

**A LONG MARCH TO CAPITALISM:**

*An Overview on the Modern Legal Frameworks of China's Corporate Structure and  
Stock Market*

by

**Chih-Chien Yen**

B.L.

Soochow University Law School, Taipei, Taiwan, 1990

LL.M.

University of Michigan Law School, Ann Arbor, USA, 1999

Submitted to the Sloan School of Management  
in Partial Fulfillment of the Requirement of the Degree of

**Master of Business Administration**

at the

**Massachusetts Institute of Technology**

June 2000

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Signature of Author: \_\_\_\_\_

Chih-Chien Yen

MIT Alfred P. Sloan School of Management

May 4, 2000

Certified by: \_\_\_\_\_

J. D. Nyhart

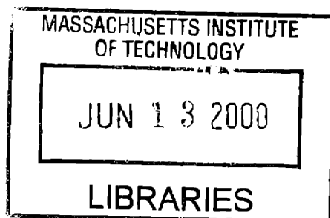
Professor of Management and Ocean Engineering

Thesis Supervisor

Accepted by: \_\_\_\_\_

Toby Woll

Director, MIT Sloan Fellows Program



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### **ABSTRACT**

From 1978, China embarked upon a course to convert its planned economy to a market economy. Among those reforms, the re-building of corporate system and the re-emergence of stock market play the vital roles. However, the primary question remains that how these Western structures will be applied given the underlying socialist ideology in China.

Two factors will further re-shape China's outlook in the future. One is the convergence of the legal and the economic systems between Hong Kong and China. Another one is China's recent bid to join the World Trade Organization (WTO.)

This thesis focuses on China's efforts to re-build its modern legal frameworks of the corporate structure and the stock market. It also touches the issues behind Hong Kong's return and China's participation of the WTO. China's change is so rapid and unprecedented. A decade ago, no one would possibly foresee China's face today. It is beyond the author's limit to predict China's future. Yet, this thesis would like to give a positive view on China's past efforts and also offer an expectation of a better future.

Thesis Supervisor: J. D. Nyhart

Title: Professor of Management and Ocean Engineering

## ACKNOWLEDGEMENTS

This thesis was made possible with the support from a lot of people. I would like to take this opportunity to express my appreciation to all of them.

Special thanks to my thesis advisor, Professor J. D. Nyhart, for his knowledge and insight that led me throughout the process. My gratitude to Dr. C. V. Chen, Nigel Li, and C. C. Lee from Lee and Li, Attorneys-at-Law, for their encouragement and support of my study in the United States.

Thanks to Toby, Judy, Dee, and all my Sloan Fellows colleagues for their friendship and hospitality throughout the year. I will cherish this wonderful experience and memory at MIT for a lifetime.

For my parents and Klom, my heart is full of happiness and gratefulness because of your understanding, support, and love.

Chih-Chien Yen  
May 3, 2000, in Cambridge

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## 1. Introduction

After the Culture Revolution, the leaders of the People's Republic of China ("China") recognized the death of the communist world and proceeded to design a new economic system to rationalize their departure of the communism and ensure their political survival. At that time, China displayed virtually none of any modern legal system except those outdated Soviet-style legal institutions since 1950s.<sup>1</sup>

From 1978, China embarked upon a course to convert its planned socialist/communist economic system to a "socialist economic structure with Chinese Characteristics." The most important creations during the transformation were the recognition of diverse forms of ownership, the opening market to foreign trade and investment, and the implementation of various new laws to assist its reformation.<sup>2</sup>

Among them, the re-building of corporate system and the re-emergence of stock markets play the vital roles in China's economic reforms. However, the 1993 Corporation Law and the current stock market system and the 1998 Securities Law still have some defects, which need to be improved in order to achieve a further accomplishment in the next century.

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<sup>1</sup> Jerome A. Cohen, John E. Lange, *The Chinese Legal System: A Primer For Investors*, 17 N.Y.L. Sch. J. Int'l & Com. L. 345, 346 (1997).

