

# DANCING WITH WOLVES: Regulation and Deregulation of Foreign Investment in China's Stock Market

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- I. THE PATH OF ECONOMIC GROWTH: CHINA AND THE ROLE OF FINANCIAL MARKETS

Nobel laureate and economist John Hicks suggested that financial markets are one of the causes for the surge in economic growth over the past two centuries, claiming the Industrial Revolution would have been impossible without the concurrent development of financial markets.<sup>1</sup> The World Bank, in its World Development Report, confirmed the finding of Hicks and concluded that financial development has been central to economic growth and poverty reduction.<sup>2</sup>

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

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<sup>1</sup> See HENDRIK VAN DEN BERG, *ECONOMIC GROWTH AND DEVELOPMENT* 290-291 (2001) (citing to JOHN HICKS, *A THEORY OF ECONOMIC HISTORY* (1969)). In Hick's view the Industrial Revolution was characterized by a sharp rise in the use of machinery and other capital goods, which needed to be sustained by large investment. "Such investment in turn required the mobilization of large amounts of saving, which would have been impossible without the creation of liquid financial assets." *Id.* at 291.

<sup>2</sup> See WORLD BANK, *WORLD DEVELOPMENT REPORT 2002*, at 75-76, available at [http://econ.worldbank.org/files/2408\\_61606\\_04\\_ch4.pdf](http://econ.worldbank.org/files/2408_61606_04_ch4.pdf) (last visited Mar. 31, 2004) [hereinafter WDR 2002].

<sup>3</sup> See *id.* at 76.

<sup>4</sup> See *id.* at 75.

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

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

China's stock market was initially launched as an effort to finance its ailing SOEs and to improve their performance through public listing.<sup>9</sup> The Chinese population has been persuaded to commit a significant part of its savings to the securities market.<sup>10</sup> However, like many other developing countries, China had implemented severe restrictions on foreign participation in its capital markets, not only in

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<sup>5</sup> See WORLD BANK, WORLD DEVELOPMENT REPORT 1999/2000, at 83, available at <http://www.worldbank.org/wdr/2000/fullreport.html> (last visited Mar. 24, 2004) [hereinafter WDR 2000].

<sup>6</sup> See *id.* at 84.

<sup>7</sup> According to the World Development Indicators of the World Bank, China's GDP in 2002 was US\$ 1,237 billion, ranking sixth behind the United States, Japan, Germany, France, and the United Kingdom. See WORLD DEVELOPMENT INDICATORS DATABASE: TOTAL GDP 2002, available at <http://www.worldbank.org/data/datatopic/GDP.pdf> (last visited Mar. 24, 2004).

<sup>8</sup> CHINA SECURITIES REGULATORY COMMISSION (CSRC), STATISTICAL REPORT SYSTEM, MONTHLY REPORT ON LISTED COMPANIES, available at <http://www.csrc.gov.cn> (last visited Mar. 24, 2004) (Of the nearly 1,300 listed companies in China's stock markets, only about a hundred of them are privately owned). See also Yinyan Li, *Wang Jue: Guoqi Gaige Reng zai Gongjian* [Wang Jue Says Reform of SOEs is Still Storming Fortifications], ZHONGGUO JINGJI SHIBAO [CHINA ECON. DAILY], Aug. 27, 2003, available at <http://www.szed.com/n/ca392383.htm> (last visited Mar. 24, 2004).

<sup>9</sup> See OECD, CHINA IN THE WORLD ECONOMY 497 (2003).

<sup>10</sup> See *id.*

foreign portfolio investment, but also in securities-related services by foreign intermediaries. Until very recently, the Chinese practice of regulating its securities markets was very restrictive, not only by comparison to countries that are members of the Organization for Economic Cooperation and Development (OECD), which have advanced market economies, but also to its Asian non-OECD neighbors as well.<sup>11</sup>

It appears that the issue of foreign participation deserves a revisit partly because China has accepted substantial commitments for trade in services upon its accession to the World Trade Organization (WTO), thereby expanding the scope of operations permitted to foreign firms, and because China has taken measures to honor those commitments. Recent efforts include the enactment of a variety of new rules allowing foreign firms to invest in the domestic shares market, which was exclusively reserved for Chinese citizens in the past, as well as the ability to acquire and merge with domestic listed companies. In some areas relating to capital markets and securities services, China's bold liberalization measures exceed its obligations under the WTO. The broader context of these efforts include not just WTO compliance, but also a sincere recognition of the fact that enlarged foreign participation can raise the general level of skills in China's capital markets, as well as the determination of its leadership to accelerate privatization of SOEs and to establish a market economy based on private enterprises.

Notwithstanding the recent liberalization measures, foreign institutions are still unable to invest without limit in China's domestic equity markets.<sup>12</sup> In the limited areas in which foreign involvement is allowed, foreign institutions are still effectively excluded from taking full advantage of their legal rights granted by Chinese laws and international legal instruments, particularly the WTO agreements, because of various barriers arising out of China's swaying regulatory culture, the ambiguity of its laws, and the poor corporate governance of many domestic listed companies.

The objective of this article is to describe and critically analyze the existing Chinese regulations on foreign participation in China's stock markets. It also explores the prospect of further liberalization and regulatory reform of Chinese securities regulations. Part II provides background information on China's stock market and introduces the basic features and the evolution of the Chinese securities regulatory framework insofar as foreign investment is concerned. Part III presents a comprehensive description of the legal framework concerning foreign participation in both portfolio investment and intermediate services.

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<sup>11</sup> See *id.* at 525.

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

Part IV examines and critically analyzes the legal barriers and de facto restrictions on foreign participation in China's stock market caused by defects in its regulatory regime as well as the lack of good corporate governance practice in China's listed companies. Part V explores the prospects of further liberalization and perfection of the Chinese regulatory system.

Ultimately, the finding of this article is that, in order for China to make its stock market one of the most successful in the world and meet its WTO obligations, China must substantially improve its regulatory and legal framework and adjust to different regulatory philosophies—including rethinking the role of foreign investors, redefining the role and function of government with the view of providing institutions with a supporting market, and creating an environment of good corporate governance within the listed companies. China will be able to establish a securities regulatory framework consistent with international practice. This, however, depends largely on the success of its reform agenda in key areas of the existing securities and corporate law.

## II. CHINA'S SPINDLING STOCK MARKET AND THE DUALIST REGULATORY REGIME

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

Before the early 1950s, China was once the home to one of Asia's largest stock markets. According to Liu Hongru, the first head of the PRC's regulatory authority on securities markets during the reform era, the first stock market in China, called the Shanghai Stock Market (*Shanghai Gufen Gongsuo*), was created by foreign firms in 1869.<sup>13</sup> In 1918, Japan set up the Shanghai Securities Branch (*Shanghai Quyin Suo*) of the Osaka stock exchange.<sup>14</sup> Two years later, in 1914, the Chinese government enacted laws to govern the Stock Exchange Market.<sup>15</sup> Between 1918 and 1920, China established three large securities

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<sup>13</sup> See ZHONGGUO ZHENGQUAN SHOUCHE [CHINA SECURITIES HANDBOOK] 513-16 (Hongru Liu ed., 1992), cited in Andrew Xuefeng Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging of Securities Regulatory Regime in China*, 12 UCLA PAC. BASIN L.J. 62, 64 nn. 6-8 (1993) [hereinafter CHINA SECURITIES HANDBOOK]. *Contra* William Goetzmann, Andrey Ukhov & Ning Zhu, *China and the World Financial Markets 1870-1930: Modern Lessons from Historical Globalization*, Yale International Center for Finance Working Paper No. 00-62 (Oct. 2001), at 7, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=289139](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=289139) (last visited Mar. 30, 2004) (finding China's first stock exchange, named Shanghai Share Broker's Association, was founded in 1891).

<sup>14</sup> See CHINA SECURITIES HANDBOOK, *supra* note 13, at 513-514.

<sup>15</sup> See *id.*

markets.<sup>16</sup> Stock of Chinese enterprises was first issued in 1872 by the Shanghai General Bureau of Shipbuilding and Commerce.<sup>17</sup> The securities markets were interrupted by both the Sino-Japanese War, beginning in the 1930s, and later, World War II.<sup>18</sup> In 1946, the Nationalist government set up the Shanghai Securities Exchange.<sup>19</sup> During the 1940s, the Shanghai Securities Exchange was the largest stock exchange in Asia and was more influential and internationally supported than that of Hong Kong.<sup>20</sup> In 1949, the Communist Party attained supreme political control over mainland China, establishing the People's Republic of China, and soon after began to institute a centrally planned economy, which would eliminate securities activities altogether along with all other forms of private ownership by 1959.<sup>21</sup> As a result, for approximately 30 years, from the 1950s to 1980s, there was no securities market in China.

Reintroduction of stock companies and the stock market was considered during the "Reform and Opening Up" era initiated by China's then paramount leader Deng Xiaoping, which featured an agenda of market-oriented reform of the flailing centrally-planned economic system. Restructuring the economy generated more and more capital needs, which could not be met by the traditional sources—collecting funds and taxes from state-owned enterprises. In addition, fed up with the poor performance of SOEs, the Chinese leadership saw capital markets as an alternative to construct new types of corporate entities.

The OECD, in a recent study on the development of China's economy, observes that the growth of Chinese capital markets, in which the stock market has been an indispensable part from the outset, proceeded through three stages: a formative period in the late 1970s to 1980s; the emergence of more formal structures including stock exchanges and a regulatory regime in the early 1990s; and additional

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<sup>16</sup> See CHINA SECURITIES HANDBOOK, *supra* note 13, at 513-514.

<sup>17</sup> See *id.* at 513-514.

<sup>18</sup> See *id.* at 514-516.

<sup>19</sup> See *id.*

<sup>20</sup> See Ann Vandeveld, *Realizing the Re-Emergence of the Chinese Stock Market: Fact or Fiction?* 30 VAND. J. TRANSNAT'L L. 579, 583 (1997) (noting that "Shanghai was then one of the most important capital markets in Asia, with a strong domestic and international banking sector and a vigorous market for domestic and foreign stocks and bonds." *Id.*).

<sup>21</sup> See Minkang Gu & Robert Art, *Securitization of State Ownership: Chinese Securities Law*, 18 MICH. J. INT'L L. 115, 117 (1996).

reforms after the 1997 Asian crisis.<sup>22</sup>

The first stage was featured with informal markets in company stocks for which initiatives, including both issuing and trading, came from enterprises themselves or from local governments without the approval of the central government in Beijing.<sup>23</sup> Many collective firms issued debentures and internal employee shares.<sup>24</sup> In 1984, China officially began experimenting with the idea of establishing joint stock companies, which started in Beijing where a department store was given permission to issue shares to its employees.<sup>25</sup> The capital markets evolved more rapidly than the government anticipated, as firms sought new ways to raise capital and find residents to invest.

Government regulation of the market activities, therefore, came only after the fact. At first, Beijing did not allow the bonds and stocks issued to be tradable. Secondary markets, however, developed underground creating a “black-market” due to the lack of official approval. Eventually the government acknowledged this practice and endorsed it with formal sanctions.<sup>26</sup>

Two securities exchanges were established in the early 1990s, one in Shanghai, the other in Shenzhen, thrusting China’s stock market into its second stage.<sup>27</sup> This stage, early on, was contaminated by stock market “fever” which broke out in southeast China in 1992.<sup>28</sup> The fever was ignited by Deng Xiaoping’s southern tour in which he declared that China would replace its planned economy with a market economy and encouraged people to boldly conduct economic experiments in every aspect of the economy, irrespective of the socialistic or capitalistic nature

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<sup>22</sup> See OECD, *supra* note 9, at 499.

<sup>23</sup> See *id.*

<sup>24</sup> See *id.*

<sup>25</sup> See SALLY HARPOLE, CHINA BUSINESS LAW GUIDE, ¶38-310 (CCH International, 1993); see also Xiaonian Xu & Yan Wang, *Ownership Structure, Corporate Governance, and Firms’ Performance: The Case of Chinese Stock Companies*, World Bank Policy Research Working Paper No. 1794 (1997), at 6, available at <http://econ.worldbank.org/docs/556.pdf> (last visited Mar. 24, 2004).

<sup>26</sup> See DANIEL LAPRES & YUEJIAOZHANG, BUSINESS LAW IN CHINA 338 (ICC Publication No. 576, 1997).

<sup>27</sup> The Shanghai Securities Exchange opened in December 1990. See CHENGXI YAO, STOCK MARKET AND FUTURES MARKET IN PEOPLE’S REPUBLIC OF CHINA 39, 50 n.150 (1998) (citing to CSRC, CHINA SECURITIES MARKET YEARBOOK 88 (1994)). The Shenzhen Securities Exchange was established in December 1990. See INTRODUCTION, SHENZHEN STOCK EXCHANGE WEBSITE available at [http://www.szse.cn/main/en/catalog\\_1378.aspx](http://www.szse.cn/main/en/catalog_1378.aspx) (last visited Mar. 31, 2004).

<sup>28</sup> See OECD, *supra* note 9, at 499.

of the economic activities.<sup>29</sup> The fever was short-lived. The institutions, nevertheless, were gradually established during this stage.

In the third stage, the central government's attitude toward capital markets changed significantly in the sense that corporatization was regarded as a major solution to the problems created by SOEs for which other mechanisms turned out to be futile. In late 1996, the central government determined that transformation of SOEs through public issuance of equity shares as well as the stock market itself should be promoted as part of the restructuring program for these industries.<sup>30</sup>

The second and third stages also featured the construction of a formal legal and regulatory framework for the securities sectors. China did not have a specialized central agency to regulate securities markets until the early 1990s; as such, overlapping authorities regulating securities co-existed for several years. Authorities such as the People's Bank of China, the Ministry of Finance, the State Planning Commission, the State Commission for Restructuring the Economic System, the State Administration for Industry and Commerce, and numerous local governments all had issued norms governing different or similar activities in the securities markets.<sup>31</sup> Confusion and conflict ultimately led to the creation of a centralized body to regulate the market.

The formation of the State Council Securities Committee (SCSC) and China Securities Regulatory Commission (CSRC) in 1992 marked the first effort to establish unified regulatory control over the market. The SCSC was charged with the primary authority for market regulation. The CSRC was designed as the SCSC's executive organ, responsible for conducting supervision and regulation of the market in accordance with

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<sup>29</sup> Deng said in this tour, "We should be bolder than before in conducting reform and opening to the outside and have the courage to experiment." In responding to someone's fear of bold experiment would lead to capitalism, Deng said, "The chief criterion for making a judgment should be whether it promotes the growth of productive forces in a socialist society, increases the overall strength of the socialist state and raises living standards." As to repealing of the planned economy, Deng said, "The proportion of planning to market forces is not the essential difference between socialism and capitalism. A planned economy is not equivalent to socialism... a market economy is not capitalism, because there are markets under socialism too." As to securities markets, he said, "Are securities and the stock market good or bad? . . . Are they peculiar to capitalism? Can socialism make use of them? We allow people to reserve their judgment, but we must try these things out." Excerpts from Addresses delivered by Deng Xiaoping in Wuchang, Shenzhen, Zhuhai and Shanghai (January 18-February 21, 1992), available at <http://www.peopledaily.com.cn/english/dengxp/vol13/text/dl200.html> (last visited Nov. 10, 1999, on file with author).

<sup>30</sup> See OECD, *supra* note 9, at 499.

<sup>31</sup> See SANZHU ZHU, SECURITIES REGULATIONS IN CHINA 8-13 (2000).

powers delegated by the SCSC.<sup>32</sup> In April 1998, pursuant to the ambitious State Council Reform Plan launched by Premier Zhu Rongji, the SCSC was repealed and the CSRC became the sole ministry under the State Council with the duty to supervise the securities markets.

China has also promulgated a formidable body of securities laws. Since 1987, various authorities have released several hundreds of norms and regulations governing the issuance and transaction of securities.<sup>33</sup> Among those laws the most important are the Company Law<sup>34</sup> and the Securities Law<sup>35</sup> of the People's Republic of China. The Company Law regulates the establishment, operation, internal management and dissolution of limited liability companies and stock companies. In terms of securities regulations, it covers the rights and obligations of shareholders, powers and responsibilities of directors, financial and accounting requirements for companies, as well as corporate termination and liquidation. The Securities Law is the primary regulation on market oversight and operation, governing registration and public issuance of shares, secondary market transactions, disclosure, insider trading, mergers and acquisitions, as well as the behavior of stock exchanges and securities firms. Supplemental to that are numerous decrees issued by the CSRC and other authorities (such as the Ministry of Finance, Ministry of Commerce, etc.) concerning detailed rules or specialized areas of stock market activities.

### B. *Special Features of China's Stock Market*

The Chinese stock market is unique among dozens of its peers around the world. A recent report by Sheldon Gao, Senior Director of the Dow Jones Indexes, identified fourteen key features of China's stock market using the Dow Jones Global Index and Dow Jones China Index as tools.<sup>36</sup> Some of these features, because of their strong relevance to the perfection of the regulatory regime, are worth noting and are

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<sup>32</sup> See CSRC, *A Brief Introduction of China Securities Regulatory Commission*, available at <http://www.csrc.gov.cn> (last visited Nov. 10, 2003, on file with author).

<sup>33</sup> See Jie Sun, *Zhejianghui Zhuxi Zhou Zhengqing Fangtan* [Interview with CSRC Chairman Zhou Zhengqing], in *ZHONGGUO ZHENGQUAN SHIBAO* [CHINA SECURITIES DAILY], Dec. 30, 1998, at 1.

