

# **FUMBLING IN THE DARK: THE CASE FOR A PARADIGM SHIFT IN ANALYZING CHINA'S CAPITAL MARKET REGULATION**

**By David Finn<sup>1</sup>**

**Summer 2006**

---

<sup>1</sup> THOMAS KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS (3<sup>rd</sup> ed., 1996) )“Almost always the people who achieve these fundamental inventions of a new paradigm have been either very young or very new to the field whose paradigm they change. And perhaps that point need not have been made explicit, for obviously these are the people who, being little committed by prior practice to the traditional rules of normal science, are particularly likely to see that those rules no longer define a playable game and to conceive another set that can replace them.”).

## TABLE OF CONTENTS

### INTRODUCTION

#### PART I: CURRENT PARADIGM AND MOTIVATIONS

- A: Current Paradigm
- B: The Motivation for Legal Reforms
  - i. The Need for Money
  - ii. Maintaining Power Through Markets

#### PART II: DEVELOPMENT, REFORM, AND ACTIONS OF CHINA'S MARKET ECONOMY

- A: China's Market Hybrid
- B: Development of China's Capital Market
  - i. The CSRC
- C: State Assets in Chinese Capital Markets
  - i. State Owned Enterprises
  - ii. SASAC
- D: Recent Securities Market Reforms
  - i. Classification of Stocks
  - ii. Split Share Reform
- E: China's Power in the International Market and Use Thereof
  - i. China Deals with Iran
  - ii. China Deals with Sudan
  - iii. China Attempts to Deal with the US: Unocal

#### PART III: LAWS AFFECTING INVESTMENT IN CHINA'S DOMESTIC MARKETS

- A: Structure of Government Under Constitution
- B: Chinese Courts
- C: Insider Trading and Market Manipulation
- D: Fiduciary Duties
  - i. The Code of Corporate Governance
- E: Private Securities Litigation
  - i. PSL and Insider Information
  - ii. PSL and the Government Enabling Requirement
- F: Laws Governing SOE's in the Market
  - i. Legal Basis for State Ownership
  - ii. Laws Affecting State Owned Assets
  - iii. SASAC as Investor
  - iv. SASAC as More Than Investor
- G: WTO Rules on Subsidies

PART IV: Towards a New Paradigm and Its Implications

A: Application of Facts and Law

i. China's Domestic Securities Markets

a. Classification of Stocks

b. Split Share Reform

c. CSRC

d. SASAC

e. Courts

f. The Torts

1. Duty of Care

2. Insider Information

ii. WTO

B: New Paradigm

C: Suggestions Based on New Paradigm

CONCLUSION

## INTRODUCTION

All the counties of the world are sitting in a dark room. They don't much about each other but they still regularly interact, such as when they trade goods and fight. The wealthy nations are familiar with each other and frequently trade with each other. Recently, someone in the room, who they are un-familiar with, has begun trading with the others much more frequently and is getting to be as wealthy as the other wealthy nations. They notice this nation trades with the others in a more restrictive fashion. The wealthier nations are becoming a little concerned because the new guy is taking away some of their trading advantages. In addition it is trading with people that the wealthier nations don't like and would prefer not be traded with. They observe the new guy growing more and more successful. The wealthy nations naturally would really like to know what this new guy has planned. Doesn't he care about not trading with the bad guys? Why is he so restrictive with his trading? How is he getting so successful?

If ever the lights were to come on, the wealthy nations would recognize the new guy as China. However, their questions and concerns about China would remain as in the darkness, for China is an enigma. It is an enigma that is becoming increasingly important in the modern 'flat world'.<sup>2</sup>

China is following a unique path to development. Inspired by the communist/socialist philosophies of Karl Marx and Lenin, China along with the USSR, emerged though revolution in the middle of the 20<sup>th</sup> Century. China watched as its former comrade, the USSR, instituted democracy and free capitalism and thereafter immediately

---

<sup>2</sup> The term 'flat world' is a reference to, THOMAS FRIEDMAN, THE WORLD IS FLAT (2006). In which the author discusses the increasing competitiveness of modern businesses due to the effects of globalization and technology.

collapsed economically. China thus learned a valuable lesson and has instituted its economic reforms through much more gradual and controlled measures.

The purpose of this paper is to shed light on the very nature of some of these reforms. In particular it focuses on Chinese domestic capital markets<sup>3</sup>, how the government and State Owned Enterprises (SOE's)<sup>4</sup> interact within the market, and how this affects fairness and equality within the market.

In contrast to many other scholarly works on this subject, this paper starts with the premise that the Chinese government knows exactly what it is doing in its economic development. The paper puts forth the proposition that the reason the Chinese government is not regulating its capital markets like Western legal scholars would like is because it realizes the danger those reforms would have on the legitimacy and control of the government. Therefore, the legal "inadequacies" in China's capital market reform that this paper examines are not really inadequate at all from China's point of view.

In Part I the current paradigm for analyzing China's capital market reform is critically evaluated and China's overall motivations in capital market reform are discussed. Part II is about the development and nature of Chinese capital markets. This part also looks at state ownership, new regulatory bodies and reforms, and recent international trade issues potentially affecting China's capital markets.

Part III goes into detail concerning a number of specific legal issues in China affecting their capital markets. In particular laws affecting fiduciary duties, insider

---

<sup>3</sup> Capital markets are intended to mean the domestic stock exchanges on mainland China, excluding Hong Kong and Taiwan due to their unique historical and legal developments.

<sup>4</sup> SOE's can refer to a wide variety of business organizations in mainland China, *See generally* Cindy Schipani and Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 Colum. Bus. L. Rev. 1, 16-24 (2002) (these include closely held corporations, wholly state-owned corporations, foreign-invested corporations, Chinese-foreign Equity Joint Ventures, Chinese-Foreign Contractual Joint Ventures, etc). For the purposes of this article the terms SOE is meant to refer generically to enterprises in China in which the Chinese government owns a substantial amount portion.

trading, private securities litigation, and the WTO are analyzed. Part III begins with an overview of the structure of the government in China in order to put the legal system and accountability of its regulatory bodies in context.

Part IV critically looks at the deficiencies in laws governing Chinese capital markets and how these deficiencies might actually benefit the government. This leads to the development of a new paradigm for analyzing Chinese capital market reforms. Finally a few meager suggestions are offering in the context of this new paradigm to demonstrate how using the new paradigm could effect critical legal evaluation of China's capital markets.

## **PART I: Current Paradigm and Motivations**

Part I examines the current paradigm with which Western scholars examine Chinese legal reforms. Generally the current paradigm is ineffective for several reasons which the following section will briefly discuss. In light of the ineffectiveness of the current paradigm some basic motivating factors behind China's reform measures are looked into.

### **Part IA: Current Paradigm**

In order to better understand Chinese economic development it may be useful to reexamine the largely dominant paradigm of many western scholars who examine the Chinese economy.<sup>5</sup> The dominant paradigm of legal scholars refers to their shared

---

<sup>5</sup> In general, a dominant paradigm refers to the basic accepted beliefs or model held by those examining a certain condition or event. *See generally* THOMAS KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS (3<sup>rd</sup> ed. 1996).

understanding of basic theories and concepts, the common language which they use, and their common methodology”.<sup>6</sup> In other words they share a common ‘legal culture’.<sup>7</sup>

Western legal scholars who examine the Chinese economy tend to hold a certain dominant paradigm which Donald Clarke calls the Ideal Western Legal Order (IWLO).<sup>8</sup> They then use a reductive methodology by applying suggestions replicating the IWLO which will result in China having a satisfactory legal reform.<sup>9</sup> This leads to a great deal of analyzing Chinese law comparatively to Western laws, finding Chinese law inadequate<sup>10</sup>, and then simply urging the replication of successful western models, which reflect a subjective view of how the law should be<sup>11</sup>, into the Chinese legal framework.<sup>12</sup>

---

<sup>6</sup> Mark Van Hoecke and Mark Warrington, *Legal Cultures, Legal Paradigms and Legal Doctrine: Towards a New Model for Comparative Law*, 495 *Int'l and Comp. L. Quart'ly*.514 (1998).

<sup>7</sup> *Id.* “Such a common legal culture includes shared understanding on, at least, the following points”, “1) A concept of what the law is and its relationship to other social norms, 2) A theory of valid legal sources. Who has the power to make the law and under what conditions. What is the hierarchy of the legal sources. How problems of collision between legal sources solved, 3) A methodology of law, both for the making and the adjudication of law. What rights do adjudicators have to interpret the law.,4) A theory of argumentation. Which kinds of arguments and of argumentative strategy are acceptable, 5) A theory of legitimating of the law. Why is it binding? What if it conflicts with some other, non-legal, social norms. 6) A common basic ideology: common basic values and a common basic world view. A common view on the role of law in society and on the role of lawyers. A view on which problems are considered to be legal problems, to be solved properly by the legal system, and not just, moral or economic problems, which remain outside the realm of law.”

<sup>8</sup> Walter Hutchens, *Private Securities Litigation in China: Material Disclosure About China's Legal System*, 24 *U. Pa. Int'l Econ. L.* 624 (2003). *Citing* DONALD C. CLARKE, PUZZLING OBSERVATIONS IN CHINESE LAW: WHEN IS A RIDDLE JUST A MISTAKE?, IN UNDERSTANDING CHINA'S LEGAL SYSTEM 93 (C. Stephen Hsu ed., 2003)

<sup>9</sup> See Michael William Dowdle, *Essay Preserving Indigenous Paradigms in an Age of Globalization: Pragmatic Strategies for the Development of Clinical Legal Aid in China*, 24 *Fordham Int'l L.J.* 59 (2000) (“International development projects need to shift their focus from one of simply replicating successful foreign models (what we will call a reductive strategy) to one of promoting discovery of the indigenous developmental implications and possibilities inherent in the domestic environment (what we will call a pragmatic strategy.”).

<sup>10</sup> See *id.* at 68 (noting that reductivist tend to view China's development pessimistically while those that focus on more pragmatic comparison are more optimistic).

<sup>11</sup> See Van Hoecke, *supra* note 5, at 528 (“When describing the law, the doctrinal legal writer is constantly, either implicitly or explicitly, formulating hypotheses as regards the meaning of legal concepts, legal rules, legal principles or legal institutions. These hypotheses are checked on the basis of material which generally are considered to be authoritative and by using the classical interpretation methods. Accepting an interpretation, eventually, is not based on some “objective” certainly but on an inter-subjective consensus with the legal community”).

<sup>12</sup> See generally, Guanghau Yu, *Using Western Law to Improve China's State-Owned Enterprises: of Takeovers and Securities Fraud*, 39 *Val. U.L. Rev.* 339 (2004); Yuwa Wei, *The Development of the*

In general this paradigm is mostly adequate. Western securities laws are after all viewed as relatively successful.<sup>13</sup> In addition its familiarity to Western scholars and long period of development and practice provides a powerful tool for scholars to approach the developing Chinese economic legal regime. Chinese lawmakers have even been openly solicitous of these Western legal reforms.<sup>14</sup> In fact, Chinese laws have incorporated many Western made legal ideas into their developing legal regime.<sup>15</sup>

However it is becoming increasingly clear that simply replicating Western legal ideas into the Chinese legal framework is unworkable.<sup>16</sup> Examples abound where applying Western legal ideas to Chinese law simply does work due to the fundamental differences between Chinese and Western economic philosophies.<sup>17</sup> Continuing to

---

*Securities Market and Regulation in China*, 27 Loy. L.A. Int'l & Comp. L. Rev. 479 (2005); and Nicholas Howson, *Speech: Regulation of Companies with Publicly Listed Share Capital in the People's Republic of China*, 38 Cornell Int'l L.J. 237 (2005).

<sup>13</sup> This is demonstrated by the success of Western capital markets, particularly in the US and London which follow a Western style regulatory framework, suggesting a correlation between their regulatory methods and overall stock market performance. There are of course a few noteworthy exceptions, such as the major financial scandals beginning with Enron, which suggest that even the Western system is not perfect.

<sup>14</sup> See Hutchens, *supra* note 7, at 672 (noting that "When Chinese legal enactments fall short of what outside observers would like, it is rarely because China to observe the outside world. It is more likely that perceived deficiencies in Chinese law arise from political and prudential constraints.").

<sup>15</sup> See Yuma Wei, *Volatility of China's Securities Markets and Corporate Governance*, 29 Suffolk Transnat'l L. Rev. 227 (2006) (noting that for example the CSRC is modeled after the US having a strong national regulatory body to govern securities markets. Professor Wei goes on to note that even if China adopts more US like legislation there is still a problem with enforcement of that legislation that makes it less sure to work).

<sup>16</sup> See Randall Peerenboom, *Law and Development of Constitutional Democracy in China: Problem or Paradigm?*, 19 Colum. J. Asian L. 197 (2005) ("While there are technical aspects to legal reform, the reform process is inherently political, with many discrete decisions to be made, often among second-best alternatives. Few if any reforms are Pareto improvements. Rather, there are winners and losers, both among individual citizens and state organs of power. Yet rather than allowing domestic political systems to weight the costs and benefits, international actors are attempting to influence, if not outright dictate outcomes. Not surprisingly, in Asia and elsewhere, countries at low levels of wealth that have taken on the broader agenda and attempted to democratize and implement a full range of social and economic as well as civil and political rights have often experienced disappointing results.").

This is of course not to say that Western legal ideas are anyway inferior to China's. However it is becoming clear that the unique characteristics of the Chinese culture may make application of Western legal ideas unsuitable. See generally Dowdle, *supra* note 8, at 66.

<sup>17</sup> See Van Hoecke, *supra* note 5, at 506 ("The Asian collectivist approach, seen most prominently in China but also in Japan, was determined principally under the influence of the Confucian theory of the natural order of reality. According to this traditional oriental thought every person has a duty to respect the natural order of things at the risk of disturbing this order. Individual rights are considered to be contrary to that

advocate for inapplicable legal norms to be applied to the Chinese economic law is not beneficial.<sup>18</sup>

The reasons these ideal Western reforms will not work in China are too numerous and complex to address in the scope of this article.<sup>19</sup> However, what is becoming clear is the awareness of an anomaly between the paradigm that scholars use to view Chinese reforms and reality. Better understanding is achieved through an exploration of this anomaly until finally the paradigm has somehow been adjusted so that the anomalous has become the expected.<sup>20</sup>

In the context of Chinese securities regulation this means examining the paradigm that Western securities regulation rules are better than the current Chinese laws and should be adopted, exploring why this paradigm in many cases simply cannot work in China, and then adjusting the paradigm until we can predict which reforms are really workable in China and which aren't.

---

natural order. The individual has no rights but only duties toward others and towards society. When using his individual rights, the individual, wrongly, opposes society. By claiming his rights he is damaging society with his combative attitude. Therefore, conflicts are preferable not brought before the court but solved through reconciliation.”). See also Jiangyu Wang, *Dancing With Wolves: Regulation and Deregulation of Foreign Investment in China's Stock Market*, 5 Asian-Pacific L. & Pol'y J. 37 (2004) (noting former CSRC chairman's attempts to model the CSRC after the SEC were futile due to the uniqueness of the Chinese market); Dowdle, *supra* note 8, at 62 (noting how China civil law system does not recognize case law precedent and that this limits the social impact of litigation thus making the American paradigm much less effective); Benedict Sheehy, *Fundamentally Conflicting Views of the Rule of Law in China and the West & Implications for Commercial Disputes*, 26 NW. J. Int'l L. & Bus. 2258 (2006) (“Each scholar comes to a problem with her or his own mindset, point of view, assumptions, and understanding of the law. Not only is this plethora of views evident within legal traditions, but it greatly and perhaps excessively influences and thwarts comparative work”); Sheehy, *supra* note 16, at 238 (noting how the even the basic principle of law may have significantly different meaning in China than it does in the West.); and at 252 (noting that the concept of reducing the power of the CCP in order to fit better with the rule of law under the WTO is not accepted in China)

<sup>18</sup> See Peerenboom, *supra* note 15, at 231 (“When laws are radically at odds with the deeply held views of the dominant majority, they are rarely implemented. This creates a gap between law on the books and actual practice that undermines respect for the legal system and rule of law, and fuels a resentful nationalism in Asia and other developing countries over the neo-imperialistic imposition of contested values.”).

