on rule of law, can provide institutions supporting the market. During the past two decades, Chinese authorities have been promoting a more effective legal and regulatory framework for the market and the nation's corporate sector. It is fair to acknowledge that important legal reforms have led to clearer rules for the transactional and contractual relationship, greater enterprise autonomy, and better corporate structures according to company laws. However, certain structural flaws remain. Due to the absence of liberal ownership ideology and effective institutions, China's stock market is suffering from over-reaching regulations, under-enforcement of laws, swaying regulatory culture, massive market manipulation and insider trading, as well as poor corporate governance and little minority investor protection. The root to all the major problems is the SOEs.

Predominance of the state shareholder in listed companies and less clear identity of the state as shareholder and regulator are the source of the flaws of the market. With those flaws, it is difficult for the market to attract international and even domestic investors.

To attack the root of the problems, China should strengthen the reform of its government, differentiating its two roles as assets owner and regulator and establishing a "Chinese Wall" between both roles. Reforming the regulatory framework should make a balance between liberalization and stable development by rethinking the role of foreign investors, drawing on the experience of developed markets as well as of previous financial crisis. It shall also take effective steps to improve corporate governance of listed companies. The key to achieve this, however, is reducing the size and influence of SOEs

in the national economy, namely, privatization. Only through privatization can it produce a sufficient number of efficient and productive market participants. Short of those qualified participants, China could succeed in developing a viable stock market simply by copying the system of laws and models which are alleged to be consistent with “international standard and practice.” In short, the country needs to depoliticize its stock market by accelerating privatization (through putting state assets for sale) and enhancing protection of private ownership. Moreover, since stock markets cannot stand alone, reform should also create a viable general environment that will have appeal to foreign and domestic investors. According to the World Bank, “this will require a wide range of supporting reforms to better protect creditors and investors and tighten up disclosure requirements, in addition to stable macroeconomic policies to raise saving and help develop the institutional investors need for good corporate governance.”²⁴⁴

²⁴⁴ See World Bank, World Development Report 1996: From Plan to Market, Executive Summary, p. 12, available at <http://www.worldbank.org>.