<sup>34</sup> COMPANY LAW OF THE PEOPLE'S REPUBLIC OF CHINA (Adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress, Dec. 29, 1993), available at LEXIS PRCLEG 641.

<sup>35</sup> SECURITIES LAW OF THE PEOPLE'S REPUBLIC OF CHINA (Adopted at the 6th Meeting of the Standing Committee of the Ninth National People's Congress, Dec. 29, 1998), available at LEXIS PRCLEG 1084.

<sup>36</sup> See Sheldon Gao, *China Stock Market in Global Perspective*, DOW JONES INDEXES (Sept. 2002). [hereinafter Gao, Dow Jones Report]

discussed below.

(1) Abnormal performance: Since the inception of two stock exchanges in the early 1990s, the Chinese stock market has delivered impressive returns in most years so far. The Dow Jones Report showed that, during the eight-year period from 1994 through 2001, as measured by the Dow Jones China Index consisting of 549 stocks as of January 31, 2002,<sup>37</sup> China's stock market outpaced many of the world's leading indexes, including the Dow Jones STOXX 600 on European markets, Hong Kong's Hang Seng Index, Japan's Nikkei 225, as well as the Dow Jones World Emerging Markets Index covering eleven emerging markets around the world.<sup>38</sup> The performance, however, could only be characterized as "abnormal" because it is not based on the performance of the listed companies and China's economy as well.<sup>39</sup>

(2) An insulated market: As this article will discuss in the following part, China's stock market divides its shares into a variety of types.<sup>40</sup> Class A shares are restricted to domestic investors.<sup>41</sup> Foreign investors originally were only allowed to buy and trade (with restrictions) the so-called "B shares." Only recently, a small number of investors in the two markets have been allowed to participate in both markets.<sup>42</sup> It is alleged that market segregation plus the foreign exchange control regime helped China to protect its economy against foreign harassment during the Asian financial crisis of 1997.<sup>43</sup> However, in recent years, segregation is increasingly viewed as a barrier between China's capital markets and international investors.<sup>44</sup>

(3) Substantial government ownership and China's low float ratio: The free-float ratio represents a stock market's liquidity and investability, and refers to the proportion of freely tradable shares available to investors.<sup>45</sup> Due to widespread state ownership, the float

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<sup>37</sup> See Gao, Dow Jones Report, *supra* note 36, at 6.

<sup>38</sup> *Id.*

<sup>39</sup> See *id.* Vivid evidence is that since 2001, the Chinese stock market has been grim despite the fact that China's economy has been experiencing explosive GDP growth. *Id.*

<sup>40</sup> See discussion *infra* Part II.C.1.

<sup>41</sup> See Gao, Dow Jones Report, *supra* note 36, at 12.

<sup>42</sup> See discussion *infra* Part II.C.1.

<sup>43</sup> See Gao, Dow Jones Report, *supra* note 36, at 12.

<sup>44</sup> See *id.*

<sup>45</sup> See Gao, Dow Jones Report, *supra* note 36, at 14.

ratio in China's stock market, close to 30 percent since 1993, appears to be extremely low.<sup>46</sup> Although things have been changing due to recent regulatory relaxation allowing foreign investors to have greater participation in SOEs,<sup>47</sup> in most listed companies which were converted from SOEs, only one-third of the company's shares are typically issued to the public, with the rest remaining in the hands of the government, the company itself, or other state-owned companies.<sup>48</sup> According to a Dow Jones survey, the average government ownership in China's stock market was 45 percent, as of January 31, 2002, with a maximum of 89 percent.<sup>49</sup> Such a high percentage of state ownership does not exist in any other stock market in the world.<sup>50</sup>

(4) Irregular expansion primarily through IPOs: The size of a stock market expands through either external expansion, which refers to the issuance of new shares such as Initial Public Offerings, secondary offerings and follow-up offerings, or internal growth, which is the appreciation of existing shares.<sup>51</sup> While in most other places in the world stock markets expand through internal growth,<sup>52</sup> in China the opposite has been true. Since the early 1990s, the total market value grew at an annual rate of 47.4 percent, but only 16.9 percent was contributed by an increase in the value of the existing stocks.<sup>53</sup> In other words, almost two-thirds of the market growth was the result of external expansion; the significance is that the return on existing stocks is substantially weakened despite the amazing expansion of market size.

(5) An emerging market embodied by confusing and restrictive regulations: Due to lack of regulatory experience, rule of law, and of fully developed market economy, China's stock market possesses many of the features that are characteristic of emerging markets.<sup>54</sup> First, there

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<sup>46</sup> One can appreciate the extremity of China's stock market in float ratio by contrasting it with that of other markets: the ratio in the U.S. is 93.9 percent, in Europe 78.7 percent, and in Japan 79.6 percent. See Gao, Dow Jones Report, *supra* note 36, at 14-15.

<sup>47</sup> See discussion *infra* Part III.

<sup>48</sup> See Gao, Dow Jones Report, *supra* note 36, at 15.

<sup>49</sup> See *id.* at 16.

<sup>50</sup> See *id.*

<sup>51</sup> See Gao, Dow Jones Report, *supra* note 36, at 17.

<sup>52</sup> For instance, during the years from 1993 to 2001, 84 percent of the market growth was the result of internal growth while only 16 percent came from new issuance of stocks in the U.S. stock market. See *id.* at 18.

<sup>53</sup> See *id.*

<sup>54</sup> See Gao, Dow Jones Report, *supra* note 36, at 21.

are too many types of shares to confuse investors.<sup>55</sup> In addition to the well-known “A shares” and “B shares,” there are several additional classes available to global investors and denominated in free exchangeable currencies, such as the H, N, L, and S shares listed in Hong Kong, New York, London and Singapore, respectively.<sup>56</sup> Secondly, initial public offerings are strictly regulated in China.<sup>57</sup> China is identified by the Dow Jones Report as “the only country in which the government completely controls the size of the stock market, the pace of issue and the allocation of resources.”<sup>58</sup> Thirdly, the market is predominated by small-cap stocks rather than blue-chip companies, in both absolute size and in relation to the rest of the world, due to the fact that most of China’s blue-chips are listed only on overseas exchanges and are not available to domestic investors.<sup>59</sup> Fourthly, the market is dominated by retail investors.<sup>60</sup> Institutional investors are underdeveloped in China’s stock market. Finally, contrary to the global trend of consolidating multiple exchanges within the same jurisdiction into one exchange structure, China has two stock exchanges of similar size, performing virtually the same functions in every aspect.<sup>61</sup>

(6) Pyramid structure and an unusual “core”: A matured stock market is typically supported by a group of blue-chip companies that acts as the “core” or backbone of the market structure.<sup>62</sup> Such a market “is generally shaped like a top-heavy gyroscope or funnel—a few of these blue-chip companies may easily represent a huge chunk of the market or dominate the benchmark index’s movement.”<sup>63</sup> The numerous small-cap companies, at the bottom of the market structure, are relatively insignificant. But in China, the stock market lacks real blue-chip stocks with high profitability and, as such, investors are overwhelmed with small-caps.<sup>64</sup>

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<sup>55</sup> See Gao, Dow Jones Report, *supra* note 36, at 21.

<sup>56</sup> See *id.*

<sup>57</sup> See *id.* at 22.

<sup>58</sup> See Gao, Dow Jones Report, *supra* note 36, at 22.

<sup>59</sup> See *id.* at 22.

<sup>60</sup> See *id.*

<sup>61</sup> See *id.* at 23.

<sup>62</sup> See Gao, Dow Jones Report, *supra* note 36, at 24.

<sup>63</sup> See *id.* at 24-25.

<sup>64</sup> For instance, the Dow Jones Report identified only one company listed in China as a large stock, Shenzhen Development Bank, and 130 companies as mid-cap

(7) Incredible speculation: In a developed stock market, because investors have more confidence in the long-term economic prospects and the steady growth of corporate profits, the turnover level, which represents the frequency of trading or the length of holding period, is generally lower.<sup>65</sup> Data demonstrates that the average turnover in China's stock market was 500 percent, indicating that an individual stock changed hands five times a year on average.<sup>66</sup> The average holding period is two months. By contrast, in a mature market, the normal holding period for a stock is about two years.<sup>67</sup> This suggests that the spirit of speculation is extremely strong and widespread. As the Dow Jones Report observes, "The fundamental truth is that the investing environment of China's stock market simply does not encourage long-term investment strategies."<sup>68</sup>

(8) Disappointing earnings of companies and low dividend yield: The phenomenon of incredible speculation could be explained by the lack of "core" blue-chip companies in the market as well as by the poor performance of listed companies in terms of making profits and distributing dividends. The fact that most companies posted low earnings, despite the abnormal performance of the market, leads to the recognition of the size of the bubble in China's stock market.<sup>69</sup> At least, it is indisputable that most stocks are seriously overvalued.<sup>70</sup> Cash dividend distribution, which plays a crucial role in long-term investment,<sup>71</sup> appears not to be so important in the Chinese stock market, albeit the law requires that no company could make a follow-up or secondary offering unless it pays a cash dividend (which helps the market's payout percentage to stay within a reasonable range).<sup>72</sup> However, China's dividend yield (0.75 percent only) is terribly low in comparison with the rest of the world as well as with other investment vehicles in China including the CD rate and bond rate.<sup>73</sup> To be sure, the

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stocks. Over 1,000 remaining companies are classified as small-cap or micro-cap companies. See Gao, Dow Jones Report, *supra* note 36, at 22.

<sup>65</sup> See *id.* at 36.

<sup>66</sup> See Gao, Dow Jones Report, *supra* note 36, at 36.

<sup>67</sup> See *id.*

<sup>68</sup> See *id.* at 37.

<sup>69</sup> See *id.* at 40.

<sup>70</sup> See *id.*

<sup>71</sup> See Gao, Dow Jones Report, *supra* note 36, at 44.

<sup>72</sup> See *id.*

<sup>73</sup> *Id.* at 45.

low payout percentage and dividend yield are rooted in the poor earnings of listed companies.<sup>74</sup>

In brief, as the Dow Jones Report has indicated, the current plight of the Chinese stock market is marked by a number of structural flaws, of which the most telling obstacle is the pyramid structure,<sup>75</sup> accompanied by confusion in its regulatory policies. These features certainly have a tremendous impact on foreign participation in China's stock market.

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

As noted previously, the original goal of the Chinese government for developing securities markets was two-fold: to mobilize private saving in order to finance SOEs, and to improve SOE performance through public participation.<sup>76</sup> Seemingly, foreign participation was not conceived as needed at the outset of the development of China's stock market. Desires for international participation, which came from both Chinese domestic enterprises in certain sectors that were in dire need of both foreign investment and the legal status as listed companies, and foreign investors who wished to participate in China's capital markets, pressed the government to create room for foreign participation in the stock market in the early 1990s. The opening up of the Chinese stock market started with the creation of a domestic B shares market which, until very recently, was only available to foreigners. This was followed by the construction of a parallel regulatory framework for foreign portfolio investment, mergers and acquisitions with foreign companies, and market access to foreign intermediaries business.

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

Though both the Company Law and Securities Law are curiously silent on the classification of corporate stocks, it remains the most distinctive feature of Chinese securities markets. The stock, in addition to its universal classification as common stock, preferred stock, etceteras, is also defined by the status and nationality of its shareholders.<sup>77</sup> There

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<sup>74</sup> See Gao, Dow Jones Report, *supra* note 36, at 46.

<sup>75</sup> See *id.* at 47.

<sup>76</sup> See OECD, *supra* note 9, at 497.

<sup>77</sup> In a developed capitalist market the idea is that "all shares are equal." Nevertheless, there are also different types of stocks which are, most commonly, common and preferred shares. The distinction between these two classes arises as a

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

**State Shares (*Guojia Gu*):** State shares refers to shares held by central governmental agencies, local governments, or authorized institutions on behalf of the State. According to relevant regulations, it shall include: the shares converted from the net assets of SOEs that have been transformed into stock companies; shares initially issued by various companies and purchased by central or local governmental departments investing on behalf of the State; and shares initially issued by companies and purchased by investment companies, asset management companies, and economic entities authorized to make investments on behalf of the State.<sup>78</sup> State shares are not allowed for trading on open markets such as a stock exchange or an Over-the-Counter (OTC) market. Nevertheless, they can be transferred upon approval of the CSRC and the State Assets Supervision and Administration Commission (SASAC). Sales of state shares to foreign investors have been allowed recently as a result of a post-WTO reform program.<sup>79</sup>

**Legal Person Shares (*Faren Gu*):** Referring to shares of a stock company owned by another company or organization with a "legal person" status,<sup>80</sup> the legal person shares can be indirectly held by the State if the shareholders are State-owned companies.<sup>81</sup> Basically, this class includes shares held by domestic entities in which the state is the majority owner but has not the entire ownership.<sup>82</sup> There are four types

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result of the investors' dividend expectations, voting rights and priority in liquidation. Apart from these differences, shareholders of each class of shares are entitled to equal rights and equal benefits, irrespective of their origin and citizenship. See William Friedman, *One Country, Two Systems: The Inherent Conflict between China's Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT'L L. 477, 495 (2002).

<sup>78</sup> See Liufang Fang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149, 203 (1995).

<sup>79</sup> See discussion *infra* Part III.C.

<sup>80</sup> Like many other civilian jurisdictions, legal persons, under Chinese law, are collective organizations considered by the law as having a legal personality distinct from the natural individuals. Legal persons, thus, are subject to the law with the attribution of legal capacity and may possess both rights and duties. Companies, public or private entities or public bodies can become legal persons through appropriate registration under the law.

<sup>81</sup> See Fang, *supra* note 78, at 204.

<sup>82</sup> See Xu & Wang, *supra* note 25, at 7. See also OECD, *supra* note 9, at 512.

of ownership for legal person shares, namely, state-owned legal person shares, collective enterprise legal person shares, private enterprise legal person shares, foreign invested enterprise legal person shares, and institutional legal person shares.<sup>83</sup> Trading of legal person shares through stock exchanges is prohibited, albeit this can be done upon case-by-case approval from relevant authorities. Like state shares, legal person shares can be sold to foreigners according to several laws issued after China's accession to the WTO.<sup>84</sup>

**A Shares or Individual shares (*Geren Gu*):** Individual shares, with an official recognized nickname of "A shares," refer to shares that may only be owned by Chinese residents (including domestic institutions). A shares resemble classic stock, and may be freely traded and transferred within domestic markets. For a long time until very recently, these shares were the only type of equity that were traded among domestic investors at the two stock exchanges and were not accessible to foreign investors.<sup>85</sup>

**B Shares or Foreign Capital Shares (*Waizi Gu*):** Foreign capital shares include B shares and overseas listing shares. B shares are shares which were originally offered exclusively to international investors.<sup>86</sup> Like other shares, they are denominated in RMB, but Chinese citizens until 2001 were not permitted to own or trade in B Shares.<sup>87</sup>

In addition, overseas listing shares are shares issued by Chinese companies listed on securities markets outside mainland China. Though subject to CSRC regulations insofar as initial approval is needed for the companies to go abroad, they are not part of the Chinese securities market but rather components of the stock markets in which they are listed and traded. They currently include H shares, N shares, L shares and S shares. H shares are offered by Chinese companies listed on the Hong Kong Stock Exchange. They are subscribed for and traded in Hong Kong Dollars, and denominated in RMB. They can only be purchased and traded by Hong Kong local investors or international investors.<sup>88</sup> N shares are issued to foreign investors on U.S. stock exchanges. Some of them are issued through IPOs but many others are denominated in RMB and subscribed for in U.S. dollar. Dividends are

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<sup>83</sup> See Fang, *supra* note 78, at 204.

<sup>84</sup> See *infra* Part III.C.

<sup>85</sup> See *infra* Part III.A.

<sup>86</sup> See *id.* (for further discussion of the China's current regulations on foreign investment in the B Shares market).

<sup>87</sup> See *infra* note 107 and accompanying text.

<sup>88</sup> See I. A. TOKLEY & TINA RAVN, COMPANY AND SECURITIES LAW IN CHINA 71 (1998).

declared in RMB but paid in U.S. dollars. As such, many N shares are not traded directly on stock exchanges but were issued by way of American Depository Receipts (ADRs).<sup>89</sup> L shares are issued on the London Stock Exchange according a Memorandum of Understanding signed between U.K. and China's relevant authorities on October 7, 1996.<sup>90</sup> S shares are offered on the Singapore Stock Exchange.

A typical domestically listed Chinese company normally has a mixed ownership structure, in which each of the three major groups (state, legal persons, and individuals) holds about one third of total outstanding shares.<sup>91</sup> The structure becomes more complex as many companies now also issue B shares to foreigners and Chinese residents. Normally those overseas listed Chinese companies have not yet entered into the stock market of their home country. In any case, only one-third of the shares in state-owned companies are tradable according to law.

## 2. The Dualist Regulatory System

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

It is not entirely clear whether foreign investment is also subject to the various laws supposed to be promulgated for domestic companies and transactions. In essence, the Securities Law applies to the issuing and trading of shares, corporate bonds and other securities "as lawfully recognized by the State Council within China."<sup>92</sup> Conceivably, the law governs foreign investment-related securities such as B shares since they are "lawfully recognized" by the central government. However, it has also to be made clear that "specific measures in respect of shares of companies in China which are to be subscribed and traded in foreign currencies by persons and institutions outside China shall be separately formulated by the State Council."<sup>93</sup>

The implication is not that shares of Chinese companies reserved

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<sup>89</sup> See TOKLEY & RAVIN, *supra* note 88, at 72.