<sup>19</sup> See Dowdle, *supra* note 8, at 66 (stating that knowledge of local conditions and cultures is crucial to effective legal development, and “identifying which of these structures and dynamic are relevant to, and can be employed in, service of legal development.”).

<sup>20</sup> See KUHN, *supra* note 4, at 53.

The development of a better paradigm will result in benefits that are highly critical at this moment in the international economy.<sup>21</sup> A better paradigm will allow those concerned to better understand what China's legal reforms mean and how they are intended by the Chinese to operate. In effect, there needs to be a paradigm shift between looking at how Western legal scholars think legal reforms should operate in Chinese capital markets to looking at how the Chinese government thinks they should operate.

### **Part IB: The Motivation for Legal Reforms**

In order to accomplish the goal of developing a better paradigm a good place to start is to examine the motivation behind the enactment of various laws and reforms in China. Two fundamental motivators are useful to keep in mind when examining Chinese law; money and power.

#### **i. The Need for Money**

To understand the effect certain laws are intended to have on the capital markets a good starting point is to follow the money. Following the money is useful due to the close relationship between money and governmental power.<sup>22</sup> Access to money is essential to the CCP in order to create and sustain power.<sup>23</sup> Money is also a temptress for corruption

---

<sup>21</sup> See Dowdle, *supra* note 8, at 63 (“inefficient developmental paradigms do become harmful when they begin to prevent the development of more efficient paradigms.”).

<sup>22</sup> See, ALEXANDER HAMILTON, THE FEDERALIST PAPERS NO. 30: CONCERNING THE GENERAL POWERS OF TAXATION, 1787 (“Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion, and enables it to perform its most essential functions. A complete power, therefore, to procure a regular and adequate supply of it, as far as the resources of the community will permit, may be regarded as an indispensable ingredient in every constitution. From a deficiency in this particular, one of two evils must ensue; either the people must be subjected to continual plunder, as a substitute for a more eligible mode of supplying the public wants, or the government must sink into a fatal atrophy, and, in a short course of time, perish.”).

<sup>23</sup> See Minxin Pei, *The Dark Side of China's Rise*, Foreign Policy ( March/April 2006), available at: <http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=18110> (“The strong belief in gradual but inexorable economic liberalization often has a political corollary: that market forces will eventually produce civil liberties and political pluralism. It's a comforting thought. Yet these optimistic

of politicians.<sup>24</sup> Evaluating China's capital market reforms in the context that they may be using these reforms in order to benefit the government financially should be considerable a plausible and important concept.

## ii. Maintaining Power through Markets

The Chinese government's power to control the regulation of markets is one the most powerful tools it has to promote social stability, because it can arrange the markets in its favor to finance its own supremacy over the people.<sup>25</sup> Examining how the Chinese government exercises this self-perpetuating power is essential to understanding how they intend market regulations to work.<sup>26</sup>

---

visions tend to ignore the neo-Leninist regime's desperate need for unfettered access to economic spoils. Few authoritarian regimes can maintain power through coercion alone. Most mix coercion with patronage to secure support from key constituencies, such as the bureaucracy, the military, and business interests.”)

<sup>24</sup> See Pai, *supra* note 22 (“The most corrupt sectors in China, such as power generation, tobacco, banking, financial services, and infrastructure, are all state-controlled monopolies.” “Various indicators, pieced together from official sources, suggest endemic graft within the state. The number of “large-sum cases” (those involving monetary amounts greater than \$6,000) nearly doubled between 1992 and 2002, indicating that more wealth is being looted by corrupt officials. The rot appears to be spreading up the ranks, as more and more senior officials have been ensnared. The number of officials at the county level and above prosecuted by the government rose from 1,386 in 1992 to 2,925 in 2002.”) continuing (“An optimist might believe that these figures reveal stronger enforcement rather than metastasizing corruption, but the evidence suggests otherwise. Dishonest officials today face little risk of serious punishment. On average, 140,000 party officials and members were caught in corruption scandals each year in the 1990s, and 5.6 percent of these were criminally prosecuted. In 2004, 170,850 party officials and members were implicated, but only 4,915 (or 2.9 percent) were subject to criminal prosecution. The culture of official impunity is thriving in China.”)

<sup>25</sup> See Sheehy, *supra* note 16, at 232 (“In societies based on economic power and rights, as opposed to those societies developed on politico-social relations, those with economic power reinforce those economic institutions which expand their control and favor development that advances their power and rights”) continuing (noting that in stable democratic governments that are under no threat of rebellion the government has given over considerable control to economic actors such as corporations which tend to have a stabilizing effect).

<sup>26</sup> See Pai, *supra* note 22 (“Today, Beijing oversees a vast patronage system that secures the loyalty of supporters and allocates privileges to favored groups. The party appoints 81 percent of the chief executives of state-owned enterprises and 56 percent of all senior corporate executives. The corporate reforms implemented since the late 1990s—designed to turn wholly state-owned firms into shareholding companies—haven't made a dent in patronage. In large- and medium-sized state enterprises (ostensibly converted into shareholding companies, some of which are even traded on overseas stock markets), the Communist Party secretaries and the chairmen of the board were the same person about half the time. In 70 percent of the 6,275 large- and medium-sized state enterprises classified as “corporatized” as of 2001, the members of the party committee were members of the board of directors. All told, 5.3 million party officials—about 8 percent of its total membership and 16 percent of its urban members—held executive positions in state enterprises in 2003, the last year for which figures were available.”)

In China a single body has almost complete power, the Chinese Communist Party.<sup>27</sup> With over 70 million members and growing with members monopolizing all important government positions and acting according to Party policy, the CCP's power over the government and market in China is unchallenged.<sup>28</sup> In fact it could be argued that the Chinese Communist Party is the most powerful body in the world based on the sheer amount of control it exercises over its countrymen and the sheer size of its country.<sup>29</sup>

However the CCP's power is not absolute power and it is certainly not an inherently permanent power. With the huge amount of control it exercises over its citizens lives comes a huge amount of obligations and responsibilities.<sup>30</sup> The populace must be placated otherwise there is civil unrest and a potential for the lose of power through rebellion. This situation is intimately familiar to the CCP, which has witnesses

---

<sup>27</sup> See Melinda Liu and Jonathan Ansfield, *Life of the Party*, Newsweek International, May 23, 2005, available at: <http://www.msnbc.msn.com/id/7937214/site/newsweek> (“The past two decades of sizzling economic growth should not obscure the fact that the Communist Party remains an opaque, hidebound, Leninist-style hierarchy. Party always trumps government. A provincial party secretary always has more clout than the governor. At the national level, the nine-person CCP Politburo Standing Committee always runs the show.”); Sheehy, *supra* note 16, at 225 (noting how the CCP is the basis of of all Law in China) and at page 234 (noting that while Western governments advocate a separation of powers, the CCP views itself, the government, and the will of the people as a single entity and has resisted separation of these powers).

<sup>28</sup> See China Daily a semi-official government website, available at <http://www.chinatoday.com/org/cpc/>

<sup>29</sup> The CCP considers itself masters of the people with the ability to mobilize them at its will. See Jiang Zemin, 16<sup>th</sup> National Congress of the Communist Party of China, 2002, available at: <http://www.china.org.cn/english/features/49007.htm#6> (“The CPC is the core of leadership for the cause of socialism with Chinese characteristics. Governance by the Communist Party means that it leads and supports the people in acting as the masters of the country and mobilizes and organizes them on a most extensive scale to manage state and social affairs and economic and cultural undertakings according to law, safeguarding and realizing their fundamental interests.”). With this kind of control over 1.3 billion people, not to mention it's control over the enormous Chinese army, it is not a stretch to say the CCP is the most powerful governing body on the planet.

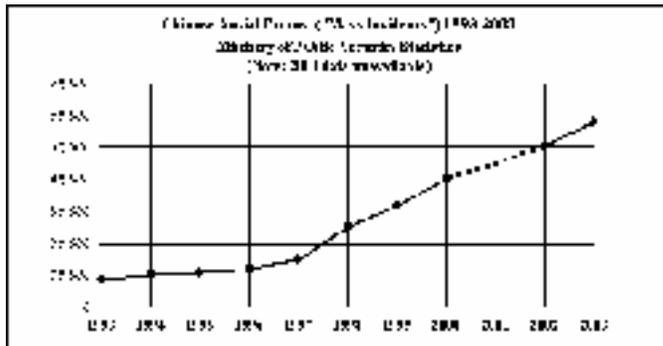
<sup>30</sup> Initially the CCP promised the people “cradle-to-the-grave” support in all matters of social life, primarily through their guaranteed employers. With the decline of this system the CCP itself is struggling to fill the social needs gap for the people.

massive civil unrest that continues to grow.<sup>31</sup> In fact, many of China’s notorious human rights abuses, such as limited free speech, are directly related to its desire to control and prevent civil unrest.<sup>32</sup>

In order to satisfy its citizens and thus retain its power the CCP is necessarily becoming increasingly concerned with wealth.<sup>33</sup> Accordingly, the CCP is beginning to

---

<sup>31</sup> The number of social protest in China is steadily on the rise. *See the following graph in* Murray Scot Tanner, *Testimony, China’s State Control Mechanism and Methods*, U.S.-China Economic and Security Review Commission. April 14, 2005. available at [http://www.uscc.gov/hearings/2005hearings/written\\_testimonies/05\\_04\\_14wrts/tanner\\_murray\\_wrts.htm](http://www.uscc.gov/hearings/2005hearings/written_testimonies/05_04_14wrts/tanner_murray_wrts.htm)



*See* Peerenboom, *supra* note 15, at 217 (Seems to apply a “Learned Hand formula” to Chinese reform, in that considering one-fifth of the worlds population lives in China, almost half in poverty, the consequences of instability in China, the region, and the world which would be very severe, there may be a argument made that tolerating China’s various abuses of rights and the rule of law should be tolerated so as to avoid this outcome); Pai, *supra* note 22 (“Since the Tiananmen Square tragedy, the party has invested billions in beefing up the paramilitary police force (the People’s Armed Police) that has been deployed in suppressing internal unrest. To counter the threat posed by the information revolution, and especially the Internet, the Chinese government has blended technological savvy with regulatory might. The Chinese “Internet police,” officially known as the Ministry of Public Security’s Internet and Security Supervision Bureau, is reportedly more than 30,000 strong. Its Beijing branch proudly claimed that, in 2002, it participated in a multi-agency exercise to see whether the government could rid the Internet of “harmful content” within 48 hours of the onset of an emergency. (During the exercise, all “harmful content” was removed in 19 hours.) The party’s refined strategy of “selective repression” targets only those who openly challenge its authority while leaving the general public alone. China is one of the few authoritarian states where homosexuality and cross-dressing are permitted, but political dissent is not.”).

<sup>32</sup> *See* Peerenboom, *supra* note 15 at 214 (noting that critics point out that the East Asian countries that have succeed in maintaining stability and social order, achieving economic growth...have adopted a restrictive approach to civil and political rights). *But see* *Id.* at 212-213 (noting an increasingly important role of the press in china through media outlets such as the internet which has become to break free from government control and influence the government through mass petitions and other methods).

<sup>33</sup> *See* Pai, *supra* note 22 (“A generation ago, the offspring of the ruling elite took up positions in the government or military; today, they go into business.” Traditionally this has not been a very fruitful relationship. *See Id.* (“Party membership and business acumen do not often go together. Because of the party’s fixation with high growth, government officials are rewarded for delivering, or appearing to deliver,

Party members for private sector positions which it helps to place them into.<sup>34</sup> All and all, it appears the CCP has no intention of relinquishing its control over the economy but rather it's seeking new methods of manifesting that control.<sup>35</sup>

In order to determine who the CCP manifests these goals it is necessary to examine the structure of the markets in which they operate. Specifically, the next section examines how the market is structured and the CCP's participation in it through SOE's, regulations, and regulatory bodies.

## **Part II: Development, Reform, and Actions of China's Market Economy**

This section examines the development and operation of capital markets in China. In order to place that development in context, it is necessary to examine the characterization of the Chinese market. The question of whether the Chinese market is really a 'market' in the Western sense is important because it will shed light on the degree of "opening up" that the CCP has really initiated and thus the degree that capital markets are intended to be free from government interference.

### **Part IIA: China's Market Hybrid**

---

precisely that. This incentive structure fuels a massive misallocation of capital to "image projects" (such as new factories, luxury shopping malls, recreational facilities, and unnecessary infrastructure) that burnish local officials' records and strengthen their chances of promotion. The results of these mistakes—gleaming office complexes, industrial parks, landscaped highways, and public squares—tend to impress Western visitors, who view them as further proof of China's economic prowess.”)

<sup>34</sup> See Liu, *supra* note 26 (“Now the party seems determined not simply to control China Inc., but to *become* it. That means the party—which used to execute landlords and persecute former capitalists—is now training private-sector business executives who are contributing significantly to China's economic boom.”).

<sup>35</sup> See Barry Naughton, *Market Economy, Hierarchy, and Single Party Rule: How Does the Transition Path in China Shape the Emerging Market Economy?*, International Economic Association, 9 (2004) (Noting that it appears that the CCP has recently began to reassert and centralize its power over the economy in recent years by strengthening ties to the provinces and streamlining its administrative control).

An accurate characterization of the Chinese economy in recent years has proven a difficult task due to apparently competing interests of communist controlled state socialism and emerging market capitalism. In the beginning it was clear that PRC was a communist state with a centrally planned socialist economy modeled largely on Marx-Lenin models derived from the USSR. In those early years, China remained isolated from the West and pursued a centrally planned socialist economy.<sup>36</sup> This socialist economic model was found to be very inefficient due to the fact that it was not based on market factors such as increasing profit but rather on increasing social stability often at the cost of making profits.<sup>37</sup>

In 1979 Chinese president Xidong introduced new market based reforms in order to improve and modernize the Chinese economy.<sup>38</sup> When China began to modernize its economy and open up to the world, it became less clear what the nature of China's economy was.<sup>39</sup> It appears that China is moving along the spectrum away from a

---

<sup>36</sup> See Chong-En Bai, Jianguong Lu, and Zhigang Tao, *The Multitask Theory of State Enterprise Reform: Empirical Evidence from China*, Stanford Center for International Development (working paper) 4 (May 2006) (“Prior to 1979, the government planned all economic activity. Companies received funding from government run banks according to the plan of the Central Planning Commission. Workers were guaranteed lifetime employment pensions and health care and other services in exchange for low wages.”).

<sup>37</sup> *Id.* (“In general this system was found to be very inefficient as companies and employees had little incentive for innovation and improvement. They stuck to the plan authored by the Central Planning Commission because the state essentially was a cash flow mechanism for poorly performing companies through the central banks.”) (“Even today there is no well-functioning independent social security network in China and SOE's are increasingly being relied upon to provide that sort of social stability in China.”). This may also be an additional reason why the state is interested in keeping SOE's even if they do not perform well.