<sup>90</sup> *Id.*

<sup>91</sup> See Xu & Wang, *supra* note 25, at 8.

<sup>92</sup> See P.R.C. SECURITIES LAW, *supra* note 35, art. 2.

<sup>93</sup> *Id.* art. 213.

for foreign investment (B shares) and overseas listing shares (H shares or N shares) are to be governed entirely by a separate set of regulations made by the State Council. Instead, regulations on foreign investment are regarded as “specific,” “special,” or even “exceptional” measures on foreign participation, supplemental to the major laws on securities as an entirety. For instance, the specific law on B shares promulgated by the State Council in 1995 states clearly that the laws “are formulated in accordance with the relevant provisions of the Company Law of the People’s Republic of China,”<sup>94</sup> implying that it is still within, rather than separate from, the framework of the Company Law.

Another example is the rules concerning mergers and acquisitions. In 2002 and 2003, China promulgated a variety of laws regulating mergers and acquisitions, with a special emphasis on takeovers of Chinese companies by foreign investors. Four of the five major laws promulgated by various ministries are concerned with foreign takeovers, and two contain rules regarding takeovers and disclosure in general, without making specific reference to purely domestic or foreign-related transactions. However, one provision of a leading law on foreign takeover stipulates that when transferring state shares and legal person shares, foreign investors shall also comply with relevant CSRC rules on takeovers and disclosure,<sup>95</sup> thus indicating that foreign-related transactions are subject to those general laws.

To summarize, although it is not explicitly established in the relevant laws, the dualist nature of the Chinese securities regulatory framework shall be understood as such, namely that regulations on foreign investment in China’s stock market serve as “special” laws to the general framework, whose provisions shall take precedent to relevant provisions of general laws in cases in which there is overlap or conflict. For matters not stipulated in foreign investment-specific laws, the provisions of general laws (such as the Securities Law or the Takeover Measures<sup>96</sup>) shall be followed.

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<sup>94</sup> See Guowuyuan Guanyu Gufen Youxian Gongsi Jingnei Shangshi Waizi Gu de Guiding [Provisions of the State Council on Foreign Capital Stocks Listed in China by Joint Stock Limited Companies] (Adopted at the 37<sup>th</sup> Executive Meeting of the State Council on Nov. 2, 1995, Promulgated by Decree No. 189 of the State Council, Dec. 25, 1995) art. 1, *available at* [http://www.ec.com.cn/english/Laws\\_list\\_997.shtml](http://www.ec.com.cn/english/Laws_list_997.shtml) (last visited Apr. 4, 2004) [hereinafter B Shares Regulations].

<sup>95</sup> See Foreign Acquisition Rules, *infra* note 136, art. 4.

<sup>96</sup> See Takeover Measures, *infra* note 133.

### III. CURRENT REGULATIONS ON FOREIGN PARTICIPATION IN CHINA'S STOCK MARKET

As noted previously, China's equity markets are connected to the international markets through a variety of channels. Originally the B shares market was only accessible to global investors. In recent years, as a result of China's WTO commitments and compliance efforts, foreigners have gained more ground in the capital markets as well as in the securities services business. Recent movements include the allowance of foreign institutional investors to buy and trade in A shares, more flexibility for takeovers of Chinese companies by foreigners, as well as greater market access for foreign securities business.<sup>97</sup>

#### A. *The B Shares Market*

Coming into existence in 1991,<sup>98</sup> the B shares market perfectly reflected PRC leadership's mixed feelings regarding the internationalization of the securities markets, namely, making use of foreign capital without shaking socialist public ownership. B shares are governed by mainly two regulations promulgated by the State Council and the CSRC, which are the B Shares Regulations<sup>99</sup> and the Circular of the Securities Commission of the State Council Concerning Issuing the Rules for the Implementation of the Provisions on Domestically-listed Foreign Capital Stock of Joint Stock Limited Company (hereinafter "B Shares Implementing Rules").<sup>100</sup> Pursuant to these two laws, B shares present the following features (as opposed to A shares which are similar in terms of functions to common stocks in a Western stock company).

First, B shares are denominated in Chinese currency (Renminbi), but are subscribed for, bought and sold in foreign currency, and listed

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<sup>97</sup> Until mid-2002, there had been severe limitations on foreign participation of any kind in the Chinese capital markets. See OECD, *supra* note 9, at 525-526.

<sup>98</sup> See Zhu, *supra* note 31, at 127. At the inception they were officially referred to as *Renminbi tezhong gupiao* [Renminbi special shares], nicknamed as "B shares." See *id.* With the enactment of the 1995 B Shares Regulations, both "B shares" and *jingnei shangshi waizi gu* [domestically listed foreign capital shares] were used in official documents. *Id.*

<sup>99</sup> See *supra* note 94.

<sup>100</sup> See Gufen Youxian Gongsi Jingnei Shangshi Waizi Gu de Guiding de Shishi Xize [Circular of the Securities Commission of the State Council Concerning Issuing the Rules for the Implementation of the Provisions on Domestically-listed Foreign Capital Stock of Joint Stock Limited Company], ZhengWeiFa No. 9, May 3, 1996, available at [http://www.ec.com.cn/english/Laws\\_list\\_996.shtml](http://www.ec.com.cn/english/Laws_list_996.shtml) (last visited Apr. 4, 2004) [hereinafter B Shares Implementing Rules].

and traded on securities exchanges in China.<sup>101</sup> Dividends and other payments by the issuing company shall be calculated and declared in Renminbi but paid in foreign currency.<sup>102</sup> Second, B shares could only be issued to overseas investors, which, according to the Chinese definition, shall include foreigners, natural and legal persons from Taiwan, Hong Kong and Macao, and Chinese citizens that are residing abroad.<sup>103</sup> Chinese investors in mainland China were not allowed to buy and trade in B shares. Third, dividends and capital gains from B shares can be sent abroad freely despite China's strict foreign exchange control.<sup>104</sup> Fourth, foreign securities firm can serve as dealers of B shares while they were not allowed to do the business of A shares. The two stock exchanges could enact rules to stipulate the requirements for foreign securities firms to enter into agency agreements with Chinese partners or to act as dealers in trading B shares.<sup>105</sup> The first foreign securities firm to enter China's securities markets was Morgan Stanley & Company, which established a joint venture entitled China International Capital Corporation with China Construction Bank and several other partners in 1995.<sup>106</sup>

Until early 2001, the B shares market was off-limits to individual and institutional Chinese investors. This policy was changed by a government decree released in February 2001, which allows domestic individual investors to buy and trade B shares.<sup>107</sup> Nevertheless, B shares are still only subscribed in foreign currency and, as such, Chinese investors have to use the foreign exchange reserve in their banking accounts to buy those shares.<sup>108</sup> The original purpose for the creation of

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<sup>101</sup> See B Shares Regulations, *supra* note 94, art. 3.

<sup>102</sup> *Id.* art. 25. Accordingly, a foreign exchange rate should be stated in the prospectus of the issuing company, or decided by a resolution of shareholders' meeting. See B Shares Implementing Rules, *supra* note 100, art. 41.

<sup>103</sup> See B Shares Regulations, *supra* note 94, art. 4.

<sup>104</sup> *Id.* art. 5

<sup>105</sup> B Shares Implementing Rules, *supra* note 100, art. 33.

<sup>106</sup> See Dave Lindorff, *In Beijing, the Long March is Just Starting*, BUS. WK., Feb. 12, 1996, at 68.

<sup>107</sup> See Zhongguo Zhengquan Jiandu Guanli Weiyuanhui, Guojia Waihui Guanli Ju, Guanyu Jingnei Jumin Geren Touzi Jingnei Shangshi Waizi Gu Ruogan Wenti de Tongzhi [Circular of the China Securities Regulatory 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) available at LEXIS PRCLEG 1739. [hereinafter B Shares Circular on Chinese Investors].

<sup>108</sup> See *id.* art. 2.

the B shares market was to open two windows for Chinese capital markets. One window was designed as a channel to help a small number of Chinese SOEs obtain scarce foreign currency, and the other was expected to demonstrate to foreigners China's resolve to open up its economy.<sup>109</sup>

Despite the poor performance of the B shares market, Chinese regulators have used many measures to boost the market, of which the most recent one was to channel the foreign currencies holdings of private citizens into the market. This move, unexpectedly, destructed the original purpose underpinning the B shares regime. In fact, the B shares market has been significantly marginalized—in the three years following the end of 2001, no single company was approved to issue B stock in the market.<sup>110</sup> More telling is the size of the market. Despite many years of development, the B shares market remains small in terms of both the number of listed companies and market capitalization.<sup>111</sup>

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

#### B. *Qualified Foreign Institutional Investors (QFII)*

It is said that within Asian countries, liberalization of capital markets has typically proceeded through three stages, including an initial permission of limited entry of foreign capital into the market, then an opening of domestic markets to foreign institutional investors, and

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<sup>109</sup> See Kejian Chao et al., *Huifu Rongzi Gongneng, Zhengxing B Gu Shichang* [Restore the Financing Functions of and Boost the B Shares Market], in SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES DAILY] (Oct. 31, 2003), available at <http://business.sohu.com/77/72/article215027277.shtml> (last visited Mar. 27, 2004).

<sup>110</sup> In November 2003, Shanggong Stock Company obtained the approval of the CSRC to issue B shares to 14 foreign institutions. This was the first approval of issuance since the end of 2001. See *Shanggong Gufen Youxian Gongsi Faxing Jingnei Shangshi Waizi Gu (B Gu) Zhaogu Shuoming Shu Zhaiyao* [Prospect of Shanggong Stock Company for the Issuance of B Shares], Nov. 5, 2003, in SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES DAILY], available at <http://www.stocknews.com.cn> (last visited n.d., on file with author). See also Jinfu Zhu, *Shanggong B Gu Qiaokai Rongzi Zhi Men, B Gu Shichang Mianlian Chongxin Dingwei* [Shanggong B Shares Opened the Doors for Financing; B Shares Market Needs Reposition Itself], in ZHONGGUO JINGYING BAO [CHINA BUSINESS OPERATION DAILY] (Sept. 30, 2003), available at <http://finance.sina.com.cn/k/20030930/0935462053.shtm> (last visited Mar. 27, 2004).

<sup>111</sup> See CSRC, DATABASE ON B SHARES MARKET, at <http://www.csrc.gov.cn>.

finally, the overall liberalization of capital markets.<sup>112</sup> Chinese regulators have witnessed this trend in the liberalization of Taiwan's securities market.

Since 1990, in an effort to liberalize its stock market for access to foreigners, Taiwan began to permit qualified foreign institutional investors (QFIIs) to directly buy and trade in Taiwan-listed securities.<sup>113</sup> Under the QFII regime, foreign banks, insurance companies and fund management institutions were allowed to invest directly in securities listed in the Taiwan Securities Exchange (TSE).<sup>114</sup> QFIIs must meet certain threshold requirements, including longevity, experience and asset.<sup>115</sup> There were also strict requirements as to inward remittance of foreign capital, profit repatriation, and percentage limits on QFII investment in target companies.<sup>116</sup>

In November 2002, roughly one year before Taiwan abolished the QFII regime,<sup>117</sup> the CSRC and People's Bank of China (PBC), the two regulators of China's financial markets, jointly introduced mainland China's QFII system in a decree titled Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (hereinafter "QFII Rules").<sup>118</sup> Effective December 1, 2002, foreign financial institutions could apply to invest directly in China's domestic A shares market. The two stock exchanges both released their own "Implementing Rules" regarding the application of

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<sup>112</sup> See, Fengqi Cao, Tan Dalu Ziben Shichang Touzi Guoji Hua Zhanlue Yu Duice [Cao Fengqi on Strategies for the Globalization of China's Capital Market], Statement by Professor CAO Fengqi in the 2003 Advanced Forum on the Globalization of China's Capital Market (Oct. 11, 2003), available at <http://news.sohu.com> (last visited n.d., on file with author)

<sup>113</sup> See Jeffrey H. Chen & Jack J.T. Huang, *Taiwan's Evolving Stock Market: Policy and Regulatory Trends*, 12 UCLA PAC. BASIN L. J. 34, 40-41 (1993).

<sup>114</sup> *Id.* at 41.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 42-44.

<sup>117</sup> Taiwan's Ministry of Finance formally abandoned the QFII system on October 2, 2003. See Paul Denlinger, *Taiwan Abandons QFII System*, available at <http://www.china-ready.com/news/Oct03/TaiwanAbandonsQFIISystem100303.html> (last visited Mar. 27, 2004).

<sup>118</sup> See Hege Jingwai Jigou Touzizhe Jingnei Zhengquan Touzi Guanli Zanzing Banfa [Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors] (Joint Decree No. 12 of the CSRC and PBC, Nov. 5, 2002), available at <http://www.szse.cn/Web/Article/2003/11/06/0935577536C3213.aspx> (last visited Mar. 27, 2004) [hereinafter QFII Rules].

QFII Rules in the effective date of December 1, 2002.<sup>119</sup>

QFII Rules define “QFIIs” as “overseas asset management institutions, insurance companies, securities companies, and other asset management institutions” approved by the CSRC and granted foreign exchange quota for the State Administration of Foreign Exchange (SAFE).<sup>120</sup> Curiously enough, foreign banks are not included in the definition, although commercial banks are mentioned in an article of the Rules concerning asset size. In addition, it is widely understood that banks can operate in China’s QFII system through their asset management subsidiaries.

Compared with Taiwan’s QFII system, the threshold access standard for foreign institutions is rather high in terms of their experience, asset requirements, and business longevity. To be qualified as QFII in China, a fund management company must have conducted fund management business for at least five years, with a managing asset size no less than US\$ 10 billion in the past year; an insurance company shall have conducted insurance business for over 30 years, with actual paid-up capital of no less than US\$ 1 billion and securities assets managed in the latest fiscal year of no less than US\$ 10 billion; a securities firm shall have conducted securities business for over 30 years, with actual paid-up capital of no less than US\$ 1 billion and securities assets managed in the latest fiscal year of no less than US\$ 10 billion, and a commercial bank shall have its total assets ranked among the top 100 in the world in the latest fiscal year and securities assets managed of no less than US\$ 10 billion.<sup>121</sup> In addition, the applicants for QFII shall have sound corporate governance structure and internal control system, and their home jurisdiction shall have signed a Memorandum of Understanding with the CSRC for cross-border regulatory

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<sup>119</sup> See e.g., SHENZHEN STOCK EXCHANGE WEBSITE, Implementation Details on the Registration and Settlement Related Business of Domestic Securities Investments of Qualified Foreign Institutional Investors, *available at* <http://www.szse.cn/UpFiles/Attach/1399/2003/11/06/1616387602.pdf> (last visited Mar. 31, 2004).

<sup>120</sup> See QFII Rules, *supra* note 118, art. 2.

<sup>121</sup> See QFII Rules, *supra* note 118, art. 7. In contrast, when Taiwan implemented the QFII regime in 1991, it only required that, in order to be approved for QFII, a commercial bank should have total assets among the top 500 in the world, with securities asset managed in the size no less than US\$ 300 million; an insurance company should have conducted insurance business for over 10 years, managing securities assets in the size no less than US\$ 500 million; and a fund management company should have been in the business for five years with the size of managed asset no less than US\$ 500 million. See *Tai Zhengquan Zhuanjia: Neidi QFII Menkan Yuan Gaoyu Taiwan Shuiping* [Taiwan Securities Experts: Mainland’s QFII Threshold is Far Higher than that of Taiwan], in NANFANG RIBAO [NANFANG DAILY] (Dec. 9, 2002), *available at* <http://www.china.com.cn/chinese/zhuanji/243938.htm> (last visited Mar. 27, 2004).

cooperation.<sup>122</sup>

A QFII can invest in A shares (but not B shares), listed government bonds, convertible bonds, corporate bonds, and other financial instruments as approved by the CSRC.<sup>123</sup> However, any investment amount must not exceed the quota granted by the SAFE.<sup>124</sup> In addition, shares held by each QFII in one listed company should not exceed ten percent of total outstanding shares of the company, and total shares held by all QFIIs in one listed company should not exceed twenty percent of total outstanding shares of the company.<sup>125</sup> QFIIs are also required to comply with provisions guiding the orientation of foreign investment issued by the State Council.<sup>126</sup>

Like the Taiwanese system, one of the most prominent features of the mainland QFII is the strict control of inflow and outflow of capital. Each QFII may only apply to remit an amount within the quota assigned by the SAFE, which ranges from US\$ 50 to 800 million.<sup>127</sup> However, it is not clear how many times a QFII can apply each year.<sup>128</sup> For capital

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<sup>122</sup> See QFII Rules, *supra* note 118, arts. 6(3)-(4).

<sup>123</sup> *Id.* art. 18.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* art. 20.

<sup>126</sup> See Zhidao Waishang Touzi Fangxiao Guiding [Provisions on Guiding the Orientation of Foreign Investment] (Promulgated by the State Council, Feb. 11, 2002, Effective Apr. 1, 2002), available at [http://www.ec.com.cn/english/Laws\\_list\\_128.shtml](http://www.ec.com.cn/english/Laws_list_128.shtml) (last visited Mar. 27, 2004) [hereinafter Guidelines for Foreign Investment]. According to the Guidelines, foreign investment projects are divided into four categories: encouraged, permitted, restricted, and prohibited. *Id.* art. 4. Foreign investment is prohibited in projects jeopardizing national security, polluting the environment and harming human health, occupying large tracks of farmland, damaging natural resources, harming the use of military facilities, and employing technologies particular to China. *Id.* art. 7. See also Attachment to the Catalogue for the Guidance of Foreign Investment Industries (Promulgated Nov. 3, 2002), available at [http://www.ec.com.cn/english/Laws\\_list\\_126.shtml](http://www.ec.com.cn/english/Laws_list_126.shtml) [hereinafter Foreign Investment Catalogue].