<sup>38</sup> *Id.* at 3 (noting that at first these market reforms were mainly based on giving greater operation autonomy to SOE's as well as allowing increasing numbers of private owned companies).

<sup>39</sup> See Peerenboom, *supra* note 15, at 232 (“Although China is often portrayed as a country dominated by the rigid ideology of Leninist socialism, Chinese leaders have in fact been resolutely pragmatic, as captured by Deng Xiaoping's homely advice that the color of the cat matters not as long as it captures mice”). See Naughton, *supra* note 34, at 4-6 (noting that one of the reasons for this is the very gradual approach that China took in the early years of its reforms. These reforms appear to have been gradual so as to allow the power hierarchy to preserve its position in the economy while increasing its overall productivity.) *Id.*, at 5 (“This appearance is also likely based on the view that the more market orientated a country becomes the less powerful its state economic control becomes eventually leading according to so to democracy as the final phase of reform.”). See Peerenboom, *supra* note 15, at 188, (“Moreover, capitalism, rule of law,

centrally planned socialist state to a market economy.<sup>40</sup> However, the Chinese government's involvement in the economy is still comparatively very high.<sup>41</sup>

China has made many important moves that indicate it is moving towards a freer market economy such as reforming its legal and economic structure to attract foreign investors.<sup>42</sup> Another example is China's diligent efforts to gain membership into the

---

democracy, and human rights are sufficiently contested in theory and varied in practice, much to chagrin of those who would choose to impose a hilly idiosyncratic version of liberal democracy on the China, the final outcome in China cannot, at this point, be accurately predicted.”)

<sup>40</sup> *But see* Chong-En Bai, *supra* note 35, at 3 (One of the reasons China has been pushed to more economic reforms is that SOE's were constantly losing out to private run Chinese companies. In other words the state sector was not able to compete in its present form with private business).

<sup>41</sup> Pei, *Foreign Policy*, “The Chinese state remains deeply entrenched in the economy. According to official data for 2003, the state directly accounted for 38 percent of the country's GDP and employed 85 million people (about one third of the urban workforce). For its part, the formal private sector in urban areas employed only 67 million people. A research report by the financial firm UBS argues that the private sector in China accounts for no more than 30 percent of the economy. These figures are startling even for Asia, where there is a tradition of heavy state involvement in the economy. State-owned enterprises in most Asian countries contribute about 5 percent of GDP. In India, traditionally considered a socialist economy, state-owned firms generate less than 7 percent of GDP.

But China's tentacles are even more securely wrapped around the economy than these figures suggest. First, Beijing continues to own the bulk of capital. In 2003, the state controlled \$1.2 trillion worth of capital stock, or 56 percent of the country's fixed industrial assets. Second, the state remains, as befits a quintessentially Leninist regime, securely in control of the “commanding heights” of the economy: It is either a monopolist or a dominant player in the most important sectors, including financial services, banking, telecommunications, energy, steel, automobiles, natural resources, and transportation. It protects its monopoly profits in these sectors by blocking private domestic firms and foreign companies from entering the market (although in a few sectors, such as steel, telecom, and automobiles, there is competition among state firms). Third, the government maintains tight control over most investment projects through the power to issue long-term bank credit and grant land-use rights. China's business cycle is therefore driven by Beijing.

Private-sector firms have very limited access to finance or new markets. The state even dominates many ostensibly deregulated sectors, such as the brewing industry, the retail sector, and textiles. Of the 66 publicly traded retailers in the country, only one is private. There are only 40 private firms among the 1,520 Chinese companies listed on domestic and foreign exchanges.”

<sup>42</sup> *See e.g.* Bradley L. Milkwick, *Feeling For Rocks While Crossing the River: The Gradual Evolution of Chinese Law*, 14 *J. Transnat'l L. and Pol.* 289; Nicholas J. Faleris, *Cross-Border Securitized Transactions: The Missing Link in Establishing a Viable Chinese Securitization Market*, 26 *Nw. J. Int'l L. & Bus.* 201, 201-206 (2005); *See* Randall Peerenboom, *Globalization, Path Dependency and the Limits of Law: Administrative Reform and Rule of Law in the People's Republic of China*, 19 *Berkely J. Int'l L.* 161 (2001). Press Release, WTO, *WTO Ministerial Conference approves China's Accession*, (Nov. 10, 2001) available at: [http://www.wto.org/english/news\\_e/pres01\\_e/pr252\\_e.htm](http://www.wto.org/english/news_e/pres01_e/pr252_e.htm) [“WTO News”];

WTO in 2001.<sup>43</sup> In general, China has been increasingly making international investments seemingly indicates its acceptance of free market economies.<sup>44</sup>

China's Constitution commits it to developing a socialist market economy.<sup>45</sup> Socialism generally means state ownership of the means of production and exchange and a centrally planned economy.<sup>46</sup> A market economy is usually understood as an economy in which goods and services are freely traded without state ownership.<sup>47</sup> In China this works out to government ownership and control over the pillars are most important assets of the country with mixed and private ownership allowed.<sup>48</sup>

The degree in which the socialist government regulates, plans and controls that market has an enormous impact on the health of the economy and those affected by it.

---

<sup>43</sup>WTO News, *supra* note 41 (“Under the chairmanship of Ambassador Pierre-Louis Girard of Switzerland, the Working Party concluded on 17 September almost 15 years of negotiations with China and agreed to forward some 900 pages of legal text for formal acceptance by the 142 Member governments of the WTO.”).

<sup>44</sup> *Chinas Securities and Futures Markets*, CSRC, 5 (April 2004) (“As of the end of December 2003, a total of 93 domestic companies had been listed overseas, raising 27.1 billion US dollars in total. Among them, 18 companies including big companies like People's Insurance Company of China (PICC), Sinotrans, Chinalife and Avichina were newly listed in overseas stock markets in 2003. The 18 companies raised 6.5 billion US dollars in total in the overseas money market via public initial offering and refinancing in the secondary market.”).

<sup>45</sup> Constitution of the People's Republic of China, (2002) Preamble.

<sup>46</sup> Merriam-Webster Online dictionary, available at <http://www.m-w.com/dictionary/socialism>

<sup>47</sup> This does not mean that state ownership in publicly listed companies does not occur in the West. See Sheldon Gao, *China Stock Market in Global Perspective*, DOW JONES INDEXES (Sept. 2002) (noting that even the US and Japan governments have ownership shares in publicly listed companies. There amount of ownership is however usually restricted to industries like telecommunications and public utilities and the size of the ownership shares has been shrinking.)

<sup>48</sup> See Ken Imai, *Explaining the Persistence of State-ownership in China*, *Institute of Developing Economies* (discussion paper) 4 (June 2006) (“what exactly the key assets are has not been defined by the government” However it is generally thought that high initial capital industries such as oil, heavy industry, infrastructure, etc. will remain SOE.”).

This type of market has been called neo-Leninist. See Pei, *supra* note 22 (“Unlike Maoism, neo-Leninism blends one-party rule and state control of key sectors of the economy with partial market reforms and an end to self-imposed isolation from the world economy. The Maoist state preached egalitarianism and relied on the loyalty of workers and peasants. The neo-Leninist state practices elitism, draws its support from technocrats, the military, and the police, and co-opts new social elites (professionals and private entrepreneurs) and foreign capital—all vilified under Maoism. Neo-Leninism has rendered the ruling Chinese Communist Party more resilient but has also generated self-destructive forces.”).

Nowhere is this interplay more evident than in China's capital markets.<sup>49</sup> Capital markets play a crucial role in a countries economic development.<sup>50</sup> In addition considering the size and global impact of China's capital markets, the importance of determining the nature of China's economy is becoming critical.<sup>51</sup>

## **Part IIB: Development of China's Capital Market**

Chinese capital markets reappeared in China in the 1980's.<sup>52</sup> They began sporadically at the local and provincial level until their lack of uniformity prompted the

---

<sup>49</sup> Chinas Securities and Futures, CSRC, 6 ("It (Chinas capital market) has now become a key component of China's socialist market economy and played a vital role in the reform and development of state-owned enterprises (SOEs) and financial markets, in mobilizing resources, in facilitating structural adjustment and economic growth.").

<sup>50</sup> See Wang, *supra* note 16, at 2 (noting the work of economist John Hicks who advocates that financial markets are crucial to economic development) and ("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 function of shifting risk to those who are willing to bear it, as well as reducing the information costs of making transactions in market economies.").

<sup>51</sup> See Solomon Tadesse, Testimony, Hearing on China and Capital Markets, U.S.-China Economic and Security Review Commission (2005) available at [http://www.uscc.gov/hearings/2005hearings/hr05\\_08\\_11.htm](http://www.uscc.gov/hearings/2005hearings/hr05_08_11.htm) (arguing that China is using its unique financial relationship with its state owned enterprises to place it in an unfair advantage to buy strategic assets around the world.) This concern also arises due to evidence that China may be using its capital markets to raise money for activities at odds with its purported goals of becoming a responsible member of the world economy. See Frank J. Gaffney Jr., *Testimony: Chinese Penetration of the Global Capital Markets: Are American Investors Unwittingly Buying the Rope to be Used for Their Hanging?*, Hearing on China and Capital Markets, U.S.-China Economic and Security Review Commission (2005) available at: [http://www.uscc.gov/hearings/2005hearings/hr05\\_08\\_11.htm](http://www.uscc.gov/hearings/2005hearings/hr05_08_11.htm) (noting companies such as Sinopec and COSCO are through their corporate relationships and subsidiaries engaging in illegal activities and relations with terrorist states. For example China National Petroleum Companys heavy interest in Sudans oil lead to reports of thousands of Chinese helping the genocide government in its atrocities in order to clear the way for oil production. Also Sinopecs \$70 billion dollar investment in Iran. Sinopec's subsidiaries have also been sanctioned for selling chemical weapons and technology to Iran. Or Norinco which is notorious weapons proliferators and is listed on Shezen stock exchange. These companies are all publicly listed and manage to put on a respectable face to attract massive foreign investments. For example, Sinopecs 3.4 billion dollar foreign investment receipt in 2000. This has lead one professor to remark, "I am concerned that the PRC's efforts to bring its dubious state-owned enterprises to the world's capital markets is not evidence of a Communist Chinese commitment to free trade. Rather, it is a reflection of Beijing's refinement of the quote attributed to Lenin: They want the capitalists to *buy* the rope with which China ultimately will hang them.").

<sup>52</sup> See, e.g., Wang, *supra* note 16, at 5-6 (noting that the first stock market in China was actually created in 1869, but that the Communist party eliminated securities markets in 1959 as part of its efforts to eliminate all forms of private property. Therefore there were no securities markets in China for nearly thirty years).

central government to consider a standard securities exchange system through China.<sup>53</sup> In the early 1990's two national stock markets emerged at Shanghai and Shenzhen which each have regulatory functions over their own markets.<sup>54</sup> China's stock market was initially launched as an effort to finance its ailing SOE's and to improve their performance through public listing.<sup>55</sup>

Major bodies of law in the 1990's were passed such as the Company Law and Securities Law governing listed companies and securities trading. The Company Law generally governs the establishment and operation of stock companies as well as regulating their behavior on securities markets.<sup>56</sup> The Company law is generally credited as the legal basis for corporatization in China.<sup>57</sup> The Securities Law generally governs the establishment and operation of stock exchanges and brokerages as well as the general issuing and trading of shares.<sup>58</sup>

### **i. The CSRC**

In the early 1990's the national securities regulation authority was consolidated into the Chinese Securities Regulatory Commission (CSRC).<sup>59</sup> The CSRC's duties and powers can be found in the Securities Law.<sup>60</sup> The Securities Law grants the CSRC broad

---

<sup>53</sup> See, e.g., Wei, *supra* note 11, at 488-490.

<sup>54</sup> *Id.*

<sup>55</sup> See, e.g., Wang, *supra* note 16, at 3.

<sup>56</sup> The Company Law was enacted in 1994 and has since not been significantly amended. There has been a good deal of debate concerning the Company law since then with most wanting to amend the Company Law to include provisions addressing such things as fiduciary duties, classification of shares, etc.

<sup>57</sup> See Wei, *supra* note 11, at 492.

<sup>58</sup> See Securities Law of the People's Republic of China, Adopted at the 6<sup>th</sup> Meeting of the Standing Committee of the Ninth National People's Congress on December 29, 1989 (hereinafter Securities Law)

<sup>59</sup> *China's Securities and Futures Markets*, CSRC, 4 (2004) ("Prior to the CSRC establishing sole authority, The People's Bank, the Ministry of Finance, local governments, and even the stock exchanges each had regulatory authority over securities markets. As a result the CSRC initially struggled to consolidate its control."). See Wei, *supra* note 11, at 489.

<sup>60</sup> Securities Law, Arts. 166-174

powers over the securities market including, formulating rules and regulations concerning the securities markets and the code of conduct of those engaged in the market, inspect disclosure, and investigate and deal with violations of securities laws and regulations.<sup>61</sup> Despite these broad powers the CSRC has no accountability to individual shareholders.<sup>62</sup>

The CSRC has become an important source of regulations concerning listed companies that would be expected to be found in the Company Law and Securities Law.<sup>63</sup> For example the CSRC has established rules concerning independent directors and corporate governance.<sup>64</sup> The number of rules and regulations issued by the CSRC is prolific. In 2001 alone the CSRC introduced 51 new regulations.<sup>65</sup>

This lawmaking function of the CSRC is referred to as the ‘development’ of the market function in contrast to the ‘regulatory’ function of the CSRC.<sup>66</sup> While the CSRC is expected to perform both functions in reality the CSRC tends to emphasize one or the other depending on who is in charge.<sup>67</sup> In 2001 the liberal-Western minded CSRC Chairman Zhou Xiaochuan who expounded and enforced the regulatory approach was replaced by a former army veteran who expounds the development approach, because there were complaints that Zhou’s strong enforcement measures were hurting the economy.<sup>68</sup>

---

<sup>61</sup> Securities Law, Art. 167

<sup>62</sup> See Wang, *supra* note 16, at 345.

<sup>63</sup> *Id.*, at 494.

<sup>64</sup> Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, CSRC (2001); Code of Corporate Governance for Listed Companies, CSRC (2002) (hereinafter Governance Code).

<sup>65</sup> See Wang, *supra* note 16, at 37.

<sup>66</sup> See *Id.*, at 34.

<sup>67</sup> See *Id.*, at 36.

<sup>68</sup> See *Id.*, at 37 (“in 2001 under Zhou the Zhou disciplined more than 81 listed companies and 10 intermediaries. The same year the Chinese stock market suffered a loss of RMB 638 billion and entered a long bear period. Many investors blamed the CSRC enforcements for these losses. When Zhou’s successor Shang Fulin took over he made it clear that all the problems “are part of the development and shall be solved through development”).

In general the CSRC faces problems with its regulatory functions. It has a small staff and limited budget.<sup>69</sup> Considering the large number of listed companies on China's stock markets there is serious doubt that the CSRC can effectively monitor all of them.<sup>70</sup> Additionally since the CSRC has sole control of securities regulation it is unlikely that it will receive any help from other agencies.<sup>71</sup>

## **Part IIC. State Assets in Chinese Capital Markets**

### **i. State Owned Enterprises**

Since the early nineties the Chinese government had to gradually began experimenting with forms of mixed ownership through 'corporatization' in order to compete with private businesses.<sup>72</sup> This triggered a large sell-off at the local level of small and medium SOE's which had been losing money and were not able to be supported by the local governments.<sup>73</sup> In addition the government allowed a large number of small SOE to file for bankruptcy.<sup>74</sup> In contrast large SOE's, which employ thousands of workers, have generally not declined.<sup>75</sup>

---

<sup>69</sup> See Hutchens, *supra* note 7, at 637.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> See Imai, *supra* note 47, at 5 ("for political reasons the Chinese government does not ever refer to this as privatization but instead as property rights restructuring"). The Company Law which was passed in 1993 provided the avenue of incorporation for SOE's.

<sup>73</sup> See Imai, *supra* note 47, at 6 ("this the primary reason why the total number of SOE's has declined dramatically in the last decade. However due to the fact that these small and medium companies were financially losers the overall assets retaining by the state the actual amount of state ownership has not really decreased. In addition the majority of these sell offs were to managers and employees of the companies and not to outsiders. The sell off was so large that the central government had to step in at the local level and slow down the sale of state assets by establishing stricter regulations and restrictions."); See Chong-En Bai, *supra* note 35, at 4 ("The sell-offs of SOE's were bad for the economy because in order to have a new owner take over large amounts of debt had to be restructured, often at the states expense.").

<sup>74</sup> See Imai, *supra* note 47, at 6.

<sup>75</sup> See *Id.*, at 7 ("large SOE generally are managed directly by central state agencies and offices who are better able to sustain the loses of poorly performing corporations and whose goals is more united with the State in providing social stability by retaining jobs.").

The governments purposes in promoting SOE's to be listed on the exchanges were several. First the state wanted to provide fresh capital to lessen the governments burden of supporting the SOE's, many of which were unprofitable or failing.<sup>76</sup> Secondly the state wanted to promote internal corporate governance through securities market requirements.<sup>77</sup>

The state is still the largest controlling shareholder of the majority of large firms in Chinese listed companies. In general for 65.6% of Chinese listed firms a single state shareholder controls between 20% and 70% of the equity.<sup>78</sup> The remaining shareholders in Chinese listed companies are predominately individual investors.<sup>79</sup>

## ii. SASAC

Another major development in the Chinese capital markets is the consolidation of state ownership into the SASAC. The SASAC was created from its predecessors in April 2003 to act for the government as the majority shareholder for large SOE's. It is the

---

<sup>76</sup> See generally Chong-En Bai, *supra* note 47 (develops the thesis that SOE have been crucial to China's developing economy because they are such a large employer and usually the only way the employees have a social security system. As such SOE have sacrificed market efficiency for social stability. They argue this is evidenced by the fact SOEs maintained by the central government are less likely to privatize than local economy's which are less concerned with social stability).

<sup>77</sup> Corporate governance which was not included in the Company Law which governed corporations was seen by the state as an important way to increase efficiency as well as to attract investors. Since the Company Law was silent the CSRC stepped in and issued Corporate Governance Guidelines for Listed Companies.

<sup>78</sup> See Howson, *supra* note 11, at 242 (analyzing data provided by CSRC in 2004).

<sup>79</sup> There are no more than 72 million securities trading accountants in China. See China Securities Depository & Clearing Co., Ltd., available at [www.chinaclear.com.cn](http://www.chinaclear.com.cn); But see Joing Deng, *Building an Investor Friendly Shareholder Derivative Lawsuit System in China*, 46 Harv. Int'l L.J. 347, 348 fn. 5 ("However there are doubts about the true number of individual investors in Chinas markets because investors have to open separate accounts on both the Shanghai and Shenzhen market as well as the problem of institutional and individual investors opening several accounts apiece.").

SASAC which creates the regulations controlling the sale of previous NTS's in the split share reform and also has final approval on the sale of those shares.<sup>80</sup>

Initially the SASAC was not authorized to have budgetary control or receive the profits of the SOE's which it managed, a position left to the Ministry of Finance. However, recently the SASAC has become ever more involved in budgetary and profit handling functions.<sup>81</sup> For example the SASAC created the management Budget Bureau and an Audit Bureau in early 2005.<sup>82</sup> Additionally local branches of the SASAC have already been given operation control over budgets and/or profit remission in several cities.<sup>83</sup>

The goal of the SASAC in the split share reform seems to be in line with the governments socialist agenda of retaining control over key large sectors of the economy, while letting smaller SOE's go.<sup>84</sup> The SASAC currently has control over 179 of the largest SOE's in China.<sup>85</sup> Even though these SOE's have participated in the split share reform program the director of SASAC has made it clear that he has no plans to sell off shares in certain companies.<sup>86</sup> Instead the plan seems to be to consolidate the best of them into larger companies which will dominate their sectors and influence the economy.<sup>87</sup>

---

<sup>80</sup> Press Release, Embassy of the People's Republic of China in the United States, *State Share Reform Not Selling Out All Shares*, June 27, 2006, available at <http://www.china-embassy.org/eng/xw/t201442.htm>

<sup>81</sup> See Chris Buckley, *In China, Power to the Center: State Firms Agency Still Calls the Shots*, International Herald Tribune, June 1, 2005, available at <http://www.iht.com/articles/2005/05/31/news/sasac.php> (describing how SASAC has shifted and placed senior management in several of the largest companies and wrestled budget control from others. Also noting that it is at the center of many major economic decisions which has prompted several multinationals to begin dealing directly with SASAC).

<sup>82</sup> Barry Naughton, *SASAC Rising*, China Leadership Monitor, No. 14 (2005) (citing the Chinese language article, Wang Shengke, *SASAC Redefines Itself*, 21 shiji jingji baodao, January 5, 2005, available at <http://www.nanfangdaily.com.cn/jj/20050106/zh/200501050004.asp>).

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> Number keeps changing and is expected to decrease

<sup>86</sup> See Buckley, *supra* note 80.

<sup>87</sup> *Id.* ("This influence has some economists wondering about the strength of Beijing's commitment to a full-blown market economy."); ("In September last year, the agency's chairman, Li Rongrong, told a

The role of the SASAC as both a shareholder for the governments assets and an important player in shaping regulatory policy has begun garnering criticism for the apparent conflict.<sup>88</sup> However, the fact that the SASAC has taken control over large SOE's in sectors such as petrochemicals and infrastructure has allowed the agency to show large profits returned since its inceptions.<sup>89</sup> This high profit ratio, since its inception, has allowed it to withstand the criticism as well as to grab more power from other agencies.

One of the most interesting issues concerning SASAC is its legal position within the Chinese government. On paper the SASAC is not a public institution such as CSRC but is rather a "special non-governmental agency reporting directly to its State Council representatives".<sup>90</sup> In reality however the SASAC is a public institution, mainly because its passage of regulations and rules governing SOE's. It's quasi-public nature is unique because there is little to no regulation and accountability governing the SASAC directly.<sup>91</sup>

### **IID. Recent Securities Market Reforms**

The Chinese Securities markets themselves have undergone a number of significant reforms in recent years. Before these reforms two of the most distinguishing

---

conference in Beijing that China must nurture its own multinationals to challenge the dominance of foreign corporations." "To accelerate the strategic adjustment of China's economic structure," he said, "we must vigorously pursue a strategy of creating major corporate conglomerates." Li also said state-owned companies that were not among the three biggest in their industries would be "restructured," a euphemistic term for privatization.").

<sup>88</sup> See Buckley, *supra* note 80; Naughton, *supra* note 81.

<sup>89</sup> See Buckley, *supra* note 80.

<sup>90</sup> See Naughton, *supra* note 81.

<sup>91</sup> *Id.*, ("The SASAC's legal position is unclear because China has never been able to draft a law governing control of state assets. A drafting group was established in 1993, but after working through a score of drafts, it found its final version junked. The group had attempted to write a broad constitutional charter for the treatment of state assets, but apparently had stumbled into far too many specific problems and conflicts of interest.").

features of the Chinese capital markets were the classification of stocks based on who the owner was and the rule against trading more than 30% of SOE's on the market. In recent years reforms have substantially altered both of these characteristics.

### **i. Classification of Stocks**

One of the most distinguishing features of the Chinese stock market is the classification of stocks. After the state retained its two-thirds majority of NTS, the remaining one-third of shares are not only classified on the universal classification as common stock, preferred stock, etc., but also on the character and nationality of the stock holder. The characterizations are state shares, legal person shares, A shares and B shares.<sup>92</sup> The origins of this classification are difficult to determine because there is no mention of it in either the Company Law or the Securities Law.<sup>93</sup>

State shares are shares held by the central government or its agencies such as local governments acting on its behalf. These shares were not allowed to be traded on the open market. Legal Person Shares are shares which are held by a legal person such as another company or organization with legal person status. Additionally the government can hold legal person shares through a legal person intermediary such as another SOE. It is common for these types of shares to be sold when the State is the majority but not sole owner of the company. While the exact number of these two types of shares is difficult to ascertain, with official estimates at just over 50 percent and many private estimates at much higher levels.<sup>94</sup>

---

<sup>92</sup> In addition there are classification of stock depending on which international market they are listed on. For example shares issued on the Hong Kong Stock Exchange are denominated H shares and stocks listed on NYSE are denominated N shares.

<sup>93</sup> See Wang, *supra* note 16, at 14.

<sup>94</sup> See Imai, *supra* note 47, at 9. Some sources place the number of state owned shares on the market as high as 80%.

A shares are shares that are owned by domestic individual investors and institutions. These are freely traded on domestic markets and in fact are the most commonly traded.<sup>95</sup> Recently in order to open up its markets to foreign investment, China has been allowing foreigners to purchase A shares through the Qualified Foreign Institutional Investor program.<sup>96</sup> In order to qualify as a QFII the purchaser must meet approval from the CSRC which requires the QFII to have very large capital reserves as well as a long and unblemished reputation. Currently the CSRC has granted QFII status to approximately 20 foreign institutional investors.<sup>97</sup> The other way that foreigners may purchase A shares is to become strategic investors. Strategic investors must buy a minimum 10% stake in the company and hold it for a minimum of three years.

B shares are shares which were originally offered to international investors and not allowed to be sold to domestic investors. In 2001 the government opened the B share market to allow domestic investors to purchase them with foreign currency.<sup>98</sup> These shares were created in order to obtain foreign currency as well as to demonstrate China's progress in opening its markets to foreign investors.<sup>99</sup> They are denominated in Chinese currency but bought and sold in foreign currency. They are listed on securities exchanges in China.

---

<sup>95</sup> China Securities and Futures, CSRC, 10 (2005) ("As of the end of December 2003, the listed companies in Mainland China had issued a total of 580.8 billion A shares and raised a total of CNY 761.7 billion. The market capitalization of A share companies amounted to CNY 4,152.1 billion, of which the market capitalization of tradable shares was CNY 1,230.6 billion.").

<sup>96</sup> Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors, Joint Decree No. 12 of the CSRC and People's Bank of China, Nov. 5 2002 China Securities and Futures, CSRC, 5 (2005) For a history of the QFII, see Wang, *supra* note 16, at 22.

<sup>97</sup> See Wang, *supra* note 16, at 22.

<sup>98</sup> CSRC, Circular of the China Securities Regulatory Commission and the State Administration of Foreign Exchange, Notice on Issues Concerning Individual Domestic Residents' Investment in Foreign Currency Stocks Listed in the Domestic Stock Markets, CSRC Decree No. 22 2001.

<sup>99</sup> See Wang, *supra* note 16, at 21 (citing Kejian Chao, *Restore the Financing Functions of and Boost the B Shares Market*, Shanghai Securities Daily (Oct. 31 2003) This article appears in Chinese at the website and I must rely on authors translation.

B shares have the same rights to dividends as A shares. However, the market for these shares remains quite small and since 2001 no company and China has been authorized to issues B shares in the market.<sup>100</sup> As a result A shares are several times more valuable in the market than B shares.<sup>101</sup>

## ii. Split Share Reform

Generally when a corporation is listed the majority of its stock is placed on the market and traded. However this would result in lose of state control and ownership of the states means of production and exchange. In order to retain the socialist doctrines of state ownership and control over the economy the government restricted the amount of shares which could be traded of a SOE to one-third of all shares. The remaining two-thirds of the corporation's shares were non-tradable shares (NTS). NTS were issued to promoters, business partners and employees, but the majority were retaining by the state. In total these NTS accounted for 63% of the total shares in Chinese capital market as late as February 2006 with the state retaining the majority.<sup>102</sup> This is referred to as the split share problem and is discussed below.

In 2005, China initiated the split share reform program in response to growing discontent about split share program.<sup>103</sup> Specifically because non state shareholders were

---

<sup>100</sup> *Id.*

<sup>101</sup> See Beltratti and Bortolotti, *The Nont-radable Share Reform in the Chinese Stock Market*, Noomura Institute (April 2006).

<sup>102</sup> *Id.*

<sup>103</sup> See ChinaDaily.com, *Poor Governance Blamed for Securities Markets*, June 20, 2006, [http://www.chinadaily.com.cn/english/doc/2005-04/03/content\\_430562.htm](http://www.chinadaily.com.cn/english/doc/2005-04/03/content_430562.htm)By 2003 ("A recent survey by a Shanghai-based investment consultancy firm shows that at least 70 percent institutional investors and 90 percent minority share holders believe that the split share structure should be given top priority by the leadership when they consider ways to revive the market. In January 2004 the Chinese government officially acknowledged that NTS were a problem with ongoing market reform and committed itself to solving the problem.

regulated to being minority shareholders there was increasing concern that there was no way in which to institute corporate governance reforms or effectively monitor actions by the corporations.<sup>104</sup> This was viewed as one of the main reasons for Chinese capital markets poor performance between 2001-2005 despite a rapidly growing economy.<sup>105</sup>

The reform essentially allows all previously non-tradable state-owned shares to be traded on the markets and all future IPO's to have entirely tradable shares.<sup>106</sup> Due to concerns about downward pressure on the market and loss of value to existing shareholders from the large amount of new stock being placed in the market the reform calls for majority state shareholders to negotiate some form of acceptable compensation to minority shareholders for the loss in value of their stock.<sup>107</sup> In effect the shareholders of the companies themselves draw up the reform plan which is then approved by regulators. In order for the plan to proceed the public shareholders must approve it by a two-thirds vote. While this negotiation is occurring the issuance of shares and IPO's is frozen in order to prevent misconduct and sell-offs. Additionally, the majority shareholder is very limited in the amount of stock that they can sell in the market in the first two years after the reform.

The split share reform program was initiated through three phases. The reform was initiated by a two trial runs involving 4 companies in April 2005 and then 42

---

<sup>104</sup> See Beltratti, *supra* note 100, at 2 (“In addition major NTS shareholders were impervious to market conditions due to the fact it was impossible to sell. Also the small free float made the market more illiquid and prone to manipulation.”).

<sup>105</sup> An additional view is that the lack of corporate governance in general was what caused the decline.

<sup>106</sup> See Beltratti, *note* 100, at 3 (noting that two previous attempts to make NTS tradeable had failed prior to this reform. One in 1999 which was an experiment involving only 2 companies was not well received by investors, and one in 2001 which failed because the government priced the tradeable and non-tradable shares equally).