<sup>127</sup> See Hege Jingwai Jigou Touzizhe Jingnei Zhengquan Touzi Waihui Guanli Zanxing Guiding [Interim Provisions on Foreign Exchange Administration of Domestic Securities Investment by QFII] (Announcement released by SAFE, Nov. 28, 2002), art. 8, available at [http://www.ec.com.cn/english/Laws\\_list\\_965.shtml](http://www.ec.com.cn/english/Laws_list_965.shtml) (last visited Mar. 27, 2004) [hereinafter QFII Rules on Foreign Exchange].

<sup>128</sup> As of this writing, UBS Warburg, the first approved QFII in China, has used up its first approved quota of US\$ 500 million and is applying for a second quota for US\$ 300 million. The two applications were certainly submitted within a year. HSBC has also applied to increase its quota. See *Haiwai Touzizhe Kanhao A Gu Shichang, QFII Fen Shenqing Zengjia E'Du* [Overseas Investor Optimistic at the A

outflow, the Rules stipulate that the principal investment shall stay in China for three years until it is allowed to repatriate only by installments.<sup>129</sup> Restrictive as it is, this provision effectively forces investors to stay in the market, irrespective of their market judgment. The rationale is, obviously, to limit the detrimental effect of international “hot money” which was alleged to cause the 1997 Asian Financial Crisis.

C. *Takeover by Foreign Companies (Mergers and Acquisitions)*

Permission of foreign access to the mergers and acquisitions (M&A) market is regarded a bold move for the Chinese government in opening up its capital markets and restructuring SOEs. Out of concern for sovereign control over the national economy, China’s government had been very hostile toward foreign takeovers of Chinese companies, be it hostile or friendly mergers or acquisitions. The two earliest foreign takeovers of PRC companies occurred in May 1995. One involves the acquisition of 25 percent of the shares of Beilu Company by two Japanese companies, and the other was the purchase of 20 percent of the shares of Jiangling Automobile Company by Ford Motor Company.<sup>130</sup> The two takeovers triggered tremendous volatility in China’s stock market and attracted the attention of Chinese regulators immediately. One month later, the PRC government issued a “notice” mandating that “no unit shall be allowed to transfer state shares and legal person shares to foreign investors until the state promulgated laws allowing this,” although the two takeovers that had already taken place were exempted from the new regulations or grandfathered.<sup>131</sup>

WTO accession, and its anticipation, has led to dramatic changes in Chinese regulators’ attitude towards foreign entry into the Chinese economy through M&As. On the contrary, as this article will discuss

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*Shares Market: QFIIs are Rushing to Apply for Increase in Quota Amount*, in ZHENGQUAN RIBAO [SECURITIES DAILY], Nov. 4, 2003, available at <http://www.china.com.cn/chinese/FI-c/435182.htm> (last visited Mar. 27, 2004).

<sup>129</sup> See QFII Rules, *supra* note 118, art. 26.

<sup>130</sup> See *Binggou Hui Jizhong Zai Naxie Hangye? [On What Areas Will Foreign Mergers and Acquisitions Focus?]*, in BEIJING CHENBAO [BEIJING MORNING NEWS] (Nov. 5, 2002), available at <http://202.84.17.28/csnews/20021105/295748.asp> (last visited n.d., on file with author).

<sup>131</sup> See *Guowuyuan Bangongting Guanyu Zhuanfa Guowuyuan Zhengquan Weiyuanhui Guanyu Zanting Jiang Shangshi Gongsi Guojiagu He Farengu Zhuanrang Gei Waishang Qingshi De Tongzhi [Notice of the State Council on the Transmission of the Request of the State Council Securities Commission Asking for Suspending the Transfer of State Shares and Legal Person Shares to Foreign Investors]*, September 23, 1995, art. 1.

later on, they might now view that as an effective way to reform China's struggling SOEs. Since 2001, a number of regulations and rules have been released to liberalize takeovers by foreign investors of Chinese companies, including, and primarily, SOEs. These laws include: Some Opinions Concerning Foreign Investment in Listed Companies,<sup>132</sup> issued by the CSRC and Ministry of Foreign Trade and Economic Cooperation (predecessor of Ministry of Commerce) in November 2001; Measures on the Takeovers of Listed Companies,<sup>133</sup> issued by the CSRC, (hereinafter Takeover Measures); Circular on the Transfer of State Shares and Legal Person Shares to Foreign Investors,<sup>134</sup> issued by the CSRC, in November 2002, by the Ministry of Finance and State Commission on Economy and Trade (hereinafter State Shares Circular); Interim Provisions on Introducing Foreign Investment to Reorganize State-Owned Enterprises,<sup>135</sup> issued in November 2002, by the Ministry of Finance, State Administration on Foreign Exchange, State Industrial Administration, and State Commission on Economy and Trade (hereinafter SOE Restructuring Rules); Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors,<sup>136</sup> issued in March 2003, by the Ministry of Foreign Trade and Economic Cooperation, the State General Administration of Taxation, the State General Administration of Industry and Commerce, and the State Administration of Foreign Exchange (hereinafter Foreign Acquisition Rules), and Measures for the Administration of Disclosure of

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<sup>132</sup> See Guanyu Shangshi Gongsi Sheji Waishang Touzi Youguan Wenti de Ruogan Yijian [Circular on Printing and Distributing Some Opinions Relevant to Foreign Investment in Listed Companies], Nov. 5, 2001, available at [http://www.ec.cn/Laws\\_list\\_976.shtml](http://www.ec.cn/Laws_list_976.shtml) (last visited Mar. 27, 2004).

<sup>133</sup> Shangshi Gongsi Shougou Guanli Banfa [Regulations on the Takeover of Listed Companies] (Promulgated and Effective Dec. 1, 2002), available at <http://www.szse.cn/Web/Article/2003/11/06/1632235068C3203.aspx> (last visited Mar. 27, 2004).

<sup>134</sup> See Guanyu Xiang Waishang Zhuanrang Shangshi Gongsi Guoyougu He Farengu Youguan Wenti de Tongzhi [Issues Related to Transferring State-Owned Shares and Institutional Shares of Listed Corporations to Foreign Investors] (ZhengJianFa No. 83, Nov. 1, 2002), available at [http://www.ec.com.cn/english/Laws\\_list\\_049.shtml](http://www.ec.com.cn/english/Laws_list_049.shtml) (last visited Mar. 27, 2004).

<sup>135</sup> See Liyong Waizi Gaizu Guoyou Qiye Zanxing Guiding [Interim Provisions on Introducing Foreign Investment to Reorganize State-Owned Enterprises], available at [http://www.ec.cn/Laws\\_list\\_550.shtml](http://www.ec.cn/Laws_list_550.shtml) (last visited Mar. 27, 2004).

<sup>136</sup> See Waiguo Touzizhe Binggou Jingnei Qiye Zanxing Guiding [Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors], available at [http://www.ec.com.cn/english/Laws\\_list\\_043.shtml](http://www.ec.com.cn/english/Laws_list_043.shtml) (last visited Mar. 27, 2004) [hereinafter Foreign Acquisition Rules].

Shareholder Equity Changes of Listed Companies,<sup>137</sup> issued by the CSRC in September 2002 (hereinafter Disclosure Measures).

The above laws, together with a number of other decrees and rules concerning IPOs, disclosure, and foreign exchange control with regard to foreign takeovers, are so confusing that even a China law expert may have difficulties in sorting them out. The basic logic is that the Foreign Acquisition Rules and the State Shares Circular are the two main laws particularly with regard to foreign takeovers, with the rest being supplemental only. As previously noted, the laws on M&A demonstrate strongly the dualist nature of Chinese securities regulations. Compared with previous M&A rules which are either prohibitive or very restrictive, the recently enacted regulations are rather liberal. Yet they still show strong Chinese characteristics which are worth noting here.

First, national treatment to foreign investors is established. Foreigners can directly buy shares of domestic firms from domestic shareholders or from new issuances of the firms (so-called “equity interest M&A”). Alternatively, they can conduct “assets M&A” by setting up foreign invested enterprises (FIEs) and use the FIEs to buy assets from domestic firms, or by buying assets from domestic firms and then using the assets to set up FIEs.<sup>138</sup> There is no percentage limitation on a foreigner’s shareholding in the targeted or new company. In addition, the laws do not differentiate foreign or domestic M&As in terms of rules on information disclosure and takeover procedures.<sup>139</sup> Accordingly, a domestic firm acquired by foreign investors is not deemed an FIE and does not enjoy the normal preferential treatment afforded to FIEs under the three major FIE laws.<sup>140</sup>

Second, in M&A, foreign investors still need to comply with

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<sup>137</sup> See Shangshi Gongsi Gudong Chigu Biandong Xinxi Pilu Guanli Banfa [Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies], available at <http://www.szse.cn/Web/Article/2003/11/06/1631537568C3204.aspx> (last visited Mar. 27, 2004).

<sup>138</sup> See Foreign Acquisition Rules, *supra* note 136, art.2.

<sup>139</sup> See State Shares Circular, *supra* note 134, art. 4. See also Henian Feng, *Waizi Shougou Shangshi Gongsi Guoyougu He Farengu de Xiangguan Fagui He Anli* [Rules and Cases Concerning Foreign Acquisition of State Shares and Legal Person Shares]; Speech delivered by Mr. Feng, Deputy Director of CSRC Legal Department, in the 2003 Advanced Forum on Foreign Acquisitions of Domestic Enterprises (Aug. 20, 2003), available at <http://business.sohu.com> (last visited n.d., on file with author).

<sup>140</sup> See State Shares Circular, *supra* note 134, art. 9. The three major FIE laws are *Zhonghua Renmin Gongheguo Zhongwai Hezi Qiye Fa* [The Law of the P.R.C. on Chinese-Foreign Equity Joint Ventures], *Zhonghua Renmin Gongheguo Zhongwai Hezuo Qiye Fa* [The Law of the P.R.C. on Chinese-Foreign Cooperative Joint Ventures], and *Waishang Duzi Qiye Fa* [The Law on Wholly Foreign-Owned Enterprises]. See e.g., HONGYING WANG, *WEAK STATE, STRONG NETWORKS: THE INSTITUTIONAL DYNAMICS OF FOREIGN DIRECT INVESTMENT IN CHINA* 40-41 (2001).

China's state policies regarding the directions for foreign investment embodied in the Guidelines for Foreign Investment and the Foreign Investment Catalogue, which prohibits foreign investment in certain sectors, such as, in production and research of transgenic plant seeds, exploration and mining of radioactive minerals, production of certain traditional Chinese medicines, and a variety of service areas.<sup>141</sup> In some other areas, such as transport by water and railway, telecommunication, distribution services, etceteras, foreign control is restricted to less than 50 percent.<sup>142</sup>

Third, the rules encourage and even require mid- and long-term investment. Foreign investors can only transfer their acquired shareholding twelve months after they have paid up "in full" the consideration for M&A.<sup>143</sup> The purpose of this provision, as stated in the leading principles of the Foreign Acquisition Rules, is to "attract mid- and long- term investment, prevent short-term speculation, and maintain due order in the securities market."<sup>144</sup>

Fourth, the price of state shares and legal person shares shall be determined by way of open tender.<sup>145</sup> More specifically, in a takeover process involving foreigners, although the parties generally can agree on the price, the Foreign Acquisitions Rules require that the parties shall base the trading price on the valuation made by assets valuation institutions.<sup>146</sup> Curiously and confusingly, the Rules say that the parties "may by agreement choose asset valuation institutions incorporated in China."<sup>147</sup> What causes confusion is the word "may," and it is not clear whether the parties can agree otherwise, as "may" is normally understood as non-mandatory. However, practitioners who do M&A legal work in China understood the rules as to require valuation by a PRC valuation institution.<sup>148</sup> The law also explicitly prohibits transfer or

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<sup>141</sup> See Foreign Investment Catalogue, *supra* note 126, pt. II (Notes for Catalogue of Restricted Industries).

<sup>142</sup> *Id.*

<sup>143</sup> See State Shares Circular, *supra* note 134, art. 7.

<sup>144</sup> See *id.* art. 1(4).

<sup>145</sup> *Id.* art. 3.

<sup>146</sup> *Id.* art. 8.

<sup>147</sup> See State Shares Circular, *supra* note 134, art. 8.

<sup>148</sup> Seminar presented by Thomas E. Jones, *Buying into China: New Avenues for M&A Transactions*, Nov. 7, 2003, Singapore (PowerPoint slides of Thomas Jones' seminar are on file with the author). Mr. Jones is a partner of the China Practice Group of the Hong Kong Office of Freshfields Bruchhaus Deringer.

sale of shares at a price manifestly lower than valuation which is deemed as transfer of assets abroad in disguised form.<sup>149</sup>

Fifth, employees of the target company shall be taken care of. Contrary to the China's M&A rules impose a social responsibility on the acquiring foreign company to deal with those matters relating to the unemployment of the workers of the target company. In order for the authorities to approve a deal, a plan for the resettlement of employees of the domestic enterprise subject to the M&A must be submitted as part of application package.<sup>150</sup>

The most interesting part of the recent M&A laws is probably the antitrust provisions, in which China asserts both domestic and extraterritorial jurisdiction over takeover activities. In the case of domestic M&As, the foreign investor must submit a report to the Ministry of Commerce (MOC) and the State Administration of Industry and Commerce (SAIC) if (1) one of the parties to the deal has a business turnover exceeding RMB\$ 1.5 billion in China; (2) the aggregate number of M&As of domestic companies in the relevant industry of China within one year exceeds ten; (3) the China market share of a party to the M&A has reached 20 percent; or (4) the M&A will result in the share of the China market of a party to the M&A reaching 25 percent.<sup>151</sup>

China also asserts jurisdiction over global M&As if they have economic interests in China. Briefly, the parties to an offshore transaction shall submit a report to the MOC and SAIC for approval if any of the following triggers is met: (1) one of the parties to the offshore M&A has assets exceeding RMB\$ 3 billion in China; (2) a party's business turnover in China exceeds RMB\$ 1.5 billion in the current year; (3) share of the China market of a party and its affiliates has reached 20 percent; (4) the M&A will result in the share of the China market of a party and its affiliates reaching 25 percent; and (5) as a result of the offshore M&A, a party to the deal will directly or indirectly hold equity in more than 15 FIEs in the relevant industry in China.<sup>152</sup> According to a practitioner, these provisions, having worldwide transactional implications, are likely to make China the third major antitrust jurisdiction after the United States and EU.<sup>153</sup>

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<sup>149</sup> See Foreign Acquisition Rules, *supra* note 136, art. 8.

<sup>150</sup> See Foreign Acquisition Rules, *supra* note 136, arts. 12(9), 15(8).

<sup>151</sup> *Id.* art. 19.

<sup>152</sup> *Id.* art. 21.

<sup>153</sup> See Jones, *supra* note 148.

D. *Foreign Participation in Securities Intermediaries Services*

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

China's restrictions on foreign participation are very severe.... In the domestic capital market, foreign institutions are now effectively excluded from virtually all activities involving Chinese domestic investors. Foreign intermediaries cannot deal with Chinese investors in domestic primary offerings, engage in secondary market trading of A-shares, and may not form investment funds or other institutional savings products that are marketed to Chinese residents. Foreign intuitions are limited to soliciting orders for B-shares from non-residents, with a Chinese partner required to complete the trade on the exchange.<sup>154</sup>

China's WTO accession fundamentally changed the situation. On June 1, 2002, half a year after joining the world trading system, the CSRC released two laws allowing foreign participation in securities firms and fund management business: Rules on the Establishment of Foreign-Shared Fund Management Companies (hereinafter Fund Rules)<sup>155</sup> and Rules for the Establishment of Foreign-Shared Securities Companies (hereinafter Securities Companies Rules).<sup>156</sup>

According to the Fund Rules, foreign companies can establish fund management joint ventures either through purchasing shares of existing domestic fund management companies or co-establishing new joint ventures with Chinese partners, both in the form of limited liability companies.<sup>157</sup> A foreign party in the joint venture shall be a financial institution with good records (meaning it has not been seriously punished by the regulatory or judicial authority of its home jurisdiction in the

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<sup>154</sup> See OECD, *supra* note 9, at 525-26.

<sup>155</sup> See *Waizi Cangu Jijin Guanli Gongsì Sheli Guize* [Rules on the Establishment of Foreign-Shared Fund Management Companies], available at [http://www.ec.cn/Laws\\_list\\_125.shtml](http://www.ec.cn/Laws_list_125.shtml) (last visited Mar. 27, 2004).

<sup>156</sup> See *Waizi Cangu Zhengquan Gongsì Sheli Guize* [Rules for the Establishment of Foreign-Shared Securities Companies], available at [http://www.ec.cn/Laws\\_list\\_124.shtml](http://www.ec.cn/Laws_list_124.shtml) (last visited Mar. 27, 2004).