<sup>107</sup> See *Id.* (“This negotiation between the NTS majority shareholders and minority shareholders is the distinguishing feature between the current reforms and previous failed attempts at reducing NTS shares. It is in fact quite innovative because it replaces the usual top down reform program initiated by the state.”).

companies in June 2005 which account for 10% of the stock market.<sup>108</sup> On August 24, 2005 the government extended the reform program to all companies with publicly listed stock. To date over 60 percent of publicly listed SOE's have participated in the reform.<sup>109</sup>

Reforms in stock classification and non-tradeable shares have significantly altered the investment environment in Chinese capital markets. The QFII reform as well as others has increased international participation in Chinese capital markets. In addition the creation of the SASAC has introduced a powerful player into the market which will have significant influence over the Chinese economy in future years. These reforms aid in making China more competitive in the international market. The next section examines this competitive position and also some of the ways that China is using it.

### **III. China's Power in the International Market and Use Thereof.**

China has become an economic powerhouse on the international level. Adjusting for purchasing power differentials, China is already the world's second largest economy. Growing at a faster clip than any other major nation, it is on course to surpass the United States as the world's largest economy within two decades.<sup>110</sup>

In many industries, especially those that are labor intensive, China is by now the dominant global player. China-based factories make 70 percent of the world's toys, 60 percent of its bicycles, half its shoes, and one-third of its luggage. In those product

---

<sup>108</sup> *Id.*

<sup>109</sup> China Daily, Split Share Reform, (March 2006) available at: <http://www.china.org.cn/english/BAT/156140.htm> (“As of Jan 20, 2006. 462 companies had participated in the reform, of these 284 were local SOE and 46 were central SOE's.”).

<sup>110</sup> See ODED SHENKAR, CHINESE CENTURY: THE RISING CHINESE ECONOMY AND ITS IMPACT ON THE GLOBAL ECONOMY, THE BALANCE OF POWER, AND YOUR JOB, (2005) (these quotes are taken out of an online article promoting the book itself, available at: <http://www.whartonsp.com/articles/article.asp?p=345008&rl=1>).

categories, it is often impossible to find a non-Chinese product on store shelves.<sup>111</sup> This drive for exporting is fueled by the need for growth in China's economy.<sup>112</sup>

China's importance in the global economy has by now surpassed most of the other members of the G-8.<sup>113</sup> Its huge effect on global supply and demand is now rivaled only by the US.<sup>114</sup> As China competes with the US for superpower strength it has become a major creditor of the US holding hundreds of billions of dollars in US securities.<sup>115</sup> This creditor status is likely to have a large strategic impact on Chinese-US relations.<sup>116</sup>

China's heavy economic clout in the global market has also given it the ability to become powerful politically.<sup>117</sup> China's huge trade deals with other countries have given

---

<sup>111</sup> *Id.*

<sup>112</sup> *Id.* China is still less reliant on exports than many other countries in Asia (such as Malaysia) and outside (such as Belgium), but its dependence is growing, and the export drive must continue for it to fund its growing imports of capital goods and production inputs and prevent a social and political time bomb from exploding, with unemployment serving as the trigger. Not only does China need to provide jobs to a huge cohort of young people, but it also must worry about the many millions still employed in money-losing state enterprises and the 100–200 million people who have left the countryside in search of work in urban areas and who would be the first to be affected by a serious economic downturn. Disaffected peasants have been a source of rebellion throughout Chinese history, and economic well-being is especially critical to a regime that has shed its ideological base and now relies on economic prosperity and nationalism as its sole sources of legitimacy.

<sup>113</sup> Jeffrey E. Garten, *China: The Missing Member at the G-8 Table*, *YaleGlobal*, (June 2004) available at: <http://yaleglobal.yale.edu/display.article?id=4023> (“China has become far more important to the global economy than most other G-8 members such as Italy, Canada and even France.”).

<sup>114</sup> *Id.* (“China has become a major player in international finance. It receives more direct foreign investment than any nation but the US. It possesses more foreign exchange reserves than any country besides Japan. Next to the US, China has more impact on global supply and demand than any other country. Indeed, China is becoming as central to global manufacturing as Saudi Arabia is to oil.”).

<sup>115</sup> *Id.* (“Beijing has become a critical creditor to Uncle Sam, holding hundreds of billions of dollars of U.S. government securities.”).

<sup>116</sup> *Id.* (“How it uses this leverage ought to be of major concern to Washington and Wall Street, and to anyone – such as home owners, car purchasers, or average investors – who is affected by interest rates or the value of the dollar.”) Keith Bradsher, *Failed Unocal Bid Unlikely to Halt China's Plans*, *New York Times* (August 3, 2005) available at: <http://www.iht.com/articles/2005/08/02/business/chioil.php> (“The Chinese government still has \$711 billion in foreign currency reserves that need to be invested. The reserves are mostly parked in Treasuries, American mortgage-backed securities and a mishmash of other financial instruments earning a meager return that has become controversial within China.”).

<sup>117</sup> There are also economically related human rights concerns, *See* Peerenboom, *supra* note 15, at 185 (“critics fear...China is likely to take advantage of its growing economic and geopolitical influence to defend and advocate rights policies and a normative vision of the world at odds with current rights policies based on secular liberalism”).

China enormous clout in such organizations as the UN and WTO.<sup>118</sup> It is predicted that China will continue to increase strategic alliances with allies such as India and Brazil to create a powerful political alliance that would have the power to significantly affect all aspects of the global economy.<sup>119</sup>

China is using its economic clout to major deals on the international level. In one area in particular, the pursuit of oil, China is brokering enormous deals throughout the world. Normally this would not be an expected move. However, China is pursuing these deals with terrorist supporting countries like Iran and Sudan. This seems to suggest that China is not interested in becoming a responsible member of the international economic community.

#### **i. China Deal with Iran**

China has recently established strong long economic term ties to Iran.<sup>120</sup> These ties are primary based on China's growing need for vast amounts of foreign oil and a thriving export market in Iran for Chinese goods.<sup>121</sup> However, China has not been

---

<sup>118</sup> See Garten, *supra* note 112 (“China’s ties to other emerging markets such as Brazil and India may also alter the course of global politics.”).

<sup>119</sup> *Id.* (“A political bloc of big developing countries could have enormous influence in the World Trade Organization, for example. There is a good chance that such a group will emerge, and under Chinese leadership.”).

<sup>120</sup> *Id.* (China has recently signed a \$70 billion dollar oil and natural gas deal with Iran that will operate for the next 20 years at least.)

<sup>121</sup> Robin Wright, *Iran’s New Alliance With China Could Cost U.S. Leverage*, Washington Post (November 17, 2004) available at <http://www.washingtonpost.com/wp-dyn/articles/A55414-2004Nov16.html> (“An oil exporter until 1993, China now produces only for domestic use. Its proven oil reserves could be depleted in 14 years, oil analysts say, so the country is aggressively trying to secure future suppliers. Iran is now China's second-largest source of imported oil.”).

content to just buy oil, increasingly China has become involved in large amounts of arms sales to Iran.<sup>122</sup>

China's economic ties to Iran have grown into a powerful strategic alliance. China has become a large obstacle to effectively dealing with Iran in the UN.<sup>123</sup> In addition, China's relationship with Iran is making it harder for the sanctions that Western countries impose on Iran to have an impact.<sup>124</sup> China's disregard for the reasons why Iran is considered a threat is likely based on its own history of not being considered a responsible world power.<sup>125</sup>

## ii. China Deals with Sudan

China's quest for oil has also led it to develop strong ties with Sudan and aid the Sudanese government in the genocide of Darfur.<sup>126</sup> Sudan is China's largest overseas oil project and also Sudan's largest supplier of arms.<sup>127</sup> China's has protected it's investment

---

<sup>122</sup> *Id.* ("Accurate trade figures are difficult to get, in part because trade is increasing so rapidly and partly because China's large arms sales to Iran are not included or publicized. But at the second annual Iran-China trade fair here in May, Chinese Vice Minister of Commerce Gao Hucheng said trade had increased by 50 percent in 2003 over the previous year, according to the Islamic Republic News Agency. Beijing has also provided Iran with advanced military technology, including missile technology, U.S. officials say. In April 2004, the Bush administration imposed sanctions on Chinese manufacturers of equipment that can be used to develop weapons of mass destruction.").

<sup>123</sup> *Id.* ("Holding a veto at the U.N. Security Council, China has become the key obstacle to putting international pressure on Iran.").

<sup>124</sup> *Id.* ("China's trade with Iran is weakening the impact on Iranian policy of various U.S. economic embargoes, analysts here say. "Sanctions are not effective nowadays because we have many options in secondary markets, like China," said Hossein Shariatmadari, a leading conservative theorist and editor of the Kayhan newspapers.").

<sup>125</sup> *Id.* ("The Iran-China ties may be partly a response to the United States, analysts here say. President Bush's strategy has been to contain both China and the Islamic republic, said Siamak Namazi, a political and economic analyst, "so that's created natural allies." But today, China with its one-party political system appears to feel fewer restraints than do Western nations in dealing with the world's only theocracy. "For China, issues like human rights don't affect your relations with Iran," Namazi said.").

<sup>126</sup> Peter S. Goodman, *China Invests Heavily in Sudan's Oil Industry: Beijing Supplies Arms Used on Villagers*, Washington Post (December 23, 2004) available at:

by seeking protection of its assets from the same government that is responsible for the genocide.<sup>128</sup> This relationship has prolonged the genocide in Sudan because China has used its strong position on the UN to block effective resolution of the genocide.<sup>129</sup>

### iii. China Attempts to Deal with the US: Unocal

In 2005 CNOOC oil company, a SOE of the Chinese government, made a \$18.5 billion dollar bid to buy US based Unocal oil company.<sup>130</sup> However US congress and presidential resistance to the deal forced the Chinese to withdrawal their offer.<sup>131</sup> The US

---

<http://www.washingtonpost.com/wp-dyn/articles/A21143-2004Dec22.html> (“China National Petroleum Corp., still owned by the Communist Party government, bought into the Sudan consortium in 1996. It joined with Sudan's Energy Ministry to build the country's largest refinery, then last year invested in a \$300 million expansion that nearly doubled production, according to a report in the Shenzhen Business Post.”).

<sup>127</sup> *Id.* (“Sudan is China's largest overseas oil project. China is Sudan's largest supplier of arms, according to a former Sudan government minister. Chinese-made tanks, fighter planes, bombers, helicopters, machine guns and rocket-propelled grenades have intensified Sudan's two-decade-old north-south civil war.”).

<sup>128</sup> *Id.* (“For years, the rebels have attacked oil installations, seeking to deprive the Sudan government of the wherewithal to pursue a civil war that has killed more than 2 million people and displaced 4 million from their homes over the past two decades. But the Chinese laborers are protected: They work under the vigilant gaze of Sudanese government troops armed largely with Chinese-made weapons -- a partnership of the world's fastest-growing oil consumer with a pariah state accused of fostering genocide in its western Darfur region.” And “A recent report in the state-controlled China Business News quotes a Chinese foreign affairs official as saying that Beijing has asked Khartoum to “send troops” to areas in which Chinese companies operate.”).

<sup>129</sup> *Id.* (“From its seat on the United Nations Security Council, China has been Sudan's chief diplomatic ally. In recent months, the council has neared votes on a series of resolutions aimed at pressuring Sudan's predominantly Arab government to protect the African tribes under attack in Darfur and stop support for militias by threatening to sanction its oil sales. China has threatened to veto such actions while watering down the threat of oil sanctions.”).

<sup>130</sup> See Ben White, *Chinese Drop Bid to Buy US Oil Firm*, Washington Post (August 3, 2005) (“Cnooc (pronounced SEA-nook), which is the Hong Kong listed unit of its state-owned parent, China National Offshore Oil Corp, was stung. The state owns 70 percent of CNOOC.”).

Shai Oster, *China's CNOOC learns from Unocal Uproar*, Wall Street Journal. Available at: [http://money.aol.com/news/articles/\\_a/chinas-cnooc-learns-from-unocal-uproar/n20060731112009990005?cid=403](http://money.aol.com/news/articles/_a/chinas-cnooc-learns-from-unocal-uproar/n20060731112009990005?cid=403)

<sup>131</sup> *Id.* (“Chinese oil company Cnooc Ltd. on Tuesday withdrew its \$18.5 billion takeover bid for California energy firm Unocal Corp., saying it could not overcome resistance from politicians in Washington who said such a deal could threaten U.S. national security and violate the rules of fair trade.” See Bradsher, *supra* note 115 (“The sight of a Chinese company trying to buy a company once known for the 76 brand made the proposed deal a lightning rod for American worries about everything from manufacturing job losses to high oil prices to the security of energy supplies. But while U.S. congressional resistance appears to have torpedoed the Chinese bid, the economic fundamentals behind that bid remain in place, from China's vast

concerns were based on loss of jobs, high oil prices and national security.<sup>132</sup> The Chinese found themselves shocked by the US resistance as the Chinese government had gone to great lengths to publicize the deal as a strictly commercial one.<sup>133</sup>

CNOOC's chairman was adamant that the deal was a strictly commercial one and that the Chinese government had no connection to the deal.<sup>134</sup> Executives emphasizing that the government did not control the decisions of the CNOOC board and were merely a shareholder.<sup>135</sup> However in order to make the financing work CNOOC borrowed nearly

---

foreign currency reserves to its ravenous appetite for imported oil.”). See White, *supra* note 129 (“But the sources said Cnooc Chairman Fu Chengyu and other executives and directors were shocked by the intensity of the negative reaction from Congress and by signals that the administration did not want to decide whether to accept or reject Cnooc's bid. The president has final authority to accept or reject such deals.”).

<sup>132</sup> Bradsher, *supra* note 115.

<sup>133</sup> *Id.* “The most immediate effect from the failed bid may be on Chinese public opinion toward the United States. China's state-controlled media had devoted extensive coverage to the Cnooc bid and presented it to the public as an exclusively commercial arrangement” ““This is a very symbolic deal that made Chinese people proud of themselves,” said Jin Canrong, associate dean of the School of International Studies at People's University. “Definitely they will feel some kind of disappointment.”).

<sup>134</sup> Shai Oster, *China's CNOOC learns from Unocal Uproar*, Wall Street Journal. Available at: [http://money.aol.com/news/articles/\\_a/chinas-cnooc-learns-from-unocal-uproar/n20060731112009990005?cid=403](http://money.aol.com/news/articles/_a/chinas-cnooc-learns-from-unocal-uproar/n20060731112009990005?cid=403) (the following are excerpts interview with Mr. Fu who is the Chairman of CNOOC.)

(“WSJ: How is Cnooc different from other major state-owned oil companies and enterprises?

Mr. Fu: We get no financial support from the state. We, the company and the board, are responsible for all the decisions we took, for all the financial results or consequences - not the government.

WSJ: Did you get any cheap loans from the state or other funding?

Mr. Fu: The government did not finance even one cent. All the money we used would be from commercial loans, most of them from our U.S. companies, issuance of new shares and partially from our parent.”).

<sup>135</sup> *Id.*

(“WSJ: I have to challenge you on that. Your biggest stakeholder is the state.

Mr. Fu: Whatever the percentage, they are all shareholders. As long as I can deliver good value to shareholders they are happy.

WSJ: But the government is the largest shareholder.

Mr. Fu: When I say the government is a shareholder, it's not just because they are largest, also because they are not interfering with our daily operations. They are not important in decision making on how we run this company. Our management is the same as any other company in the market.

WSJ: So, who does make the final investment decisions at Cnooc?

Mr. Fu: The final approval is by our board, not by the government.”).

\$6 billion from a large state owned bank, which had just recently received a large influx of government cash.<sup>136</sup>

These three deals show that while China's SOE's may appear to be pursuing legitimate government interests there is in fact a large degree of state involvement involved in these SOE's as evidenced by the Chinese governments involvement at a political level to support them. These deals illustrate one form of how the Chinese government is willing to support SOE's in a competitive global market in order to further its national interest. It is easy to image that the Chinese government supports its SOE's in the competitive domestic market in the same kinds of ways.