<sup>157</sup> See Fund Rules, *supra* note 155, arts. 2-4.

recent three years) and with a paid-up capital no less than RMB\$ 300 million (about US\$ 36 million), in addition to any other prudential requirement that might be raised by the CSRC.<sup>158</sup> It shall also come from a jurisdiction which has signed a Memorandum of Understanding (MOU) with the CSRC.<sup>159</sup> The Fund Rules also stipulate the percentage limit on the shareholding of foreign investors in the joint ventures. In line with China's WTO commitments, the foreign partner is limited to a 33 percent stake initially, but foreign ownership will be allowed to rise to 49 percent three years after China's accession to the WTO.<sup>160</sup>

The Securities Companies Rules have similar provisions allowing foreigners to buy shares from a domestic securities company or jointly establish a new company with a domestic partner (not limited to domestic securities firms) in the form of limited liability companies.<sup>161</sup> The foreign partner, being a financial institution which has engaged in financial business for more than ten years with good records, shall also have good internal control system as well as good reputation and business performance in international securities markets.<sup>162</sup> Needless to say, this kind of soft "requirements" place great discretion in the hands of Chinese bureaucrats in charge of the approving process. The share percentage of the foreign partner in the joint venture is limited to one-third.<sup>163</sup>

A foreign invested securities firm is allowed to engage in a broad range of securities services, including underwriting of stock (for both A shares and B shares) and bonds (government and corporate bonds), brokerage of B shares, brokerage and self-operation of bonds, as well as other businesses as may be approved by the CSRC.<sup>164</sup> Compared with domestic securities firms, they are not allowed to provide brokerage services for A shares, and to engage in securities custody, buying and selling stocks for their own account, as well as in consulting services.

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<sup>158</sup> *Id.* art. 6

<sup>159</sup> *See id.* art. 6(2).

<sup>160</sup> *See* Fund Rules, *supra* note 155, art. 8.

<sup>161</sup> *See* Securities Companies Rules, *supra* note 156, art. 2.

<sup>162</sup> *Id.* art. 7.

<sup>163</sup> *Id.* art. 10.

<sup>164</sup> *See id.* art. 5.

#### IV. TRAPS FOR WOLVES: ANALYZING THE LEGAL PROBLEMS FACING FOREIGN INVESTORS

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

##### A. *Legal Risks Peculiar to the Chinese Stock Market*

Unique features of China's stock market have caused a variety of legal and policy risks which shall be characterized as systemic problems peculiar to China. As previously noted, the stock market comprises substantial state ownership, with the State-Owned Enterprises constituting the majority of listed companies. In addition, two-thirds of the shares are non-tradable. In such a context, regulators of the stock market often face an "identity" problem—namely, whether they shall act as regulators of the market, for which they should treat all parties equally, or as owner of state shares, for which their priority is to ensure realization of multiple objectives of the government in terms of both the maximizing of state assets and the maintaining of social stability, even at the expense of the economic interest of other shareholders. As a matter of fact, most paradoxes in China's stock market are closely tied to SOEs.

The vivid characteristics of emerging markets also present problems in connection to the rule of law, corruption, poor corporate governance, and lack of a credit system. Moreover, the current laws place tremendous power on the part of majority shareholders while providing little protection for minority shareholders. Judicial remedies, while only emerging recently, are quite limited as well as restrictive—as foreign investors may still only be able to hold minority shares, and in many cases due to various constraints, protection of the minority will be a concern.

The B Shares market can be used to illustrate some of the problems facing foreign investors. Notwithstanding the many efforts used by Chinese regulators to boost it, the market is still far from attractive and has performed poorly so far. Notorious problems in the B Shares market include the lack of liquidity, restrictions on foreign

securities firms, lack of proper disclosure of information, and uncertainty of B shareholders' rights with respect to the issuers.

First, under the B Shares Regulations, information disclosure documents of the issuers for B shares shall be prepared in Chinese.<sup>165</sup> Although the laws state that foreign language version documents can be provided when needed, it is not required.<sup>166</sup> This could be justified to the extent that investors should not expect documents in a language other than Chinese as they choose to invest in Chinese companies. However, as the investors originally targeted are solely foreigners, the provision of documents in a language they are familiar with should reasonably be the requirement; otherwise, it would result in inadequate disclosure due to language barriers.

Investors also lack trust in China's accounting system. While the B Shares Regulations stipulate that the issuing company may provide financial reports adjusted according to international accounting standards or accounting standards of the place outside China where the offer is conducted,<sup>167</sup> reports produced are still unreliable because the overall reports of the company produced are based on China's own Enterprise accounting standards for its enterprises, which has not inspired confidence so far.<sup>168</sup>

In terms of shareholder's rights, the B Shares Regulations explicitly offer the same rights to foreigners as their domestic counterparts.<sup>169</sup> In addition, a foreign shareholder may entrust a proxy with exercising his shareholder's rights on his or her behalf.<sup>170</sup> However, this provision may not be meaningful because the regulations did not grant shareholders the right to pursue derivative action. The absence of such a provision means that shareholders may not have a legal basis to sue directors and officers who have violated their fiduciary duties.<sup>171</sup> Moreover, shareholders who intend to control a Chinese company through trading of B shares may be frustrated, because they are not allowed to buy A shares which generally constitute the majority of total shares in a company. All these serve as obstacles to bar the further development of the B shares markets.

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<sup>165</sup> See B Shares Regulations, *supra* note 94, art. 17.

<sup>166</sup> *Id.*

<sup>167</sup> See B Shares Regulations, *supra* note 94, art. 15.

<sup>168</sup> *Id.* art. 14.

<sup>169</sup> *Id.* art. 5.

<sup>170</sup> *Id.* art. 21.

<sup>171</sup> See Jay Zhe Zhang, *Securities Markets and Securities Regulations in China*, 22 N.C. J. INT'L L. & COM REG. 557, 615 (1997).

B. *The Regulations and Regulatory Culture: Too Burdensome and Ambiguous To Be Tolerable?*

Any investor must face regulations and regulators, which jointly form the regulatory regime. In advanced stock markets there is always a boundary as regulators normally play the role of watchdog for the marketplace, providing the rule of law and maintaining a fair, orderly, and transparent market. For instance, the primary duty of the U.S. Securities and Exchange Commission (SEC) is to ensure the implementation of federal rules regarding disclosure, and in no case is it expected to be a guarantor of corporate profits.<sup>172</sup> The uniqueness of the Chinese regulators (especially the chief regulator, CSRC) is that they are designed to play multiple roles, in which service as watchdog is the ancillary role. Briefly speaking, the CSRC is chiefly equipped with two tasks, including “developing” as well as “regulating” the capital market—and it is expected to do both well.<sup>173</sup> In addition, as a state agency, the CSRC and other regulators concerned (such as the PBC) are more or less considered as representatives for the state in taking care of state assets.

Thus, conflict of interests and ambiguous identity caused by multiple roles of the regulators, in conjunction with lack of experience, have led to under-regulation and over-regulation, as well as ambiguous laws. In one sense, the CSRC is probably the most powerful regulator in the world, and China is the most heavy-handedly regulated market.<sup>174</sup> Contrary to the belief of a free market theory in most developed capital markets, China’s IPO market is dominated by the mentality of a centrally planned economy in which the government directly controls the IPO process as well as any follow-up issuance, determining which enterprise is able to issue shares. The CSRC views this market access authority as its main duty. Consequently, the CSRC is in charge of issuing licenses to intermediary service providers including securities companies, accounting firms, brokers, fund managers, and securities consultants. Even newspapers and magazines must have obtained licenses from the

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<sup>172</sup> See Donald C. Clarke, *Corporate Governance in China: An Overview*, in CHINA ECON. REV., Jul. 15, 2003, available at <http://papers.ssrn.com/abstract=424885> (last visited Mar. 28, 2004).

<sup>173</sup> See Wenguang Zhao, *Gushi Fazhan Xuyao “Liangzhi Shou” Tuidong [The Growth of the Stock Market Needs Push from “Two Hands”]*, in ZHENGQUAN SHICHANG ZHOUKAN [SEC. MARKET WKLY.], Sept. 22, 2003, available at <http://news.sohu.com> (last visited n.d., on file with author).

<sup>174</sup> See Yingbo Shao, *Guodu Guanzhi Daozhi de Cuoche – Fang Liufang Jiexi Zhongguo Zhengquan Shichang [Frustration Caused by Over-Regulation – Fang Liufang on China’s Securities Market]*, in JINGJI GUANCHAO BAO [ECON. WATCH DAILY], Dec. 6, 2001, available at <http://news.sohu.com/17/39/news147363917.shtml> [hereinafter Shao, *Frustration Caused by Over-Regulation*] (last visited Mar. 28, 2004).

CSRC in order to publish statements of listed or prospective listed companies. For a long period before 2003, lawyers needed to obtain licenses from the CSRC in order to provide legal opinions for companies with regard to securities. Most of those licenses are only in effect for one-year, enabling the CSRC flexibility in regulating the market by withdrawing or refusing to renew license.<sup>175</sup>

Regulations in China's stock market often go into ridiculous detail and specificity. For instance, before the launch of an IPO, the CSRC sends personnel called a "preliminary interviewer" to the company seeking listing to check its qualifications. The preliminary interview decides all the material issues relating to IPO, including, *inter alia*, the number of shares, price, timing of the issuance, as well as selection of the listing stock exchange.<sup>176</sup> When intermediaries are involved, the CSRC has detailed provisions as to how the underwriters shall proceed to "educate" their clients, the kind of lawyers a company shall employ, which accounting firms shall be retained by listed companies conducting financial business, and so on.<sup>177</sup> Furthermore, self-regulation is almost non-existent as all NGOs in China's securities market are de facto inferior subsidiaries of the CSRC. The two stock exchanges are no more than two departments of the CSRC, at least in the sense that their heads are appointed and their internal rules approved by the regulator.<sup>178</sup>

As noted by Professor Fang of the China University of Political Science and Law, "*guanzhi guodu*" (over-regulation) is the major problem in China's securities market.<sup>179</sup> To dodge these burdensome domestic restrictions, capital has flowed out of China through the construction of offshore companies.<sup>180</sup> Indeed, since 1990s, the amount of capital flowing out of China has been larger than China's receipt of oversea capital.<sup>181</sup> Ironically, although it is equipped with over-reaching regulatory power, the CSRC has no accountability to shareholders.

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<sup>175</sup> *Id.*

<sup>176</sup> Shao, *Frustration Caused by Over-Regulation*, *supra* note 174.

<sup>177</sup> *Id.*

<sup>178</sup> *Id.* The paternal relationship is so strong that Mr. Gao Xiqing, then Executive Vice President of the CSRC, had to ask the securities associations to "speak against" the CSRC when it was necessary. See Gao Xiqing: *Zhengquanye Xiehui Keyi Dui Zhengjianhui Shuo "Bu"* [Gao Xiqing: *Securities Business Associations Could Say "No" to the CSRC*], in RENMIN RIBAO [PEOPLE'S DAILY], July 4, 2002, available at <http://business.sohu.com/90/47/article201994790.shtml> (last visited Mar. 28, 2004).

<sup>179</sup> See generally Fang, *supra* note 78.

<sup>180</sup> See Shao, *Frustration Caused by Over-Regulation*, *supra* note 174.

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

Xinhua News Agency recently claimed that the CSRC “should be responsible for the listing of unqualified companies, the falsification of financial statements by listed companies, joint trading of listed companies with their controlling shareholders, excessive speculation and insider manipulation.”<sup>182</sup> Certainly neither the CSRC as an agency nor any of its individual officers have been pursued for responsibility.

Another risk resulting from conflicting multi-objectives of the regulators is the swaying and often unpredictable regulatory culture due to a change of the person in charge. The swaying culture is most prominent in recent years in the sense that certain chiefs of the CSRC prefer to play a larger role in regulating while others prefer to help develop the stock market with certain tolerance of fraudulent activities. In February 2000, liberal-minded Zhou Xiaochuan ascended to the chairmanship of CSRC. With the assistance of Executive Vice President Gao Xiqing, an America-educated lawyer,<sup>183</sup> Zhou began to transform substantially the Commission into a regulatory machine, with a view to establishing a transparent market subject to clear rules and a powerful regulatory framework modeled after the SEC of the United States. For Zhou, the major task for the CSRC was to establish its role as an independent regulator rather than the representative of state ownership.<sup>184</sup> Using the metaphor of American football, he stressed that the regulator should act as a judge for all the players, and shall not attempt to play the game itself.<sup>185</sup> Zhou’s commission focused its work mainly on enacting and enforcing disclosure rules.

In 2001, the CSRC introduced 51 new regulations and disciplined more than 81 listed companies and 10 intermediaries, including law firms and accounting firms, for violations of securities laws.<sup>186</sup> The result was more than obvious: China’s stock market entered into its longest bear period since the beginning of 2001, and has not recovered

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<sup>182</sup> See Gordon G. Chang, *China’s Equity Markets: Floating With Helium, Part I*, in 2 CHINA BRIEF, Apr. 25, 2002, available at [http://www.jamestown.org/publications\\_details.php?volume\\_id=18&issue\\_id=649&article\\_id=4632](http://www.jamestown.org/publications_details.php?volume_id=18&issue_id=649&article_id=4632) (last visited Mar. 28, 2004).

<sup>183</sup> Mr. Gao graduated from Duke University Law School with a JD degree in 1986. Gao became the CSRC’s Vice President in 1999.

<sup>184</sup> See Speech by Xiaochuan Zhou delivered at China’s Capital Forum (Dec. 5, 2002), available at <http://www.csrc.gov.cn> (last visited n.d., on file with author) (discussing the structure of China’s capital markets (*zhongguo ziben shichang de zuzhi jigou*)).

<sup>185</sup> *Id.*

<sup>186</sup> See Feiwen Rong, *Chinese Investors Dislike Market Regulation*, at <http://journalism.berkeley.edu/projects/greaterchina/story-stock.html> (last visited Mar. 28, 2004).

so far. According to the statistics provided by the CSRC, from the middle of 2001 to the end of 2002, the stock market suffered a loss of RMB\$ 638 billion.<sup>187</sup>

The Zhou-Gao regulatory style, emphasizing supervision and compliance, irritated many investors with a stake in the market, and even, incurred blame from many investors for their losses. In a 2002 stock market seminar, four former CSRC chairman made speeches declaring that development of the market should be priority under any circumstance.<sup>188</sup> In December 2002, Zhou was moved to the position of president of the People's Bank of China and was succeeded by Shang Fulin, a former army veteran. Shortly after his appointment as head of the CSRC, Shang made it clear that all the problems "are part of the development and shall be solved through development,"<sup>189</sup> and required a "correct solution to the relationship among reform, development, and stability."<sup>190</sup> Needless to say, investors see another shift in regulatory culture, without being able to know the orientation of the next personality in charge of the CSRC.

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

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

In the words of Professor Fang Liufang, "[I]n theory, China's Securities Law, Company Law, and the regulatory framework are strict

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<sup>187</sup> See CSRC, DATABASE, at <http://www.csrc.gov.cn> (last visited Apr. 6, 2004). In July 2001, the total capitalization of tradable shares China's stock market was RMB\$ 1,886.6 billion, which became RMB\$ 1,248.4 in December 2002. *Id.*

<sup>188</sup> See Rong, *supra* note 186.

<sup>189</sup> See Fulin Shang, *Tuijin Ziben Shichang Gaige Kaifang He Weiding Fazhan [To Push the Reform, Opening Up, and Stable Development of the Capital Markets]*, in GUOJI JINRONG BAO [INT'L FIN. DAILY], Apr. 21, 2002, at 8, available at <http://www.people.com.cn> (last visited n.d., on file with author). See also Speech by Fulin Shang delivered at the 2003 Forum for China's Financial Reform and Development (Apr. 22, 2003) (on the need to actively push for the reform, opening up, and stable development of a stable market).

<sup>190</sup> *Id.*

enough to prevent any market fraud activity.”<sup>191</sup> The reality, however, is markedly different. Due to structural flaws of the market arising out of its initial design, massive fraudulent activities exist in both the first (IPO or new issuance) and the secondary (exchange) markets. In 2001, Wu Jinglian, one of China’s preeminent economists, proclaimed in a program of China’s Central Television (CCTV) that China’s stock market “is just like a casino, but worse than that,” because “even casinos have rules so that you can’t look at other people’s cards. But in our stock market, many people can peer at the cards of others, can cheat, and practice fraud. [In brief], market manipulation and insider trading have reached their extremity.”<sup>192</sup>

The root of the problem rests with China’s struggling SOE reform. To reinvigorate its cumbersome SOEs, China has tried several approaches. In the early 1990s, concurrent with the drafting and passage of the Company Law, the government launched a new approach, “corporatization,”<sup>193</sup> one aspect of which is to transform SOEs into listed stock companies. On behalf of the Chinese Communist Party, Jiang Zemin stated, “The joint stock system is a form of capital organization of modern enterprises, which is favorable for separating ownership from management and raising the efficiency of operation of enterprises and capital.”<sup>194</sup> From the government’s perspective, this approach presents benefits, such as, expanding the fund-raising channel for SOEs, transforming the operational mechanism of SOEs in compliance with the requirements of modern enterprises, and helping to allocate financial resources to benefit SOEs.<sup>195</sup>

Still, many if not all corporatized stock companies merely exhibit a corporate veil familiar to the West, but are still being run under traditional forms of administrative control known to China.<sup>196</sup> For many

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<sup>191</sup> See Shao, *Frustration Caused by Over-Regulation*, *supra* note 174.