### **Part III: Laws Affecting Investment in China's Domestic Markets**

This Part examines various aspects of the Chinese legal framework governing capital markets. In particular it focuses on various the protections offered under Chinese laws against various market manipulations and breaches of fiduciary duties. In addition this part focuses on some of the laws affecting SOE's in the marketplace. Finally there is a brief discussion concerning WTO laws which could be construed to affect Chinese domestic capital markets. In order to place the Chinese legal framework in context this section outlines the structure of the Chinese government and its relations to the judiciary.

#### **Part IIIA: Structure of Government Under Constitution**

---

<sup>136</sup> Bradsher, *supra* note 115 ("A Cnooc deal could have provided another investment opportunity; the government announced in late spring that it would inject \$15 billion into a big state-owned bank, which in turn agreed to lend \$6 billion for the Cnooc bid. Jin Canrong, associate dean of the School of International Studies at People's University, said that the State Administration of Foreign Exchange would continue managing the reserves with an eye to maximizing the return on them.").

The Chinese Government is a hierarchical government established and run by the Chinese Communist Party.<sup>137</sup> The Chinese Communist Party is the sole party with any real authority within the Chinese Government.<sup>138</sup> While not required, nearly all members of government are members of the CCP.<sup>139</sup> Therefore the CCP has complete control over all aspects of the central government.

The National Peoples Congress is by name the supreme organ of power in the Chinese government.<sup>140</sup> However the NPC meets only once a year for a few weeks and essentially approves the actions of the real organ of power in Chinese politics, the Standing Committee of the NPC. The Standing Committee which is composed of powerful member of the CCP includes the president and premier and is the permanent role of the NCP exercising nearly all of its powers.<sup>141</sup>

Subordinate to the Standing Committee are the major organs of administration, judicial, and military power. The State Council is the highest administrative party with broad administrative powers exercised subserviently to the Standing Committee.<sup>142</sup> Below the State Council are the various Ministries such as the Minister of Finance and the SASAC.<sup>143</sup>

---

<sup>137</sup> China's Constitution which was formulated by the CCP and structures the government in such a way that the CCP is the primary authority in government usually acting through the Standing Committee.

<sup>138</sup> See *infra* footnotes, 25-27 and accompanying text

<sup>139</sup> *Id.*

<sup>140</sup> Constitution Article 57 (naming the NPC the "highest organ of state power).

<sup>141</sup> Constitution Article 57 (naming the Standing Committee as the permanent body of the NPC).

Constitution Article 67 (gives the Standing Committee nearly all of the power of the NPC including interpreting and enforcing the Constitution, enacting, amending, and interpreting laws and supervising the State Council, CMC and Supreme Court).

<sup>142</sup> Constitution Article 85, (naming State Council as "highest organ of state administration). Constitution Article 89 (giving State Council power to adopt administrative rules, control Ministries, and direct some economic affairs). Constitution Article 92 (making State Council responsible to NPC and Standing Committee).

<sup>143</sup> Constitution Article 89(3).

Equally powerful to the State Council are the Supreme People's Court and the Central Military Commission. The Supreme People's Court while guaranteed independence in the constitution, is in fact responsible to the Standing Committee.<sup>144</sup> The CMC is a very powerful force in China and is considered crucial to the Standing Committee in order to exercise power and maintain domestic stability.<sup>145</sup>

Local governments are modeled similarly to the central NPC and are broken down into provinces, municipalities, counties, cities, etc.<sup>146</sup> Their power is based on a hierarchy within the government.<sup>147</sup> Large local governments elect members to serve as delegates to the NPC, thus in theory obtaining equal representation before the Central Government.<sup>148</sup> Thus the enforcement of laws in China, by both the courts and regulatory bodies occurs within a highly hierarchical political framework, as opposed to separate from the political framework as occurs in most Western democracies.

### **Part IIIB: Chinese Courts**

Chinese courts tend to be limited in their powers by largely non-legal concerns. Politically, the Constitution which gives the Standing Committee the power to supervise the courts has been interpreted by the Standing Committee to give it the authority to supervise final judicial decisions.<sup>149</sup>

---

<sup>144</sup> Constitution Article 126 (“in accordance with the law exercise judicial power independently and are not subject to interference by administrative organs, public organizations, or individuals.”) Constitution Article 128, (“The Supreme People's Courts is responsible to the NPC and its Standing Committee.”).

<sup>145</sup> Constitution Article 94 (the CMC is responsible to the NPC and its Standing Committee).

<sup>146</sup> Constitution Article 95.

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> See Peerenboom, *supra* note 15 at 218.

Chinese courts operate under the civil law tradition and therefore generally do not allow for judge made law.<sup>150</sup> Under this civil law system it is the local and central governments that largely provide the law which Chinese courts are forced to follow. Chinese courts invoke a very limited power to interpret legislation. Courts are not allowed to strike down even administrative regulations because they are unconstitutional or inconsistent with a higher level court holding.<sup>151</sup> The only option the courts can seek is to apply a higher level law or administrative decision.<sup>152</sup>

In addition governments at the same level as the courts exert budgetary and appointment powers over the courts.<sup>153</sup> These appointment powers include appointing judges to the courts and the control over their promotion.<sup>154</sup> Additionally government adjudication committees oversee the courts and can influence the decisions of courts in some cases.<sup>155</sup> It is within these limited political constraints that the Chinese courts decide cases involving Security Law violations.

### **Part IIIC: Insider Trading and Market Manipulation**

In general, insider trading and market manipulation are illegal under the laws of China.<sup>156</sup> The primary law governing these activities is the Securities Law of the People's

---

<sup>150</sup> However do to increasing publication of important or sensitive cases and judicial comments in China there is a inevitable degree of precedent in interpretation. *See generally* Hutchens, *supra* note 7, at fn. 84 and 85 (which while citing some of the numerous articles dealing with the problems of the civil law tradition in China, also notes that in particularly publication of cases in the Supreme People's Court have begun to have a precedent value).

<sup>151</sup> *See* Peerenboom, *supra* note 15, at 219.

<sup>152</sup> *Id.*

<sup>153</sup> *See* Hutchens, *supra* note 7 at 621 ("For examples, the Qingdao People's congress controls the budget and personnel of the Qingdao People's Courts.")

<sup>154</sup> *Id.* at 643.

<sup>155</sup> *Id.* at 621.

<sup>156</sup> Securities Law of the People's Republic of China, Adopted at the 6<sup>th</sup> Meeting of the Standing Committee of the Ninth National People's Congress on December 29, 1989. Article 5.

Republic of China.<sup>157</sup> The Securities Law is premised on the fact that all parties involved in the trading of securities have equal legal statutes and must adhere to the principles of voluntariness, compensation and good faith.<sup>158</sup>

Insider trading is the where persons with knowledge of material inside information on securities trading take advantage of such inside information to engage in securities trading.<sup>159</sup> Market manipulation is generally manipulating the trading prices of share through unfair means such as carrying out combined or successive purchases to build an advantage or selling to oneself or another acting on one's behalf.<sup>160</sup>

Persons with knowledge of inside information include directors, supervisor, and managers of companies as well as members of the securities regulatory authority and other public intermediary organizations that participate in securities trading pursuant to duty.<sup>161</sup>

The Securities Law prohibits certain members of the government from holding, purchasing, and selling shares.<sup>162</sup> These government members include staff members of the securities regulatory authority and employees and of stock exchanges and securities registration and clearing institutions.<sup>163</sup> Generally State-owned enterprises and enterprises where State-owned assets constitute a controlling interest may not speculate in listed shares.<sup>164</sup> Due to the lack of the courts interpretive powers it is unclear whether they interpret the definitions of insider and inside information to government officials such as the SASAC from trading on political or economic information.

---

<sup>157</sup> *Id.*

<sup>158</sup> Securities Law, Article 4

<sup>159</sup> Securities Law, Article 67

<sup>160</sup> Securities Law, Article 71

<sup>161</sup> Securities Law, Article 68

<sup>162</sup> Securities Law, Article 37

<sup>163</sup> *Id.*

<sup>164</sup> Securities Law, Article 76

### **Part IIID: Fiduciary Duties**

Chinese law lacks a comprehensive definition of the fiduciary duties (duty of care and duty of loyalty) for directors, officers, board members, and controlling shareholders in either the Security Law or the Company Law. The Company law does have some articulation of these duties, however they are frequently described as weak and fragmentary.<sup>165</sup>

The description of fiduciary duty is found in Article 59 the Company Law which states that “directors, supervisor, or the general manager shall abide by the articles of association, faithfully perform their duties, and safeguard the interests of the company, and may not abuse their positions and authorities at the company for private gain.”<sup>166</sup>

There is also a duty of loyalty found in Article 61 of the Company Law which states that “A director or the general manager may not engage in the same business as the company in which he serves as a director or the general manager either for his own account or for any other person's account, or engage in any activity detrimental to company interests.”<sup>167</sup> This is followed in Article 62 by a duty not to disclose confidential information unless required by law or consented to by the shareholders committee.<sup>168</sup>

---

<sup>165</sup> See Company Law arts. 57-63.

<sup>166</sup> Company Law Art. 59.

<sup>167</sup> Company Law Art. 61.

<sup>168</sup> Company Law Art. 62.

The Company Law also makes the director, supervisor or general manager personally liable for causing detriment to the company in violation of any national statute, administrative regulation, or the articles of association.<sup>169</sup>

### **i. The Code of Corporate Governance**

In 2002, the CSRC issued the Code of Corporate Governance for Listed Companies in China. The Code is applicable to all listed companies in China.<sup>170</sup> Companies must incorporate the requirements of the Code in their Articles of Association, or when they amend them.<sup>171</sup> Listed companies are required to act in the spirit of the Code and if the CSRC determines that a company's corporate governance structure has major problems it may instruct the Company to make corrections.<sup>172</sup>

One of the most important aspects of the Governance Code is rules governing the behavior of controlling shareholders. The Governance Code specifically states that the controlling shareholders have a "duty of good faith" towards the listed company and to the other shareholders.<sup>173</sup> The controlling shareholder is required to strictly observe laws and not allowed to harm the interest of the company through asset restructuring or seeking personal gain.<sup>174</sup> In addition, the controlling shareholder, prior to listing the

---

<sup>169</sup> Company Law Art. 64.

<sup>170</sup> Code of Corporate Governance for Listed Companies in China, CSRC, preface. Available at [www.csrc.gov.cn](http://www.csrc.gov.cn).

<sup>171</sup> *Id.* ("Requirements of the Code shall be embodied when listed companies formulate or amend their articles of association or rules of governance.") It is not clear if companies which have already filed their Articles of Association prior to the 2002 issuance of the Code are required to embody the principles of the Code. If not than this leaves a vast number of companies in China that are not bound by the Code.

<sup>172</sup> *Id.* This language seems to clearly indicate that breaches of the Code that are not otherwise violations of the Securities Laws and Company Law will not be subject to real enforcement such as penalties, imprisonment, or civil liability.

<sup>173</sup> Governance Code, section 19.

<sup>174</sup> *Id.*

company, must sever its social functions from the company such as stripping out non-operational assets and welfare institutions.<sup>175</sup>

The Governance Code also describes several duty of loyalty type provisions for controlling shareholders. A controlling shareholder who owns other business or institutions that provide services to the listed company must act in accordance with commercial principles.<sup>176</sup> More specifically:

“A listed company's business shall be completely independent from that of its controlling shareholders. Controlling shareholders and their subsidiaries shall not engage in the same or similar business as that of the listed company. Controlling shareholders shall adopt efficient measures to avoid competition with the listed company.”<sup>177</sup>

The Governance Code also contains several provisions on the independence of controlling shareholders. The controlling shareholder shall not directly or indirectly interfere with the company's decisions or business activities.<sup>178</sup> More specifically:

“A listed company shall be separated from its controlling shareholders in such aspects as personnel, assets and financial affairs, shall be independent in institution and business, shall practice independent business accounting, and shall independently bear risks and obligations.”<sup>179</sup>

The Governance Code also addresses related party transactions. These are not defined in the Governance Code except calling them connected parties, but it is likely to include companies which have an overlap of owners.<sup>180</sup> When related party transactions occur they must be in writing and describe the transactions in specific and concrete terms.<sup>181</sup> The related party transactions must observe the principles of equality,

---

<sup>175</sup> Governance Code, section 16.

<sup>176</sup> Governance Code, section 17.

<sup>177</sup> Governance Code, section 27.

<sup>178</sup> Governance Code, section 21.

<sup>179</sup> Governance Code, section 22.

<sup>180</sup> Governance Code, section 12.

<sup>181</sup> *Id.*

voluntarily, and making compensation for equal value.<sup>182</sup> Measures must be taken by the listed company in prevent the connected party from harming the listed company by monopolizing purchase or sales channels.<sup>183</sup> The prices in the transaction must conform to independent third party prices.<sup>184</sup>

### **Part III E: Private Securities Litigation**

Until recently Chinese Courts refused to accept private securities litigation claims. This was despite the fact that there was some legal basis for the filing of such claims.<sup>185</sup> In fact courts were faced with several securities litigation cases but simply refused to hear them.<sup>186</sup>

In September of 2001 the SPC issued a notice which placed a temporary ban on all private securities litigation suits.<sup>187</sup> In early 2003 the SCP released the ban in a limited way when it issued Several Regulations Concerning the Adjudication of Civil Compensation Based upon Misrepresentation.(PSL Rules).<sup>188</sup>

The PSL rules create a systematic framework for private securities litigation concerning misrepresentation or false disclosure. The PSL Rules address several issues concerning both the substance and procedure for private litigants bring a claim for

---

<sup>182</sup> *Id.*

<sup>183</sup> Governance Code, Section 13.

<sup>184</sup> *Id.*

<sup>185</sup> Securities Law, Article 63 (provides a basis for civil liability for disclosure fraud.) In addition the General Principles of Civil Law of the People's Republic of China Art. 213 (provide that tort victim are entitled to civil compensation).And CSRC, Notice on Issuing the Guideline on the Management of Listed Companies Art. 4.

<sup>186</sup> *See generally* Hutchens, *supra* note 7, at footnote 17.

<sup>187</sup> Supreme People's Court, Notice Concerning Temporarily Not Accepting Civil Compensation Cases Related to Securities, September 21, 2001.

<sup>188</sup> Supreme People's Court, Several Regulations Concerning the Adjudication of Civil Compensation Securities Cases Based upon Misrepresentation, Jan, 9 2003.

misrepresentation including who has standing, definition of the tort, statute of limitation, evidence requirements, and jurisdiction.<sup>189</sup>

Under the PSL Rules Misrepresentations are defined as outright false statements, misleading statements, and material omission.<sup>190</sup> The PSL however has important limitations on the scope of the tort. For instance plaintiffs may not recover when they buy a security prior to false disclosure and sell it prior to the time that the false disclosure is made public.<sup>191</sup>

### **i. PSL and Insider Information**

The PSL rules limit private securities litigation to case for misrepresentation. The 2001 ban on private causes of action remains in effect for insider trading and market manipulation cases.<sup>192</sup> In fact, courts hearing cases of misrepresentation must separate damages caused by insider trading and market manipulation from those caused by misrepresentation and only allow for recover of damages caused by misrepresentation.<sup>193</sup>

### **ii. PSL and the Government Enabling Requirement**

The PSL Rules require that before any private securities litigation suit may be brought in Chinese Courts there must be a prior administrative penalty or criminal penalty imposed on the defendant.<sup>194</sup> This is referred to as the requirement of enabling government action. The requirement does not have a basis in any Chinese law concerning

---

<sup>189</sup> *Id.*

<sup>190</sup> PSL Rules, Art. 17.