<sup>192</sup> See Interview of Wu Jinglian on *Economy 30 Minutes*, CHINA CENTRAL TELEVISION (Jan. 15, 2001) (transcript available at <http://www.people.com.cn/GB/jinji/35/159/20010115/378998.html> (last visited Mar. 28, 2004)).

<sup>193</sup> See Deborah Kay Johns, *Reforming the State-Enterprise Property Relationship in the People's Republic of China: The Corporatization of State-Owned Enterprises*, 16 MICH. J. INT’LL. 911, 913 n.11 (Spring 1995).

<sup>194</sup> JIANG ZEMIN’S ADDRESS TO THE 15TH NATIONAL CONGRESS OF THE COMMUNIST PARTY OF CHINA, *Hold High the Great Banner of Deng Xiaoping Theory for an All-Round Advancement of the Cause of Building Socialism with Chinese Characteristics into the 21 Century* (Sept. 12, 1997) available at <http://ce.cei.gov.cn/efor/b3100j01.htm> (last visited Mar. 28, 2004) [hereinafter JIANG 1997 ADDRESS].

<sup>195</sup> *Id.*

SOEs, the main benefit from the transformation into a joint stock company is not the opportunities to “restructure itself into modern enterprises,” but simply to raise capital to alleviate financial difficulties.<sup>197</sup> To obtain approval from the CSRC to make an initial public offering, they often disclose false figures of profits or even forge financial reports.<sup>198</sup> As stated by Fang Liufang during an interview:

When a SOE obtains a quota for IPO, even though it has suffered loss in the past three years [which hence cannot meet the initial legal requirement for IPO], it can immediately have profit earnings in the past three consecutive years simply by requesting those “securities accountants” to cook accounting statements for them, of course with extra high pay to those accountants. . . . The issuer’s “make-up” fee is eventually absorbed by the “issuance cost,” which shall be deducted from the capital contribution paid by investors purchasing the shares. SOE’s made-up—intermediaries provide make-up service—investors pay the bill: this is the entire process of the game.<sup>199</sup>

Because each SOE has a supervising body which is either an agency of the central government or local government, and which has a tremendous stake in the company’s public offering, the listing process is highly politicized, involving enormous rent-seeking activities and corruption. The 2002-litigated Macat case is a telling one.<sup>200</sup> Macat Optics and Electronics Company, Limited obtained approval from the CSRC and launched an IPO in August 2000.<sup>201</sup> Beginning in November 2000, the CSRC identified that Macat falsified hundreds of millions of dollars of profit and revenue in its financial statements.<sup>202</sup> According to

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<sup>196</sup> See QINGLIAN HE, XIANDAIHUA DE XIANJING – ZHONGGUO ZHI WENTI [THE TRAP OF MODERNIZATION – CHINA’S PROBLEMS] 24 (1998).

<sup>197</sup> *Id.* at 24.

<sup>198</sup> *Id.*

<sup>199</sup> See Shao, *Frustration Caused by Over-Regulation*, *supra* note 174.

<sup>200</sup> See Huawei Ling, Shuo Wang & Ming Yu, *Maikete E’Meng—Yitiao Kongqian Wanzheng de Zhengquan Shichang Zaojia Liushuixian de Wanzheng Baoguang* [Macat’s Nightmare—A Whole Production Line Making Falsified Reports in the Securities Market is Exposed], in CAIJING MAG., Mar. 20, 2002, available at <http://business.sohu.com/39/60/article200406039.shtml> (last visited Mar. 28, 2004) [hereinafter Ling et al., *Macat’s Nightmare*].

<sup>201</sup> *Id.*

the CSRC report and court judgment for this case, not only did the company, a small entity without any substantial assets, purposely defraud the public, but all the intermediaries, including an accounting firm, an asset valuation institution, a law firm, and a securities company also helped Macat to fabricate the false statements.<sup>203</sup> The case was characterized as involving a “sophisticated production line for producing false accounting reports and numbers in the securities market.”<sup>204</sup> Eventually a dozen managers and professionals were criminally prosecuted for violating the law.<sup>205</sup>

According to one commentator, the massive accounting fraud perpetrated on the market in the Macat case was akin to a phenomena rather than an individual case.<sup>206</sup> In light of the Macat case, for both foreign and domestic investors since, the quality of listed companies shall become carefully scrutinized, as the disclosure reports provided by various intermediary service providers, which are supposed to serve as the “soft” regulatory infrastructure, cannot be trusted nor depended on outright.

#### D. *Poor Corporate Governance: Listed Companies Too Dark To Be Visible*

Corporate governance was suddenly brought into the landscape of China’s securities market in 2001 by the famous YinGuangXia case.<sup>207</sup> Since then, this issue has become a high profile topic and has been made top priority of the regulator’s agenda, being mentioned frequently in all recent keynote speeches by the Chinese, ranging from the Premier to university professors.<sup>208</sup>

Poor corporate governance is still a problem caused by the inherent paradox of SOEs which constitute the majority of listed

<sup>202</sup> See Steven Shi & Drake Weisert, Commentary, *Corporate Governance with Chinese Characteristics*, 29 CHINA BUS. REV. (Sept.-Oct. 2002), available at <http://www.chinabusinessreview.com/public/0209/shi.html> (last visited Mar. 28, 2004).

<sup>203</sup> See Ling et al., *Macat’s Nightmare*, *supra* note 200.

<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> See Shuguang Li, *Gusi Zhili de Shengtai Weiji [Ecological Crisis in Corporate Governance]*, in CAIJING MAG., Mar. 20, 2002, available at <http://www.caijing.com.cn> (last visited n.d., on file with author).

<sup>207</sup> See *Standard & Poors Country Governance Study— Corporate Governance in China*, Nov. 2003, at 1, available at <http://www.standardandpoors.com> [hereinafter the S&P Study]; *Victims of Fraud*, SHANGHAI STAR, May 23, 2002, available at <http://app1.chinadaily.com.cn/star/2002/0523/bz10-1.html> (last visited Mar. 28, 2004).

<sup>208</sup> *Id.*

companies. Part of the problem is due to government restriction over the sale of tradable shares to investors—as normally, in any listed SOE, the state owns at least two-thirds of the shares (including state shares and legal person shares), which are not tradable as a matter of law (and thus non-transferable to private investors by any means). Consequently, this naturally leads to the problem of the single shareholder (often the state shareholder) dominating. Thus, owners of the remaining one-third tradable shares, composed mainly of dispersed individual investors, have no meaningful influence on the decision-making process in the listed SOEs.<sup>209</sup> In addition, China's corporate and securities laws, understandably, in the sense that they were made to protect state assets, place much power in the majority shareholder with respect to voting rights and corporate management.

The state is, after all, an abstract owner. It must exercise its ownership through human agents. As one scholar has observed, "State-owned enterprises were thus always controlled, both at the enterprise level and at the level of the administrative body in charge of them, by human beings who did not own the enterprise."<sup>210</sup> As such, due to the absence of the effective ultimate owner (the state), power to control the SOEs rested in the hands of appointed managers, which can only be monitored by competent government agencies. When serious violations of securities laws or infringements of state assets are discovered, it is not uncommon to find that the state agencies either lacked the necessary supervisory capability or simply conspired (through corrupt officials) with the directors and managers of the listed companies to defraud the shareholder property.

The YinGuangXia case is the most influential one of this kind involving severe losses to thousands of minority shareholders due to almost non-existent corporate governance. In May 2002, the CSRC issued a penalty report finding that, from 1998 to 2001, YinGuangXia fabricated sales receipts and disclosed false information about various production facilities that actually never existed. The company lied to the

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<sup>209</sup> This is exacerbated by another problem—China's investors have little sense of responsibility as shareholders. Popular interest in purchasing stock has been overwhelmingly motivated by the prospect of rapid appreciation in market value, rather than by long-term analysis of the fundamentals of the company. It is a well-known fact that 99 percent of private investors are oriented towards speculative profits. Investors rarely inquire into the stock issuer's economic condition, operations, or future prospects, apparently assuming that the government will not allow an enterprise to fail. Dividends do not enter into the analysis and attention is directed solely to short-term fluctuations in price. A report by Guangzhou East Market Research Firms indicated that, in a poll about shareholders sense of Guangzhou, about 50.6 percent of those investors stated that they had little or no knowledge of the operation of their companies. 43.7 percent stated that they never had the sense of a shareholder. See HE, *supra* note 196, at 27.

<sup>210</sup> See Clarke, *supra* note 172, at 6.

market concerning RMB\$ 1 billion in revenue and RMB\$ 771 million in profit.<sup>211</sup> The fabricated financial statements led investors to believe it was a profitable blue chip stock among the listed companies in China's securities market. The sole purpose of all the misrepresentation was to induce investors to buy its follow-up issuances. According to an investigation by the Xinhua News Agency, since 1994 to 2001, YinGuangXia made three follow-up offerings and collected RMB\$ 574 million from the market, resulting in severe losses to thousands of small investors.<sup>212</sup>

One of the major reasons causing the YinGuangXia scandal was the virtual non-existence of corporate governance in this state-owned listed company. According to the Xinhua investigation, the meetings of the board of directors had always been done perfunctorily, with decisions decided by "core" people without transparency.<sup>213</sup> The fraudulent activities were conducted by the CEO of a wholly-owned subsidiary of YinGuangXia, which was the major revenue source of the listed company. As noted by Professor Li Wei'an, Dean of the International Business School of Nankai University of China, the board of directors completely failed in certain aspects of corporate governance, including governance of its subsidiary and the corporate management. In addition, non-state shareholders were entirely deprived of the right to monitor the board and the management.<sup>214</sup>

In the foreseeable future, foreigners still have to face the problem of poor corporate governance and the predominance of the state shareholder. Needless to say, the acumen of foreign investors participating in China's stock market, which the Chinese regulators see as an opportunity to restructure its SOEs and national economy, will be limited if the corporate governance problem is not resolved.

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<sup>211</sup> See Zhengjianhui Xiada Chufa Jueding, *ST YinGuangXia Jiang Zanting Shangshi* [CSRC Issues Penalty and Trading of YinGuangxia Shares Will be Suspended], in ZHENGQUAN SHIBAO [SEC. TIMES] (May 16, 2002), available at <http://www.people.com.cn/GB/jinji/35/159/20020516/729584.html> (last visited Mar. 28, 2004).

<sup>212</sup> See Jinsong He & Zhenjun Han, *YinGuangXia Zhuizong: 7.7 Yi Yuan de Paomo Shi Zenyang Chuida De?* [Tracing YinGuangXia: How was the Bubble of 770 Million in Profit Made?], XINHUA NEWS AGENCY, May 26, 2002, available at <http://www.xinhuanet.com> (last visited n.d., on file with author).

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

<sup>214</sup> See Gongsu Dongshihui Nanci Qijiu: *Jingjixue Jia Tan YinGuangXia Shijian* [Economist on YinGuangxia: The Board of Directors is Liable], in SHENZHEN TEQU BAO [SHENZHEN SPECIAL ADMIN. REGION DAILY], Aug. 27, 2001, available at <http://business.sohu.com/20010827/file/0092,023,100050.html> (last visited n.d., on file with author).

E. *Absence of Effective Judicial Protection of Minority Investors*

Despite the enormous number of securities disputes regarding fraud, judicial involvement is so far limited and self-constrained on the part of Chinese courts. When the YinGuangXia scandal and another fraudulent case (Yorkpoint Science and Technology Co.) occurred in 2001, hundreds of investors rushed to courts for help, and they were frustrated by the judiciary's reluctance to process securities litigation. On September 21, the Supreme Court of China released a notice requiring all lower courts temporarily not to accept securities lawsuits concerning insider trading, fraud, market manipulation, and the like, based on the "constraints created by the current legislative and judicial conditions."<sup>215</sup> A shock to investors, professionals and scholars, the notice fueled much debate over the rule of law and the role of the Chinese judiciary in the development of China's securities market.

Yet the Court's decision appeared reasonable and understandable, at least according to then Vice President of the Supreme Court, Li Guoguang.<sup>216</sup> First, there was an issue of lack of judicial coordination—as investors would have to initiate different lawsuits against the same defendants across multiple jurisdictions, and different lower courts would almost certainly render conflicting rulings due to the absence of coherent criteria. Second, there was concern of overloading the entire court system by individual securities lawsuits. Third, judicial incapability was frankly admitted, especially with respect to the lack of experienced judges, and the absence of a national uniform standard regarding evidentiary rules. Lastly, there was concern over protecting state assets. As indicated by Justice Li, "[I]f there were to be numerous lawsuits against all these listed firms and if the private plaintiffs were awarded the rightfully deserved relief, it would lead to major losses of state assets (since the listed companies are mostly state-controlled)."<sup>217</sup> Clearly, the socialist ideology of state ownership prevailed over justice for individual rights.

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<sup>215</sup> See Zuigao Renmin Fayuan Guanyu She Zhengquan Minshi Peichang Anjian Zhanbu Shouli de Tongzhi [Notice of the Supreme People's Court on the Temporary Ban on Private Securities Lawsuits] (FaMingChuan, Court Doc. No. 406, Sept. 21, 2001), available at <http://www.court.gov.cn> (last visited Mar. 28, 2004) [hereinafter SPC, Ban on Private Securities Lawsuits].

<sup>216</sup> See Zhiwu Chen, *Capital Markets and Legal Development*, Yale School of Management Working Paper (Sept. 12, 2003), available at <http://icf.som.yale.edu/research/china-initiative.shtml> (last visited n.d., on file with author).

<sup>217</sup> *Id.*

Four months later, a second notice came from the Supreme Court allowing Chinese courts to accept private securities cases concerning misrepresentation.<sup>218</sup> It set up relevant judicial standards and a definition for “misrepresentation,”<sup>219</sup> but confined a court’s jurisdiction only to these types of claims. Moreover, it preconditioned judicial acceptance of these cases on the prior penalty report of the CSRC establishing facts and evidence.<sup>220</sup> Arguably, this breached the principle of judicial independence guaranteed by the PRC Constitution and was alleged to be a re-writing of the Securities Law enacted by the country’s top legislature, the National People’s Congress (NPC).<sup>221</sup> Nevertheless, a wave of lawsuits flooded the courts after the promulgation of this notice.<sup>222</sup>

The most comprehensive judicial interpretation, Provisions concerning Civil Securities Litigation on Misrepresentation Cases [hereinafter CSL Provisions],<sup>223</sup> was released in January 9, 2003, obviously as a response to outcry from lower courts for more detailed procedural and substantive rules. The CSL Provisions make no change to the confinement of private securities litigation only to misrepresentation cases, and affirm the requirement of preconditioning private lawsuits on the prior investigation and administrative decisions of the CSRC and other state ministries. Investors in China’s securities market still have no judicial recourse for cases concerning insider trading, market manipulation, and other fraudulent activities, and they have to sue in the courts of the places where defendants are headquartered and where local protectionism is a prevailing concern.

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<sup>218</sup> See Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang Yin Xujia Chenchu Yinfa de Minshi Qinquan Jiufen Anjian Youguan Wenti de Tongzhi [Notice of the Supreme People’s Court (SPC) on Accepting Civil Tort Disputes Arising out of Misrepresentation in Securities Markets] (Jan. 15, 2002), *available at* <http://www.court.gov.cn> [hereinafter SPC, Notice on Securities Tort Disputes].

<sup>219</sup> *Id.* art. 1.

<sup>220</sup> See SPC, Notice on Securities Tort Disputes, *supra* note 218, art.2.

<sup>221</sup> See Chen, *supra* note 216.

<sup>222</sup> *Id.*

<sup>223</sup> Zuigao Renmin Fayuan Guanyu Shenli Zhenquan Shichang Yin Xujia Chenshu Yinfa de Minshi Peichang Anjian de Ruogan Guiding [Supreme People’s Court Provisions Concerning Civil Securities Litigation on Misrepresentation Cases (Promulgated Jan. 2, 2003, Effective Feb. 1, 2003), *available at* <http://www.court.gov.cn> (last visited n.d., on file with author).

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

As noted by many commentators, there will be no future for China's securities markets—and accordingly, no future for the success of foreign participation in its markets—if those structural flaws and systemic problems are not resolved.<sup>224</sup> Given the indicia of paternalism in China's securities markets, viable securities regulations should play a significant role in shaping a sound environment for the development of the market. However, improvement of China's securities regulations concerning foreign investment will depend on consideration of the following factors: China's determination to honor its WTO obligations; reevaluation of the role of foreign investors; repositioning the Chinese government's role in economic development; advancement of a true form of privatization for China's SOEs; and, most importantly, the rule of law and institution-building for the market economy.

A. *WTO Compliance*

As a member of the World Trade Organization, China is expected to comply with all obligations under the General Agreement on Trade in Services (GATS)<sup>225</sup> in terms of financial services and has, thus far, obtained mixed evaluations with regard to its performance. China struggled for 15 years to join the multilateral trading institution largely due to the stern demands on market access from other GATT/WTO members whose foreign economic relations are primarily governed by WTO agreements. China's compliance with WTO obligations constitutes the most important aspect of its bilateral and multilateral engagements with other countries.