<sup>191</sup> PSL Rules, Art. 19.

<sup>192</sup> *See Wei, supra* note 14, at 140.

<sup>193</sup> *Id.*

<sup>194</sup> PSL Rules, Art. 6.

securities but is rather more like a judge made legislation. This requirement can be met by a Chinese Court or any administrative agency with jurisdiction not just the CSRC.<sup>195</sup> Therefore there is a powerful government controlled gatekeeper on private securities litigation in Chinese courts.

### **Part III F. Laws Governing SOE's in the Market.**

This section examines the laws effecting SOE's in the Chinese capital markets. Specifically it will focus on the laws affecting SASAC since they are likely to become the most influential players in the capital market. However, prior to discussing the these laws it will be useful to provide a brief background into the legal basis of state ownership in China.

#### **i. Legal Basis of State Ownership**

China's Constitution strongly commits it is to socialist ideal of public ownership of the means of production.<sup>196</sup> The Constitution names public ownership as the dominant force in the socialist economy and committees the State to ensuring the consolidation and growth of the State-owned economy.<sup>197</sup>

The Constitution also recognizes private economies as major components of the socialist market economy.<sup>198</sup> The State pledges itself to the protection of private sectors

---

<sup>195</sup> Id.

<sup>196</sup> Constitution, Article 6 (“The basis of the socialist economic system of the PRC is socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people. The system of socialist public ownership supersedes the system of exploitation of man by man; it applies the principle of “from each according to his ability, to each according to his work”).

<sup>197</sup> Constitution, Article 7 (“the State-owned economy, that is, the socialist economy under ownership by the whole people, is the leading force in the national economy. The State ensures the consolidation and growth of the State-owned economy.”).

<sup>198</sup> Constitution, Article 11(1).

of the economy and encourages, supports and guides their development.<sup>199</sup> The Constitution also acknowledges private property as inviolable and commits the State to private property protection.<sup>200</sup> The State may like many countries exercise eminent domain in the public interest provided it makes compensation.<sup>201</sup>

## **ii. Laws Affecting State Owned Assets**

The organization with direct control over the most important state owned assets is the State-Owned Assets Supervision and Administration Commission (SASAC). The primary law governing the SASAC is the Interim Regulations on Supervision and Management of State-owned Assets of Enterprises, which was adopted by the State Council in May of 2003.<sup>202</sup> Under this law the SASAC is directly subordinate to the State Council and performs its functions on its behalf.<sup>203</sup>

The SASAC was established to “suit the needs of the socialist market economy, better run State-owned enterprises, push forward the strategic adjustment of the layout and structure of the State economy, develop and expand the State economy, and realize the preservation of and increase the value of State-owned assets”.<sup>204</sup> The SASAC therefore has traditional investor objectives as well as non-investor State objectives.

## **iii. SASAC as Investor**

---

<sup>199</sup> Constitution, Article 11(2). (“The State encourages, supports and guides the development of the non-public sectors of the economy and, in accordance with law, exercises supervision and control over the non-public sectors of the economy.”).

<sup>200</sup> Constitution, Article 13.

<sup>201</sup> Constitution, Article 13(3).

<sup>202</sup> Interim Regulations on Supervision and Management of State-owned Assets of Enterprises, adopted at the Eighth Executive Meeting of the State Council on May 13, 2003 (hereinafter SASAC Regs.)

<sup>203</sup> SASAC Regs, Article 12 (which also notes that the SASAC is a specially established authority).

<sup>204</sup> SASAC Regs, Article 1.

A number of provisions of the SASAC Regulation make the SASAC conform to traditional investor objectives. The Regulations state that the SASAC shall not interfere with the independence of State-owned enterprise apart from performing the responsibilities of investor.<sup>205</sup> In addition, The SASAC is to eliminate the functions of social and public administration formally assumed by the Peoples governments in their management of State-owned assets of enterprises.<sup>206</sup>

The rights and responsibilities of the investor to which the SASAC must conform are set forth in the Company Law of China. These rights and responsibilities include enjoy capital gains, taking part in major policy decisions and choosing managers in proportion to share of the investment they make in the company.<sup>207</sup>

#### **iv. SASAC as More Than Investor**

In addition to performing the responsibilities of the typical investor the SASAC performs several additional functions. The SASAC has the power to formulate laws and regulations on its own which effect its management and the management by others in SOE's.<sup>208</sup> The SASAC has the power to broadly audit the financial and strategic positions of each of its state invested enterprises.<sup>209</sup> The SASAC has the power to dispatch supervisory panels to the invested enterprises and punish and reward responsible persons

---

<sup>205</sup> SASAC Regs, Article 10 (“The SASAC shall support the independent operation of enterprises according to law, and shall not interfere in their production and operation activities, apart from performing the responsibilities of investor.”).

<sup>206</sup> SASAC Regs, Article 7 (Noting also that other institutions and departments under the government shall not perform the responsibilities of Investor of State-owned assets of enterprises).

<sup>207</sup> Company Law of the People’s Republic of China, promulgated by the Standing Committee of the National People’s Congress on June 1, 1994 (revised 2004) Article 4.

<sup>208</sup> SASAC Regs Article 13.

<sup>209</sup> SASAC Regs, Article 13(5) (“supervise and administer the preservation of an increase in the value of State-owned assets of enterprises by means of statistics or auditing”. These audits and statistics gathering operations are quite extensive giving detailed insight to the SASAC of the financial situation and operation of the state invested enterprise); *See* The Measures for the Statistic Reports on State-owned Assets of Enterprises, promulgated by the State Council on February 2, 2004.

in the invested enterprise.<sup>210</sup> It also has the authority to “undertake other tasks assigned to it by the government of the corresponding level”.<sup>211</sup>

The SASAC has obligations in regard to state invested enterprises which supersede those of a typical investor. Such obligations include promoting the reasonable flow and optimized allocation of State-owned assets<sup>212</sup>, propel the adjustment of the layout and structure of the State economy<sup>213</sup>, and maintain and improve the controlling power and **competitive power** of the State economy in areas which have a vital bearing on the lifeline of the **national economy and State security**<sup>214</sup>. In general SASAC has the obligation to improve the overall quality of the State economy<sup>215</sup>.

It may accomplish these goals by offering “guidance and coordination” to State invested enterprises in “overcoming difficulties and solving problems” in their reform and development.<sup>216</sup> In the event of wars, serious natural calamities or other “major and emergent situations”, the SASAC may uniformly reallocate and dispose State-owned assets of enterprises.<sup>217</sup> These objectives obviously go beyond the privileges and responsibilities of the traditional investor.

To shift gears a bit, the next section deals with the WTO. Considering the degree to which the Chinese government both directly and indirectly plays a role in the Chinese domestic markets it is necessary to determine whether its membership in the WTO subjects it to restrictions on that involvement.

---

<sup>210</sup> SASAC Regs, Article 13(3) (authority to dispatch supervisory panels; Article 13(4) authority to appoint, remove, punish, and reward responsible persons of the invested enterprise).

<sup>211</sup> SASAC Regs, Article 13(6) (this article appears somewhat vague but it does not seem to limit meddling by the government into the actions of the SASAC).

<sup>212</sup> SASAC Reg Article 14(1).

<sup>213</sup> *Id.*

<sup>214</sup> SASAC Reg Article 14(2).

<sup>215</sup> *Id.*

<sup>216</sup> SASAC Reg Article 14(6).

<sup>217</sup> SASAC Reg Article 9.

### Part III.G. WTO Rules on Subsidies

One of the main goals of the WTO is to promote fair international trade by prohibiting member countries from granting subsidies to industries in their country. The major rules governing subsidies of WTO members is the Agreement on Subsidies and Countervailing Measures (SCM Agreement)<sup>218</sup>, which acts to supplement the General Agreement on Tariffs and Trade (GATT)<sup>219</sup>. In addition, the China Ascension Protocol contains several China specific rules concerning government subsidies for SOE's.<sup>220</sup>

Under WTO law a subsidy exists if there is a financial contribution by a government and a benefit is therefore conferred.<sup>221</sup> A 'financial contribution' by the government includes direct transfers of money (grants, loans, or loan guarantees), non-collection of money owned to the government (e.g. tax credits), goods or services provided by the government other than infrastructure, or purchase of goods by the government.<sup>222</sup> In addition if a government provides funds for or entrusts a private body to engage in any of these financial contributions 'which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments' it is considered a financial contribution by the government.<sup>223</sup>

WTO is concerned primary with international trade in the import and export markets. The rules under GATT deal with subsidies generally as any form of income or

---

<sup>218</sup> WTO, *Agreement on Subsidies and Countervailing Measures*, (hereinafter SCM)

<sup>219</sup> WTO, *General Agreement on Tariffs and Trade*, (Hereinafter GATT)

<sup>220</sup> WTO, *Protocol on the Accession of the People's Republic of China*, WT/L/432, 10 November 2001. (hereinafter Protocol).

<sup>221</sup> SCM, Article 1.1.

<sup>222</sup> SCM, Article 1.1(a)(1)(i-iii).

<sup>223</sup> SCM, Article 1.1(a)(2)(iv).

price support which operates directly or indirectly to increase any exports from the country or decrease any imports into its country.<sup>224</sup>

There are generally two relevant exceptions to the subsidy prohibitions under the WTO agreement. They are the for subsidies granted by a developing country member in connection with a privatization program<sup>225</sup> and those used by a transition economy member to facilitate its transformation from a centrally planned into a market economy.<sup>226</sup>

However, under the China Protocol, China may not take advantage of the privatization exception.<sup>227</sup> The transition exception also does not apply to China because it allows for a 7 year period to phase out such subsidies, a deadline which has already expired for China.<sup>228</sup> Therefore there are no major exceptions under the WTO exempting China from government subsidies.

Under GATT if a state enterprise or governments grants any exclusive or special privilege to an enterprise, such enterprises are required to make all sales and purchases of goods solely in accordance with non-discriminatory commercial considerations.<sup>229</sup> However there is a general provision for non-disclosure of confidential information if such information is contrary to public interest or would prejudice the legitimate commercial interests of particular enterprises.<sup>230</sup>

The China Protocol however does include many China specific rules which were developed in the Report of the Working Party on the Accession of China and

---

<sup>224</sup> GATT, Article XVI (A)(1).

<sup>225</sup> SCM, Article 27.13.

<sup>226</sup> SCM, Article 29,

<sup>227</sup> See Julia Ya Qin, *WTO Regulation of Subsidies to State-Owned Enterprises: A Critical Appraisal of the China Accession Protocol*, 7 J. Int'l Econ. L. 887 (2004).

<sup>228</sup> See Id.

<sup>229</sup> GATT, Article XVII(1)(a)-(b).

<sup>230</sup> GATT, Article XVII(4)(d).

incorporated into the China Protocol. The Protocol prevents SOE's from making purchases and sales on anything other than commercial considerations.<sup>231</sup> China must also ensure that other WTO members are allowed to compete in the market under non-discriminatory basis.<sup>232</sup> Further, the Government of China would not influence, directly or indirectly, commercial decisions on the part of SOE's.<sup>233</sup>

China must apply and administer all laws and regulations affecting trade in a uniform, impartial and reasonable manner.<sup>234</sup> Foreign individuals and enterprises must be accorded treatment no less favorable than any others on the prices and availability of goods and services supplied by public and state enterprises.<sup>235</sup>

## **Part IV: Towards a New Paradigm and its Implications**

### **Part IVA: Application of Facts and Law**

In order to satisfy its citizens and thus retain its power the CCP is necessarily becoming increasingly concerned with wealth. It may be argued that this pragmatic approach may be the best way for China to proceed in order to ensure social stability.<sup>236</sup> It does not take much to envision the human travesty that would occur if wide scale social instability broke out in China due to botched market reforms. Along the same line it's important for China and the world to prevent China from becoming an arguably failed capitalist state like Russia.

---

<sup>231</sup> Protocol, Article 9(1).

<sup>232</sup> Protocol, Article 3.

<sup>233</sup> Protocol, Article 6.

<sup>234</sup> Protocol, Article 2(A)1.

<sup>235</sup> Protocol, Article 3(b).

<sup>236</sup> See Peerenboom, *supra* note 15 (the article makes the point that countries in east Asia that are more restrictive of political and human rights while the government pursues economic reforms outside the control of an effective rule of law, are more successful in the long the run).

However, the money that the CCP needs to prevent this social instability is in large part generated through international trade, domestic markets, and foreign direct and indirect investment. When China competes with other countries in the global market there will surely be losers if China does not play fair. Therefore while the pragmatic approach may be the most efficient for China it could have seriously unfair effects on competing countries.

### **i. China's Domestic Securities Markets**

Recent reforms in the Chinese Securities Markets appear to be decreasing the power of the State over the market, but are in fact actually creating a more flexible and powerful means for the government to unfairly benefit at the use of its markets. The classification of shares based on the origins of ownership and the split share reform are two very subtle methods which combined actually increase the State's unfair advantage in the market.

#### **a. Classification of Stocks**

The classification of stocks based on ownership has the effect of keeping a large number of foreign investors from participating in China's securities markets. Absent large QFII's and other special international investors which are allowed to trade in A Shares, the rest of the outside world is restricted to B shares which have an intrinsically lower value and are very rarely offered by Chinese companies.<sup>237</sup> This has the effect of excluding the vast majority of the world's investors from the Chinese market.<sup>238</sup>

The exclusion of smaller foreign investors from the Chinese market is actually advantageous to the government for at least two reasons. First, China is able to avoid

---

<sup>237</sup> See *Infra*, footnotes 94-99 and accompanying text.

<sup>238</sup> See Gao, *supra* note 46 at 11-14.

strict scrutiny over unfair practices in its markets. While China has complete control over its domestic press, it could not prevent international investors who were aggrieved by the situation of unfair market practices and lax enforcement to openly criticize and expose the Chinese government's role.<sup>239</sup>

The classification of stocks and the restrictions limit foreign investors to large institutional investors. These investors are very sophisticated and successful investors who are capable of obtaining sufficient information to make wise investment choices in Chinese companies. However, smaller, less sophisticated investors would be more likely to make unwise investment choices and be harmed as a result. The cry of injustice from this multitude of 'little guy' investors would attract more public sympathy and pressure their governments to confront China about its unfair domestic markets. This is a situation that China's stock classification effectively avoids.

Secondly, by largely restricting the domestic market, China is preventing foreigners from taking strategic stakes in the Chinese economy.<sup>240</sup> This appears to be a method the Chinese government is using as evidenced by its \$711 billion dollar stake directly in the US government through debt. Such a strategic stake is beneficial to the Chinese government because the threat of calling in debts and the desire of countries like the US to borrow more money likely has the effect of chilling attempts to openly criticize

---

<sup>239</sup> This also prevents domestic actors from learning about successful foreign strategies to achieve justice, *See Dowdle, supra* note 8, at 56 (“Globalizaion also makes it esier for domestic actors seeking to promote domestic access to justice to learn about successful experiences abroad that might be useful to their cause.”).