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<sup>224</sup> In recent years, Chinese commentators commonly recognize that China's securities markets have been marginalized in terms of playing a meaningful role in the economic development. In an ongoing debate on the problems of the stock market, the meaningfulness of having such a distorted market has been put on doubt. See e.g., Xianrong Yi, *Guonei Gushi Weihe Bianyuan Hua?* [Why is the Stock Market Marginalized?], and Li Yu, *Quanshang Zhi Huan: Shoudu Jingmao Daxue Liu JiPeng Jiaoshou Zhuan Fang* [Worries of the Securities Business – Interview with Professor Liu Jipeng of Capital Economic and Trade University], both in NANFANG ZHOUMO [NANFANG WKLY.], Sept. 11, 2003, available at <http://www.nanfangdaily.com.cn/zm> (last visited n.d., on file with author). In Li Yu's interview, Professor Liu stated: "It can basically be concluded that the capital market is in its most difficult, grim period since its inception 11 years ago. The grim situation does not lie in the fact that it is fundamentally a bear market. More severely, we don't know what the future of China's capital market is, and we are at loss, not knowing where it is heading to." *Id.*

<sup>225</sup> See WORLD TRADE ORGANIZATION, General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization [hereinafter WTO Agreement], Annex 1B [hereinafter GATS].

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

(1) Most Favored Nation (Normal Trade Relations)<sup>226</sup> treatment: Members are required to "accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favorable than that it accords to like services and service suppliers of any other country."<sup>227</sup> The objective of this provision is to ensure that a WTO Member treats other members on a non-discriminatory basis. In China's Accession Protocol, it agrees to accord to foreign individuals and enterprises as well as foreign-funded enterprises "treatment no less favorable than that accorded to other individuals and enterprises in two respects: (a) the procurement of inputs and goods and services necessary for production and the conditions under which their goods are produced, marketed or sold, in the domestic market and for export; and (b) the prices and availability of goods and services supplied by national and sub-national authorities and public or state enterprises, in areas including transportation, energy, basic telecommunications, other utilities and factors of production."<sup>228</sup> Apparently, financial services, including securities services, are embedded in this commitment. However, pursuant to GATS Article II(2), which authorizes Members to make deviations from MFN obligation, China can accord particular countries less than MFN treatment so long as it has listed these deviations (called MFN exemptions) in its GATS Article II Schedule.<sup>229</sup>

(2) Transparency: Article III of GATS provides that each Member shall "publish promptly" all relevant domestic measures of general application that pertain to or affect the operation of GATS as well as international agreements pertaining to or affecting trade in services to which the Member is a signatory.<sup>230</sup> According to its commitments with regard to transparency, China undertakes only to

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<sup>226</sup> See <http://www.itds.treas.gov/mfn.html> (last visited Mar. 28, 2004) (for an explanation on the change from the term of "Most Favored Nation" (MFN) to "Normal Trade Relations" (NTR)).

<sup>227</sup> See GATS, *supra* note 225, art. II.

<sup>228</sup> See Protocol on the Accession of the People's Republic of China, Nov. 10, 2001, Accession of the People's Republic of China, WT/L/432, Part I(3), *available at* <http://www.mac.doc.gov/China/ProtocolandDecision.pdf> (last visited Mar. 28, 2004) [hereinafter Accession Protocol].

<sup>229</sup> See GATS, *supra* note 225, art. II(2).

<sup>230</sup> *Id.* art. III.

enforce laws that are published. In addition, it agrees to provide WTO Members, upon request, all laws affecting trade in services and to establish an official journal and entry point making Chinese laws readily available to any individual, enterprise or WTO Member.<sup>231</sup>

(3) Fair application of laws: Article VI of GATS requires WTO Members to ensure that “measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner.”<sup>232</sup> This article is intended to prevent Members from denying, nullifying, or impairing GATS benefits to other Members through the use of onerous domestic administrative measures. In this regard, China commits itself to “apply and administer in a uniform, impartial and reasonable manner all its laws, regulations and other measures of the central government as well as local regulations, rules and other measures issued or applied at the sub-national level pertaining to or affecting trade in.... services....”<sup>233</sup>

The above principles, covering all aspects of regulatory and administrative measures affecting trade in services, form general obligations that apply almost without qualification to all financial services activities, including securities services. China has also given a variety of specific commitments with regard to securities services. Those commitments, although fully binding and embodying the principle of market access and national treatment, apply to a Member only to the extent that the country has made an affirmative commitment in their Schedule to be bound (to the so-called “positive list”).<sup>234</sup>

Specifically, China allows foreign securities institutions to engage directly (without Chinese intermediaries) in B Shares business. They may also become Special Members of all Chinese stock exchanges. Foreigners are permitted to establish joint ventures with foreign investment of up to 33 percent within three years after China’s accession, and 49 percent thereafter. From 2005, they can also establish joint ventures in China in the underwriting of A shares and in the underwriting and trading of B shares and H shares as well as government and corporate bonds.<sup>235</sup>

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<sup>231</sup> See Accession Protocol, *supra* note 228, Part I(2)(C).

<sup>232</sup> See GATS, *supra* note 225, art. VI.

<sup>233</sup> See Accession Protocol, *supra* note 228, Part I(2)(A)(2).

<sup>234</sup> See GATS, *supra* note 225, arts. 16, 17 & 18.

<sup>235</sup> See WTO, Report of the Working Party on the Accession of China, Addendum, Schedule CLII – The People’s Republic of China, Part II – Schedule of Specific Commitments on Services, List of Article II MFN Exemptions, WT/ACC/CHN/49/Add.2 (Oct. 1, 2001), available at [http://www.ivyeshipment.com/ivy/docs/Annex9\\_en.pdf](http://www.ivyeshipment.com/ivy/docs/Annex9_en.pdf) (last visited Apr. 4, 2004) [hereinafter China’s Service Commitments].

In sum, Part III of this article demonstrates that, according to “the law on paper,” China has enacted laws fully consistent with its WTO obligations.<sup>236</sup> There is little doubt that the “law in reality,” however, will be significantly different as China’s policies are exposed to interest groups politics, in which the lobbying power of international financial capitalists, who have an enormous stake in China’s honoring of its commitments, plays a substantial role. What’s more, the WTO has posed challenges to China’s perspective concerning its socialist ideology of property ownership, country governance, relationship between government and private citizens, as well as economic integration and globalization. In essence, WTO accession and compliance provides the momentum for further constructing of the rule of law and civil society in China, in addition to reducing state ownership to a minimum through privatization. The following sections will discuss the impact of the WTO on China in these areas.

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

Policy makers and regulators in China are often preoccupied with concern over sovereign control of its domestic economy. While they long for foreign investment and have successfully established China among the largest recipients of foreign capital in the past decade,<sup>237</sup> they have also taken tremendous precautionary measures to prevent foreign control of Chinese companies, except in a limited, selected body of enterprises. Fortunately, this mentality has changed, particularly in recent years, due to challenges posed by both poor performance of a substantial number of domestic SOEs and economic globalization. Yet it might still be a very subtle issue in the sense that domestic sovereignty and financial stability are legitimate concerns among many nations of the

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<sup>236</sup> It shall be noted that China’s commitments do not contain obligations relating to opening up China’s domestic capital markets to foreigners. They merely apply to measures allowing service market access and MFN and NTR treatment, when obligated, to foreign suppliers of services. For example, permitting foreign enterprises to takeover Chinese SOEs is not included in China’s GATS obligations.

<sup>237</sup> In 1993, China became the second largest recipient of foreign direct investment (FDI) after the United States. In 2002, largely due to the 9/11 incident, which frustrated the confidence of international investors in the United States, led to China replacing the U.S. as the largest destination of FDI. *See generally World Investment Report 1994, Transnational Corporations, Employment and the Workplace*, United Nations Conference on Trade and Development, U.N. Doc. UNCTAD/DTCI/10, U.N. Sales No. E.94.II.A.14 (1994); *World Investment Report 2003, FDI Policies for Development: National and International Perspectives*, United Nations Conference on Trade and Development, U.N. Doc. UNCTAD/WIR/2003, U.N. Sales No. E.03.II.D.8 (2003).

world, and this is especially true to those alleging that short-term-profit-oriented international investors contributed to the Asian Financial Crisis during 1997 to 1998.

Embracing foreign investors, however, is a global trend. The OECD notes that “All OECD countries have accepted the principle that foreign investors should be allowed to invest without limit in their domestic equity markets, although some countries make exceptions for certain ‘strategic’ industries.”<sup>238</sup> Foreign investors, especially foreign institutional investors, should not only enlarge the investor base, but also contribute to financial innovation within the domestic market. Moreover, foreign investors may even help with the formation of a positive culture of corporate governance by defining their expectations concerning disclosure governance and profitability into markets, thereby encouraging listed companies to adhere to global standards of practice.<sup>239</sup>

One may argue that introduction of such international expectations, or global best practice, might not necessarily be desirable. However, there are at least two counter-arguments to refute. First, global capital flow, necessary for the development of any economy, is very sensitive with regard to international standards; and global capital is more likely to float to the place where global best practice is adopted.<sup>240</sup> Secondly, the content of global best practice per se is sufficient to instill confidence in the mind of international investors—in particular, it dictates that “shareholder value is becoming an accepted standard by which corporate performance is assessed throughout the world.”<sup>241</sup> The World Bank describes the overall benefits of foreign participation in developing countries’ stock market as the following:

Opening stock markets to foreign participation increases liquidity by deepening the pool of buyers and sellers. Price earning ratios rise as liquidity increases, making the market a far more attractive source of equity financing. As the stock market develops and strengthens, it benefits other parts of the financial sector as well as the wider economy—foreign direct investment accompanies stock market purchases, for instance. Stock market development and

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<sup>238</sup> See OECD, *supra* note 9, at 526.

<sup>239</sup> *Id.*

<sup>240</sup> See Jeong Yeon Lee, *The Role of Foreign Investors in Debt Market Development: Conceptual Frameworks and Policy Issues*, World Bank Policy Research Working Paper, No. 2428 (Aug. 2000), available at <http://www.worldbank.org/research/pdffiles/Role%20of%20Foreign%20Investors.pdf> (last visited Apr. 4, 2004). See also WDR 2000, *supra* note 5, at 84.

<sup>241</sup> See OECD, *supra* note 9, at 526.

banking development have a strong positive relationship, as do stock market liquidity and economic growth.<sup>242</sup>

There is still the crucial question of how to achieve a subtle balance in light of the risks associated with global capital flow. Financial crises in recent years suggest that foreign portfolio investors can play a key role in a contagion of crises by quick shifts in capital flows, making the host economies more susceptible to volatility and sometimes causing their collapses.<sup>243</sup> The 1997 Asian Financial Crisis is a vivid example. Ironically, China escaped the crisis largely thanks to the fact that its financial system was less liberalized than most of its Asian neighbors. As noted by Nicholas Lardy of the Institute for International Economics, "China's experience in the Asian financial crisis supports the view that premature capital account liberalization increases a country's vulnerability to a currency crisis."<sup>244</sup>

There is little doubt that China will promote the orderly flow of foreign investment in its securities markets. It is, however, important to stress that improvement and reform does not necessarily mean unfettered liberalization. A financial crisis caused by over-speculative capital markets is more detrimental and even dangerous to both the Chinese and world economy. China's problem is that its financial regulators (when regulating the capital markets) and its trade negotiators (when giving concessions for trade in services) have struggled in striking a balance between liberalization and restrictive regulation. Hence, the extreme conservatism in certain respects, particularly in cautiously allowing foreign investors to invest only in portions of China's equity market, while tending to adopt bold liberalization measures in other aspects, namely the sudden acceptance of foreign takeovers of SOEs without first resolving a variety of internal problems (e.g., the proper valuation and pricing of state assets) which should precede SOE reform.

Moreover, China's external commitments in services were not a result of deliberation over the country's "national condition," an excuse often asserted by China's officials when faced with challenges of legitimacy to its policies, but rather part of a liberalization package that has incorporated many social, political, and self-interested factors. As observed by Lardy, "In its WTO negotiations, China's MOFTEC

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<sup>242</sup> See WDR 2000, *supra* note 5, at 84.

<sup>243</sup> See Lee, *supra* note 240, at 2.

<sup>244</sup> See Nicholas R. Lardy, The Case of China, Paper Prepared for the Conference on Comparative Study of Financial Liberalization in Asia at the East-West Center (September 22-23, 1999), at 33, available at <http://www.brookings.edu/views/articles/lardy/20030101.htm> (last visited Mar. 29, 2004).

negotiators made commitments in services without sufficiently consulting with the relevant domestic regulators.”<sup>245</sup>

Overall, China should continue to encourage foreign portfolio equity investment without undermining efforts in attracting foreign direct investment. The distinction between A and B shares, which generates pricing distortions, should be abandoned. Yet there is no need for China to rush to capital account liberalization until a general environment that will have appeal to foreign investors is established. As one World Bank researcher noted, “[I]n sequencing capital account liberalization, the greatest danger is removal of most restrictions on capital account transactions before major problems in the domestic financial system are addressed. Countries in which these problems are severe, but that choose to suddenly and fully open the capital account, run the risk of incurring a crisis.”<sup>246</sup>

Still, it is fair to say that China has acted prudentially and appropriately in many regulatory aspects. Namely, China enhances the stability and controllability of the domestic stock market by requiring QFIIs not to repatriate their principal within a period of three years, and foreign companies not to transfer their shares within one year after their takeover of a Chinese company.<sup>247</sup> However, China should, and can, safely advance further liberalization on two additional fronts.

First, foreign institutional investors should be given more flexibility and larger freedom for portfolio investment. While the QFII regime is a good start, the access requirements are simply too high and excessively cautious. For instance, the requirements for business experience (up to 30 years), paid-up capital (US\$ 1 billion), and managed assets (up to US\$ 10 billion) are higher than those initially set in Taiwan, considered a pioneer of the QFII system.<sup>248</sup> Thus, a tremendous amount of medium to small institutional investment firms, while equipped with excellent management experience, know-how, and dedicated enthusiasm to emerging markets, are excluded from entry into China’s stock market. In addition, the requirement that each QFII is only allowed to invest up to US\$ 800 million will make the aggregate investment of institutional investors a tiny part of the total capitalization of China’s stock market.

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<sup>245</sup> See Nicholas R. Lardy, *Problems on the Road to Liberalization*, in FIN. TIMES, Mar. 15, 2002, available at <http://www.brookings.edu/views/op-ed/lardy/20020315.htm> (last visited Mar. 29, 2004).

<sup>246</sup> See Lee, *supra* note 240.

<sup>247</sup> See QFII Rules, *supra* note 118, art. 26.

<sup>248</sup> See *supra* note 121 and accompanying text (highlighting the differences between Taiwan and mainland China’s QFII regime).

Second, greater market access should be given to foreign financial service suppliers, including securities firms, investment banks, and fund management companies. While the number of China's own securities firms has exceeded a hundred, which, in theory, could form the basis for fair competition, there appears to be no standard of practice—in line with international expectations—given the rampant occurrences of fraudulent activities and the cheating culture. Gao Xiqing, while Executive Vice President of the CSRC, once pointed out that every Chinese stock was manipulated by Chinese institutions, indicating that almost all securities firms and other institutions played a negative role in standardizing the market order.<sup>249</sup>

On another occasion, Gao said again that if he could exercise his free will, he would hire no Chinese fund management companies to manage China's social securities funds, and the only reason preventing him from doing so was because existing state laws prohibited such action.<sup>250</sup> Gao's views on Chinese intermediaries are affirmed by Cheng Siwei, another senior Chinese official who said recently that violation of laws by securities firms was one of the major problems in the implementation of China's Securities Law.<sup>251</sup> One of the telling pieces of evidence was that in the Macat case, discussed previously, almost all the intermediaries perpetrated fraud by helping to falsify documents.<sup>252</sup> Given the problem of potentially unreliable Chinese intermediaries, there appears to be little incentive for foreign competitors, who themselves implement and adhere to a standard of international best practice in supplying securities services, to enter the current landscape of China's securities market.

C. *Redefining the Role of Government and Regulations:  
Primacy of the Rule of Law and Institution Building*

In the days of the planned economy, China's government agencies controlled every aspect of society, including the development of economy. This tradition, together with the underlying mentality, persists

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<sup>249</sup> See Gao Xiqing Renwei, *Gushi Muqian Wugu Buzhuang* [Gao Xiqing Views that No Stock Is Not Manipulated by Institutions], SOHU, May 24, 2001, at <http://business.sohu.com/44/52/article13745244.shtml> (last visited Mar. 29, 2004).

<sup>250</sup> See Hao Ming, *Shebao Jijin Luzhan Lubai* [Social Security Funds Repeatedly Make Losses], 21 SHIJI JINGJI BAODAO [21<sup>ST</sup> CENTURY ECON. REP.], Aug. 20, 2003, available at <http://www.nanfangdaily.com.cn/jj/20030821/cj/200308200606.asp> (last visited n.d., on file with author).

<sup>251</sup> See Cheng Siwei: *Zhengquan Fa Shishi Zhong Cunzai De Wenti Burong Hushi* [Cheng Siwei Says the Major Problems in the Implementation of the Securities Law Should Not be Ignored], RENMIN RIBAO [PEOPLE'S DAILY], Nov. 19, 2003, available at <http://www.people.com.cn> (last visited n.d., on file with author).