<sup>240</sup> *Id.*, at 64 (noting how foreign investment and export promotion are two ways in which underdeveloped countries become significantly more dependant both economically and politically to more developed countries).

unfair trade practices of the Chinese government or their support of human rights abuses and alliances with terrorist states.<sup>241</sup>

In addition it provides a security blanket for the activities of Chinese companies since they are insulated from the rest of the world by complete ownership of their strategic industries. There is little threat foreign investment could inadvertently reveal sensitive national security plans within China, such as how the massive amounts of spending on the military is being utilized through domestic contracts.<sup>242</sup>

### **b. Split Share Reform**

The split share reform program has the effect of streamlining the governments internal investment and making strategic acquisitions and sales easier for the government. Since the government is no longer constrained by rules which require it to retain large shares of un-profitable companies the government is able to shed these companies and reinvest their money in more profitable companies and thus increase their control over important industries and increase revenue. Such a practice does not in itself seem unfair as long as the Chinese government does not use it to create an unfair advantage in the market.

What the split share reform has essentially accomplished is allow much greater flexibility to the Chinese government to participate in the market. This flexibility only makes the Chinese governments participation more efficient, which is of course the goal.

---

<sup>241</sup> Id. (noting how developed countries are increasingly conditioning aid to developing countries as a method of promoting the developing countries willingness to enact legal reforms.) China has in effect reversed this tactic on the US, by not requiring aid and instead holding massive amounts of US securities, China is able to resist pressures from the US to enact legal reforms.

<sup>242</sup> See Philip Pan, *In China Rumsfeld Urges Greater Global Role, Freedom, Military Candor*, Washington Post (October 19, 2005) available at: <http://www.washingtonpost.com/wp-dyn/content/article/2005/10/18/AR2005101800182.html> (Rumsfeld made remarks concerning the secrecy of Chinese military spending, saying that it may be much larger than the Chinese government is saying)

It should be noted that in companies that really matter, the same ones the government is holding onto or increasing its stake in, there is no benefit to the shareholders since the management structure of these companies will remain unchanged. Thus saying that the program is a market reform intended to benefit the shareholders would be inaccurate.

### **c. CSRC**

The CSRC is hugely ineffective when it comes to dealing with abuses by SOE's in the market. The CSRC and SOE's have the same boss, the State Council and ultimately the CCP. The CSRC is very much unlikely going to investigate or discipline large SOE's because it would in fact be disciplining itself. This situation is further aggrieved by the State's complete control over the personnel and budget of the CSRC which are both inadequate to effectively regulate all of China's listed companies.

The Chinese government is subtle about reigning in the CSRC due to its public role of investor protection. For instance the government would decrease the CSRC's already sorely underfunded budget because that would be an obvious indication to the public that the government's priority is not really the shareholders' protection. However, the government through its control of the media is able to make scapegoats out of enforcement-friendly CSRC personnel and have them removed such as the case of director Zhou in 2002. Through actions such as these the Government is able to minimize the enforcement role of the CSRC.

### **d. SASAC**

The SASAC is a very powerful tool of the government in increasing its control over the market. The SASAC is the centralized owner over the largest and most

important SOE's in China reporting directly to the State. This consolidation has created a more loyal servant to the government by cutting out the provincial or military owners which might have objectives that differ from the central government.

The SASAC also has the very powerful affect of concerted action. Sitting at the top of the most important industries in China the SASAC is able to have significant control over supply chains, certain markets, and other economic factors that can be affected by a network of enormous enterprises acting in concert. This advantage has the effect of making sure that SASAC companies have a dominant market position. Of course this is the purpose of the SASAC.<sup>243</sup> However, this also has the effect of greatly distorting the domestic market.

The SASAC is also a central clearing house of information about the companies it owns. All the companies that the SASAC owns provide it with detailed financial information which would normally only be available to a purely public organization like the CSRC. This information is powerful because it allows the SASAC to gauge the performance of huge market players prior to the time that anyone has this information.

With the split share reform the SASAC is now free to trade on this information. For example, the SASAC could obtain information from one its mining companies that a large deposit of copper has been discovered thus driving down the price of copper. The SASAC could then increase its investment in any company which the state has significant investment in that really heavily on the use of cooper such as a electric wire manufacturer whose shares are likely to increase in value due to the decline in the price of copper. Or the SASAC could obtain information concerning important political or economic moves

---

<sup>243</sup> See *Infra*, footnotes 211-214 and accompanying text.

soon to be made by the government concerning certain sectors of the economy and trade on that information.

### **e. Courts**

Even if the CSRC found violations of SOE's in the market there would be little redress due to the fact that the courts are controlled by and defer to the government. It is highly unlikely that the Courts are going to discipline SOE's because the governments that own them also in effect own the Courts.

The Courts have already gone along with the government on stopping one of the most effective means of market regulation, private securities litigation. While the Courts have recently created civil liability for misrepresentation, there are currently no civil torts for breach of fiduciary duty and insider information.

The lack of private securities litigation serves the government in other ways as well. There is a cultural disconnect with the adversarial process that could be borne directly out of the CCP's fear of social unrest.<sup>244</sup> This fear of unrest is a good candidate for limitation of private actors suing companies which are largely controlled by the state, and of increasing regulation which could expose not only the state companies themselves to liability but also to expose the system of economic control held by the CCP.

### **f. The Torts**

#### **1. Duty of Care**

---

<sup>244</sup> See Hutchens, *supra* note 7, at 645 (while discussing PSL and the implications that it would have for the development of class action suits, one Supreme People's Court judge said "the word 'class'... is in the name of this legal device. You are going to get all the angry shareholders organized in one class. That is politically too dangerous")

The Chinese government has not been encouraging making breach of fiduciary duties an actionable violation of the law. This is because the fiduciary duty in China's SOE's is not really to the shareholders but rather to the State, which could have very different investment objectives considering it's vast market control and ability to leverage companies against each other.

In addition the SASAC and other state actors such as local governments have an inherent conflict of interest between their different holdings. For example the SASAC may have control of the two competing mining companies. With directors on boards of these two companies the SASAC would likely be less willing to compete with each in a market environment to secure a certain assets such as government contracts. This would stagnant the share price as neither company bet the other in bidding on the asset which would have the effect of increasing share price.

The recent attempts by the CSRC to define the fiduciary duties in the Governance Code are inadequate. First of all there is little to no real disciplinary measures set out in the Governance Code. This is a fact that will likely be recognized by the Courts when they refuse to hear cases based on breach of fiduciary duty. In addition the duties themselves are very vague. In the Civil Law system defining these duties in a statute is an almost impossible task and courts as well as the CSRC will have little to no direction when determining whether certain actions of SOE's constitute a breach of fiduciary duties.

## **2. Insider Information**

With large state shareholders such as the SASAC and local governments having several different holdings the availability of inside information to these organizations is inherent. For example two companies competing on a contract would likely be aware of the position of the other company. There is nothing preventing local governments or the SASAC from exchanging this information between the two. There are no laws saying that the SASAC can not exchange information learned in one of its companies with another. The insider trading law does not seem to include the SASAC under its definition of who can have inside information. This complete lack of regulation concerning insider information in the laws governing the SASAC indicates that the government is not prepared to limit these companies from exchanging insider information.

### **ii. WTO**

There are several aspects of the Chinese capital markets which could be considered violations of China's WTO agreements. For example, in affect the SASAC is a government subsidy since the Government is providing goods and services in the way of facilities and manpower to SOE's in order to boost their competitiveness. The Chinese government established the SASAC, has oversight over it, and provides for its funding and infrastructure. The SASAC has definitely conferred a benefit to the companies under there control as evidenced by their increase in market value.

In the abstract a regulatory regime that is conducive to Insider information violations could be considered a subsidy. Indirectly permitting SOE's to trade on insider information due to the lax regulatory framework to prevent it can allow for benefits

between domestic companies that distort trade with international companies competing in the domestic market. By allowing for, or at least not effectively regulating, insider information the Chinese government is allowing indirectly a benefit to be conferred on the domestic industries. This constitutes a financial contribution indirectly because it allows the SOE's to use inside information to increase their share price just as sure as if the government had given them the extra money themselves.

In sum, these perceived legal inadequacies in China's securities market regulation which in effect benefit the Government both economically and politically calls for a paradigm shift to assessing the China securities market reforms based on their actual intended objectives.

#### **Part IVB: New Paradigm<sup>245</sup>**

The paradigm of suggesting that increasingly the amount of western-styled reforms into the Chinese securities regulation framework simply does not work, because it is based on a misconception about what the Chinese securities market really is and what recent reforms are intended to accomplish. This article has attempted to show that the Chinese securities market is nothing like a real securities market but is rather a mechanism controlled by the Chinese government in order to increase its own revenue and allow it to compete more effectively on the global market. In effect it is a government piggy bank.

---

<sup>245</sup> This attempt at formulating a new paradigm for analysis of Chinese capital market reforms is admittedly greatly simplified and incomplete. However, *see* KUHN, *supra* note 4 at 156 (“The early versions of most new paradigms are crude. By the time their full aesthetic appeal can be developed, most of the community has been persuaded by other means. Nevertheless, the importance of aesthetic considerations can sometimes be decisive”). After all, *Id.* at 158 (“Something must make a least a few scientist feel that the new proposal is on the right track, and sometimes it is only personal and inarticulate aesthetic considerations that can do that”)

The traditional conception of a securities market is as a mechanism whereby capital can be most effectively raised and distributed to the most effective corporations with the benefit going to the shareholder. The traditional market is regulated by an uninterested third party that seeks no benefit within the market for itself. Under these conditions incorporating corporate governance mechanisms like fiduciary duties and strict prohibition against insider trading can and are usually effective. However this is not what the Chinese securities market is.

The Chinese securities market is a mechanism whereby capital can be most effectively raised and distributed for the benefit of the government. The communist government in China claims to hold all its assets in the name of the people under the constitution. This makes government ownership and prosperity a national priority to which individual gain is subjected.<sup>246</sup> In this type of market objecting to the government prospering at the expense of the individual shareholders is not tolerated.

Referring to the primary motivators of money and power discussed earlier, these motivators shed a great deal of light on the Chinese securities market. The Chinese government is seeking both essential power and money from its involvement in the securities market. It is seeking power by establishing an insulated securities market which is not foreign investor friendly in order to prevent the same market leverage it has used against countries like the US from being used on itself.

---

<sup>246</sup> See Van Hoecke, *supra* note 5, at 593 (Discussing how western legal cultures are different in the aspect that they are defined by individualism“ By individualism what is meant is a belief in the autonomy and total liberty of the individual in, and possibly against, society. This conception is diametrically opposed to the notion of collectivism, or the idea of the submission of the individual to the community. Here, the individual is considered to be unable to live or develop without being related to his or her society. From this premise even individual liberty is subordinated to the interest of society. Community life based on free will is contrary to a community life imposed or perceived as evident”).

The Chinese government's motivations for seeking money from the securities markets are numerous. For one they simply wish to cut the cost of providing social benefits to the populace. By having an effective control over the supply side of the economy the government can reduce its cost through defeating competition which would increase the costs of goods and services it is required to provide its citizens. Secondly the government is promoting national security by giving it the money it needs to ensure that it will be an effective competitor in international markets for such critical goods as oil. Thirdly it is attempting to prevent civil unrest and provide jobs for its citizens.

The Chinese securities market than is a government piggy bank whose proceeds are used in the national interest in order to promote social stability and keep the CCP in power. This reflects major differences with western markets based on a fundamental ideological difference.

In Western countries, capital markets exist for the benefit of the corporation and ultimately for the shareholder, who uses his share value to presumably increase the quality of life and pay for the basic necessities. In China, capital markets exist for the benefit of the corporation, particularly ones owned by the government, and ultimately for the government itself, who uses its share value to increase the quality of life for all citizens and pay for their basic necessities. Viewed from this perspective, critical analysis of laws affecting Chinese securities markets should shift dramatically.

#### **Part IVC. Suggestions Based on New Paradigm**

Viewing the legal framework of Chinese capital markets through this new paradigm minimizes the effectiveness of advocating for the adoption of Western style

reforms in Chinese capital markets. The Chinese government is well aware of how foreign markets work and likely know exactly what they could do to make theirs a fair and equal market. However, they have not done so, because there is no will to do it. This leaves the paradigm of suggesting western ways to make the market more fair and equal in shatters.

Since the Chinese government is using its domestic markets to increase its competitiveness in the international market and likely has no desire to fix its market, because it would hurt the interest of the Government, options for effective regulation to prevent an unfair advantage in international trade might have to come from outside of China.

The easiest way to impact unfair competition in Chinese domestic markets is investigation and education. Little research has been done on the Chinese government's direct influence in its domestic markets through actual participation. Of course, this information is terribly difficult to come by due to the fact that the Chinese government is able to partially restrict the freedom of press and is certainly not going to be willing to detail its unfair market involvements. Another reason this information is so hard to get is the lack of information made available to researchers in foreign languages. However, empirical evidence must be obtained otherwise mere speculation regarding unfair practices will never induce correction.<sup>247</sup>

There are two additional ways that outside influences might effectively correct the Chinese domestic market; international organizations and direct investment restrictions imposed by individual foreign governments. The default candidate for a

---

<sup>247</sup> See KUHN, *supra* note 4, at 87 (“Since no experiment can be conceived without some sort of theory, the scientist in crisis will constantly try to generate speculative theories that, if successful, may disclose the road to a new paradigm and , if unsuccessful, can be surrendered with relative ease.”).

corrective international organization is the WTO which is the only international body with a dispute resolution mechanism. Actions could be initiated at the WTO to investigate the distortion in the Chinese market and how that gives China an unfair trade advantage over other nations. Specifically, the WTO could recognize that Chinese lax enforcement and participation through organizations like the SASAC constitute a government subsidy. This would allow other countries to take countervailing measures against Chinese goods and thus force the Chinese government to adopt a different strategy for increasing its competitiveness.

However, there are serious flaws with the WTO system which would likely prevent such a large scale effort against one of the most power economic countries on the planet.<sup>248</sup> The scope of the problems with WTO enforcement is beyond the scope of this article. However, it is possible that even if the WTO were to initiate enforcement in certain instances, it is possible that China's economic partners would ignore WTO regulations of China in exchange for beneficial trade agreements, the type of which the WTO is met to prevent.

Another method to counter China's unfair market practices would domestic divestment campaigns. A couple of US states have already passed legislation prohibiting public pension funds from investing in companies deal with terrorist sponsoring countries.<sup>249</sup> Such measures have been taken in the past against countries like South

---

<sup>248</sup> See Sheehy, *supra* note 16, at 227 (noting that the WTO dispute resolution mechanism is "long, drawn out, and requires high-level government involvement"). And at 262 ("it seems unwise to rely on reforms promised under the conditions of accession to the WTO given that the WTO is a matter of national government and policy. Such being the case, these WTO commitments are not likely to have a bearing on individual private enterprise or to address matters of credibility necessary in specific litigation or disputed matters.").

<sup>249</sup> See Gaffney, *supra* note 49.

Africa during apartheid.<sup>250</sup> Of course to have any real impact on China's domestic market such campaign would have to greatly increase in scope to include such things as aiding human rights abuses or unfair market activities which detrimentally affect the US economy.

While there is no obvious solution to the problem of China's inadequate capital market regulation these meager solutions are intended to invoke a sense of how legal scholars can view solutions to Chinese legal reforms as viewed through the new paradigm.

### **Conclusion**

This article has attempted to make the case for a paradigm shift from viewing Chinese capital markets as in need of better Western style reforms to China's unwillingness and inability to pursue such reforms as evidenced by the current intentionally unfair legal framework. With this paradigm shift comes new implications for future legal analysis of Chinese domestic capital markets.

---

<sup>250</sup> *Id.*