<sup>252</sup> See Ling et al., *Macat's Nightmare*, *supra* note 200, and accompanying text.

still today even though many prefer to characterize China in a transition period toward a market economy. As the country advances from a planned to market economy, the role of the government shall also be transformed from an “instrument of the ruling class,” as Communist ideology suggests, to a functional institution that provides good governance. According to the World Bank:

Good governance includes the creation, protection, and enforcement of property rights, without which the scope of market transactions is limited. It includes the provision of a regulatory regime that works with the market to promote competition. And it includes the provision of sound macroeconomic policies that create a stable environment for market activity. Good governance also means the absence of corruption, which can subvert the goal of policy and undermine the legitimacy of the public institutions that support market.<sup>253</sup>

In China’s transition to a market economy, the government’s chief task is to provide institutions supporting the market through regulatory reforms. Regulatory powers are centered on the system of law.<sup>254</sup> “The foundation of a rule of law is built from respect by both government and citizens for the legitimacy of regulation, from high-quality regulations, from openness and clarity in the regulatory system, and from processes by which regulators can be held accountable for the contents of rules.”<sup>255</sup> As a general matter, the government has the mission to provide a functional and enforceable legal and regulatory framework that meets the following objectives with regard to mature financial and capital markets:<sup>256</sup>

(1) Establish viable, predictable, and flexible commercial rules for the financial market and financial transactions. Private financial transactions should be the focus of financial law, simply because they constitute the foundation of financial markets. Without prosperous and growing commercial transactions, all public regulatory regimes would

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<sup>253</sup> See WDR 2002, *supra* note 2, at 99.

<sup>254</sup> See OECD, *supra* note 9, at 368.

<sup>255</sup> See *id.*

<sup>256</sup> The following points are incorporated from the author’s work in Professor Philip R. Wood’s class “Global Comparative Financial Law” while studying at Oxford in 2002-03. The author acknowledges tremendous thanks to Professor Wood for enlightening discussions on the topic of the goals of financial law. For further reference on an exemplary regulatory and legal model for mature markets, see generally, Financial Services and Markets Act 2000 of the United Kingdom, chapter c.8, *available at* <http://www.hmso.gov.uk/acts/acts2000/20000008.htm> (last visited Apr. 4, 2004).

lose their sense and justification for existence. The commercial rules include those on contract, agency, tort, property, and many others.

(2) Protect investors and finance consumers (including banking clients, securities investors, insurance policy holders) against the failure (e.g., insolvency or bankruptcy) of the service providers as well as against bad selling or advisory practices, often caused by conflicts of interest, and against risky products. The underlying philosophy is that those investors are just like normal consumers, who are part of the public and should, therefore, be protected. In addition, the damage caused to them because of failure or bad practice of service providers is usually more severe than normal consumer loss in any other commercial/consumer transactions.

(3) Prevent or minimize contagion or systemic risk of the financial market. It has become a common phenomenon that, because of the enhanced linkages across national and international financial markets, the volatility of capital flows and the potential for concentrated disturbance are more easily and broadly transmitted across institutional groups or markets, thus triggering inter-market contagion and causing systemic collapse. In the end, that will lead to financial and economic crises, like those that happened in Mexico and East Asia. Frankly, systemic risk has provided a major incentive for financial regulation.

(4) Safeguard the proper functions of markets and maintain investor confidence, including the smooth operation of markets, price transparency and proper information supply, particularly the prevention of market abuse or manipulation and insider dealing. A related point is the provision of adequate clearing and settlement and custody facilities.

(5) Regulate financial intermediaries (service providers) with regard to their conduct of business, integration, and reputation. This is essential for financial laws to work as those intermediaries are presently the pillars of markets. A related point is to create a fair competition environment for those institutions by creating a level playing field and preventing monopolies among those intermediaries in the financial services.

To be sure, China's overall regulatory dilemma is that, on the one hand, regulations are overreaching, overly-complex, multi-layered, often arbitrary and very interventionist—leading to excessively high transaction costs. But, on the other hand, many sectors of China's market also suffer from substantial under-regulation, poor enforcement, and under-institutionalization, which lead to insufficient confidence in the market by consumers and investors. Additionally, the regulators, particularly the CSRC, undertake conflicting tasks when attempting to both develop and regulate the market. Especially now, while the stock market continues to undergo its longest bear period, the CSRC is under enormous pressure from powerful interest groups (including many Chinese securities firms) to “save the life of the market” (*jiushi*). The CSRC, however, should realize that—borrowing the Chinese idiom

“*yinzhen-zhike*”—‘drinking poison to quench thirst’ provides no solution to the problem at hand. For the regulators, there is no alternative but to foster and safeguard a market environment that ensures reasonably accurate disclosure of information and a good corporate governance structure. Regulatory “forbearance” might be inevitable in many cases due to limitation in the regulatory capacity; however, regulators should by no means become accomplices of those market manipulators, insiders, and other law-breakers.

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

A viable stock market should have an effective judiciary to ensure the proper application of the rule of law, rights of administrative procedure, and efficient dispute resolution regimes—thus establishing institutions that will serve as checks and balances against abuse of public powers and instill confidence for international and domestic investors. In China, the judiciary is rather weak and self-constrained in providing protection for investors. Within and beyond China’s borders, the consensus is that China needs a strong judicial system to safeguard the stock market and provide adequate dispute settlement mechanisms. Concern is over the Chinese judiciary’s capacity as well as certain socialist ideological concepts that wholly and unabashedly favor the state (e.g., the concept of “preventing the loss of state assets”). While the first concern of judicial incapacity could be solved as the experiences and resources of the judiciary expand, the second concern could possibly remain in place indefinitely, unless full-pledged protection for private property is established.

In addition, judicial reform should focus on developing politically independent judges, and this can only be accomplished within a context of social responsibility. Given the nature of China’s transitional political structure, it has a long way to go before true judicial independence is established. Nevertheless, it is still possible to establish a judiciary that is keen on providing equal protection to both state and private property, as social ideology appears to be diminishing due to recent reform movements initiated by the Chinese Communist Party with regard to SOEs and state-owned assets.

D. *SOE Reform, Privatization, and Good Corporate Governance*

It is repeatedly emphasized that a well-functioning stock market depends on two factors: a reasonably accurate information disclosure system and a good corporate governance structure. Corporate governance is centered on the idea that companies are governed with the aim of providing investors with reasonable financial return, and operators of the companies act within institutional constraints to manage them with integrity and responsibility. To enhance corporate governance, there is no alternative but to reform the ailing SOEs. For a long period during the reform era, the officially proclaimed guideline of China's SOE reform was "separating State ownership from corporate management," with the intention of preserving state dominance and government control in the national economy.<sup>257</sup> According to a policy on SOE reform issued by the central government, SOE managers should be familiar with the business they engage in and armed with modern knowledge of business management and even finance, science and technology, and the law.<sup>258</sup> However, in many cases the quality of the managers appointed fell far short, as evidenced by numerous cases concerning management corruption and embezzlement of corporate property—overall, agency problems have led to severe losses in wealth of the state and domestic and foreign investors.<sup>259</sup>

With the retreat of the State from management of enterprises, State supervision of the management has withdrawn as well. Some managers have treated State assets as their own private property. Corruption, thus, rampantly emerged and festered with the absence of an effective ultimate owner. Obviously, major problems are caused by the ambiguity of the state-enterprise property relationship. Clear ownership rights are fundamental to a market economy; it can provide important incentives to use assets productively. As Demsetz so stated:

[P]roperty rights derive their significance from the fact that they help a man form those expectations which he can reasonably hold in dealing with others. Without those expectations, people are unable to predict whether they will have a given set of assets at their disposal and are thus less

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<sup>257</sup> See JIANG 1997 ADDRESS, *supra* note 194.

<sup>258</sup> See *infra* note 262 and accompanying text.

<sup>259</sup> See e.g., Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Frank Eastbrook, *Two Agency Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984); Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

likely to make the most efficient use of those assets. At a minimum, then, a system must parcel out some (or most) of the constituent rights of ownership into a bundle of rights which are clearly defined and legally protected.<sup>260</sup>

However, clear ownership by itself is not sufficient for establishing good corporate governance. Insofar as ownership is concerned, an enterprise has what are known as “residual risk holders.” In order for these risk holders to be willing to accept risk, they must either be compensated for holding that risk by being the owner (and therefore having control over the enterprise’s operations and profit and loss distribution), or be able to escape the risk by selling the right to hold it. The existence of either of these two conditions could lead to an environment in which the owners of the enterprise behave efficiently.<sup>261</sup>

Under the ownership structure of SOEs, the State legally owns all the assets of SOEs, and SOE managers are entrusted by the State to operate the enterprise. This formula, however, rarely has the chance to achieve success. First, managers have no or little incentive to behave efficiently and to make profits for the enterprise because, considering China’s current employment system, a manager’s compensation has little to do with his or her performance in managing the company. Second, managers have no or little responsibility for the failure or loss of profit of the company because the current system does not pursue a manager’s personal liability in such cases. In fact, it is neither feasible nor fair to place such a heavy liability on managers given the low pay they receive in comparison to the income of private owners of enterprises.

SOE managers must be subject to effective external supervision. In a free economy, the shareholders are responsible for selecting managers of a company and those managers are accountable to them. This formula, however, does not currently operate in China, partly because the State is not well equipped with the necessary capability to supervise management of every company, and partly because minority shareholders (other than the State) are somehow consciously excluded from supervising management.

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

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<sup>260</sup> See Johns, *supra* note 193, at 923 (quoting Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347, 348 (1967)).

<sup>261</sup> *Id.* at 924.

approach might be their last but, nevertheless, best resort to solve its SOE problems. During the Fourth Plenum of the 15<sup>th</sup> CPC Central Committee on September 22, 1999, the Communist Party issued its Decisions on Major Issues Concerning the Reform and Development of State-Owned Enterprises (hereinafter 1999 Decisions),<sup>262</sup> which, though it does not contain the word “privatization,” implied the Party’s strong interest on its furtherance. According to the 1999 Decisions, the State will control only those industries relating to national security, public utility and natural monopolies, while withdrawing from other commercial industries. It also calls for the development of non-public ownership that refers to the de facto private sector. More revolutionary was that it allows the transfer of small and medium-sized SOEs (SMEs) to private citizens through merger, leasing, or sales. Finally, it mandates that failed SOEs must be diminished through bankruptcy and closure.

A much bolder move, labeled a “radical break” by the *Washington Post*,<sup>263</sup> was taken in October 2003. In the Third Plenum meeting of the Communist Party’s Central Committee, the ruling party passed a resolution with its most explicit language ever regarding the opening of greater doors to private business.<sup>264</sup> Significant to the reform of SOEs and the development of capital markets are these two decisions that are likely to fundamentally change the landscape of China’s corporate ownership structure. First, the socialist ideology on ownership should be virtually diminished. And in addition to the call to give private businesses equal treatment and legal protection, it redefines “socialist public ownership” as “shareholders’ ownership” (*Gufenzhi*), saying this is the primary form of public ownership. The CCP 2003 Decisions also calls for a “mixed ownership” (*hunhe suoyouzhi*), which is characterized as owned by “diversified owners” (*duoyuanhuo touzi zhuti*) who can trade their ownership in a property market according to the “modern property system” (*xiandai chanquan zhidu*) proposed by the

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<sup>262</sup> THE DECISION OF THE CENTRAL COMMITTEE OF THE COMMUNIST PARTY OF CHINA ON MAJOR ISSUES CONCERNING THE REFORM AND DEVELOPMENT OF STATE-OWNED ENTERPRISES (Adopted at the Fourth Plenum of the 15th CPC Central Committee, Sept. 22, 1999), available at <http://www.eastlaw.net/service/datacnlaw/code/corp/decision.htm> (last visited Apr. 4, 2004) [hereinafter 1999 DECISIONS].

<sup>263</sup> See John Pomfret, *Chinese Leaders Endorse Property Rights*, WASH. POST, Oct. 15, 2003, at A17; see also PEOPLE’S DAILY, *Party Decision to Press Forward Market Economy*, Oct. 22, 2003, available at [http://english.peopledaily.com.cn/200310/21/eng20031021\\_126546.shtml](http://english.peopledaily.com.cn/200310/21/eng20031021_126546.shtml) (last visited Apr. 4, 2004).

<sup>264</sup> See SEVERAL DECISIONS OF THE CCP CENTRAL COMMITTEE ON THE PERFECTION OF SOCIALIST MARKET ECONOMY (Adopted by the CCP Central Committee in its Third Plenum Meetings, Oct. 14, 2003, available at <http://www.people.com.cn> [hereinafter CCP 2003 DECISIONS].

Decisions.<sup>265</sup> Affirming the previously established principle that state ownership shall exist only in areas that “are vital to national security and economic lifelines, the CCP 2003 Decisions explicitly permit private capital to invest in the areas of infrastructure, utilities, and other industries so long as no law prohibits its entry.<sup>266</sup> The implication is that not only state-owned SMEs can be privatized, big SOEs, especially those under the direct control of the central government, could also be sold to the private sector through corporatization.<sup>267</sup>

The second significant aspect is that it clarifies the different roles of the state as shareholder and regulator. The recently established State-owned Asset Supervision and Administration Commission (SASAC) is authorized to perform the function of a state owner, representing the state as shareholder in a company. Furthermore, the CCP 2003 Decisions provide that the law should safeguard “the equal legal status and development rights” of all market participants, including the state owner.<sup>268</sup> Conceivably, government agencies with regulatory powers like the CSRC should act only as regulators, treating public and private owners equally.

As stressed by Wu Jinglian, effective corporate governance for China’s listed companies could be established only after the predominance of state ownership is eliminated.<sup>269</sup> The CCP 2003 Decisions certainly attempts to solve the problem and the Minister of SASAC has stated that “very, very few enterprises” would remain wholly state-owned, even predicting the country could enter a “peak period of mergers and acquisitions” because his agency and local governments had been granted the authority to dispose of SOEs.<sup>270</sup>

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<sup>265</sup> See CCP 2003 DECISIONS, *supra* note 264.

<sup>266</sup> See *id.*

<sup>267</sup> See Xinpeng Tan, *Guoqi Gaige: Zou Guqan Duoyuanhua Daolu – Fang Guowuyuan Fazhan Yanjiu Zhongxin Fu Suozhang Zhang Wenkui* [Reforming SOEs: The Road is Diversification of Shareholdings – Interview with Mr. Zhang Wenkui, Deputy Director, Center for Development and Research of the State Council], available at <http://www.people.com.cn/GB/jingji/1045/2150295.html> (last visited Apr. 21, 2004).

<sup>268</sup> See CCP 2003 DECISIONS, *supra* note 264.

<sup>269</sup> See CHINA NEWS AGENCY, Wu Jinglian: “Yigu Duda” Rengshi Gongsi Zhili de Zhuyao Wenti [Wu Jinglian Says “Predominance of Single State Shareholder” Is Still the Major Problem in Corporate Governance], May 12, 2002, available at <http://www.chinanews.com.cn>.

<sup>270</sup> See Guowuyuan Xinwen Ban Zhaokai “Binggou Chongzu Guoji Gaofeng Luntan” Jizhe Zhaodahui: Li Rong, Huang Shuhe Da Jizhe Wen [Press Conference of the State Council News Office on the International Merger & Acquisition Summit Beijing 2003: Interviews of Li Rongrong and Huang Shuhe], (Nov. 11, 2003), available at [http://www.sasac.gov.cn/eng/new/new\\_0007.htm](http://www.sasac.gov.cn/eng/new/new_0007.htm) (last visited Apr. 6, 2004).

Apparently, outdated socialist ideals are leaving China as the wave of mass privatization has been heralded.

## VI. CONCLUSION

International investors play a key role in major world capital markets. China, never hiding its ambition to make its stock market one of the most successful on the globe, has recognized this in recent years. To turn recognition into results, China has taken a variety of measures to attract international portfolio investment; and the market had advanced very cautiously until recently, in 2003, when China boldly and widely opened doors to its stock market to foreigners as well as to domestic citizens. The objective is clear: China is seen as striving to swallow more global capital to excite its domestic market and to finance and privatize its ailing SOEs.

To achieve this objective, the key will be to enhance the regulatory framework which, based on rule of law, can provide financial institutions with a supportive market. During the past two decades, Chinese authorities have been promoting a more effective legal and regulatory framework for the market and the nation's corporate sector. It is fair to acknowledge that important legal reforms have led to clearer rules for the transactional and contractual relationship, greater enterprise autonomy, and better corporate structures according to company laws. However, certain structural flaws remain. Due to the absence of liberal ownership ideology and effective institutional operation, China's stock market is suffering from over-reaching regulations, under-enforcement of laws, a swaying regulatory culture, massive market manipulation and insider trading, as well as poor corporate governance and little minority investor protection—with the root of all these problems being the SOEs. The predominance of state shareholders in listed companies, coupled with an undefined role of the state as shareholder and regulator, provide the source for flaws in the market—and with these flaws, China faces difficulty in attracting international and even domestic investors.

To eradicate its problems, China should bolster reform of its government by differentiating its two roles as asset owner and regulator, and by establishing a clearly defined wall between both roles. Reform of the regulatory framework should seek to strike a balance between liberalization and stable market development by rethinking the role of foreign investors, drawing on the experience of other developed markets as well as from previous financial crises. China should also take effective steps to improve corporate governance of listed companies. The key to achieving this, however, will be in reducing the size and influence of SOEs in the national economy through privatization. Only through privatization can China produce a sufficient number of efficient and productive market participants.

Most importantly, the Chinese government needs to depoliticize its stock market by accelerating privatization (through placing state assets for sale) and enhancing protection of private ownership. Since stock markets cannot stand alone, reform should strive to create a viable general environment that will have appeal to both foreign and domestic investors alike. The possibilities for China's burgeoning stock markets are extraordinary, but without a sound regulatory culture and an accountable legal regime, foreign investors may very well be the prey—and not the predator—and may balk at the ironic prospect of having their investment capital fed to the wolves.