<sup>2</sup> Ann M. Han, *China's Company Law: Practicing Capitalism in a Transitional Economy*, 5 Pac. Rim L. &

To gain a better view of how a company or stock markets will operate in China's transitional economy, Section II of this note gives a glance over China's economic system and its efforts to create a so-called "Socialist Market System." One thing worth noting is that, after Hong Kong's return to Chinese sovereignty, a harmonization of legal and market systems has undergone smoothly and silently. This convergence will not just change Hong Kong, but also change China ultimately. Section III describes some of the legal ideas that emerged from the efforts during the 1980s to reform the "State-Owned Enterprises" and "Township and Village Enterprises." In addition, this part also tries to distinguish China's approaches from the ways that Western Capitalists adopted and deals with the motivation and ideological issues behind the current reforms.

Section IV criticizes the 1993 Corporation Law and points out its external and internal challenges. Section V gives a brief of the recent development of the China's stock markets and its legal framework. Assuming that the ideological barriers are not insurmountable and that Deng Xiao Ping's successors will continue to implement economic reforms, China should take certain fundamental steps in the near future to realize the true re-emergence of its stock markets in the twenty-first century.

In the conclusion, though China has done little for its political reforms, I would like

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Pol'y J., 457, 457 (1996).



to give a positive view of China's recent economic and legal reforms. Having tasted the benefits of marketization on a limited scale, the Chinese people are unlikely to willingly relinquish their economic gains. In order to maintain the outstanding economic growth, China has no alternative but to further improve her market system and legal framework. Hopefully, Deng's successors will be smart enough to launch a political reform internally if they really want to lead China moving to the next level.

## **2. The Context of China's Economic System**

### **2.1 A Brief History of the People's Republic of China**

After expelling the National Party (also known as Kuo Min Tung) and creating the People's Republic of China in 1949, the Chinese Communist Party immediately adopted an economic system and management style patterned after the Soviet Union.<sup>3</sup> Private ownership officially existed for a short period of time until the early 1950s. It consisted primarily of the providers of skilled trades, which had not been subsumed by the collective work groups. During the "Great Leap Forward," such private ownership was virtually eliminated.<sup>4</sup> From that time on, property was owned either by the state or by the collectives. Until 1978, China's economic system did not allow any of the normal

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<sup>3</sup> Zhou Shulian, Reform of the Economic Structure, in China's Economic Reform (1992), at 2.

<sup>4</sup> Du Mengkun, Government Budgets, in China's Economic Reform (1992), at 39-40.

market mechanisms found in other countries to function. The economic system was almost fully centralized and every aspect of the economic was planned.<sup>5</sup>

The government engaged in both macro and micro planning. The macro planning included a master list of priority industries, which would receive materials and funds first. The various levels of government administrators micro-managed the enterprises on every aspect of their operations, including purchasing, production, quality control, and labor practices.<sup>6</sup> Those industries on the priority list were supplied with raw materials at state-plan prices, which were unrelated to market conditions. The system controlled everything from the purchasing of materials to the sale of products. This centralized management approach governed nearly every aspect of all enterprises from 1958 to 1978, covering nearly eighty-five percent of the total economy of China.<sup>7</sup>

At that time, China engaged in what is known as “directive planning,” where production units were given specific production targets to meet.<sup>8</sup> Under directive planning, management of Chinese enterprises was nominally controlled by the state, and the actual power resided in the hands of the Chinese Communist Party. Numerous problems resulted from this arrangement. Enterprises lacked the most basic decision making powers. Manager lacked the authority to make production and sale decisions,

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<sup>5</sup> A. James Gregor, *Marxism, China, and Development* (1995), at 80.

<sup>6</sup> Chen Jiyan, *the Planning System, in China's Industries Reform* (1987), at 197.

<sup>7</sup> Du, *supra* note 4, at 40.

such as determining what to produce, what to purchase, whom to hire, when to borrow money, and repay loans, and how to distribute products. All these decisions were determined by the state's plan as interpreted by several layers of bureaucracy.

Before China opened its door to the rest of the world, this directive planning worked effectively because China's market was isolated and there was no competition at all. Most importantly, with such arrangement, China was able to invest all its resources to certain industries, which China envisioned that it could compete with Soviet Union and the United States. Unfortunately, China paid too much attention on the heavy and national-defense industries while spending too little money on those fields that could improve the living standard of Chinese people.

The centralized system took away any incentive for Chinese enterprises to be innovative and profitable. To the enterprises, profits were irrelevant since excess earnings were not retained but simply turned over to the government. Losses did not decrease jobs, output, or salaries since the government subsidized these losses. The net effect of this highly centralized system was to encourage, across the economy as a whole, complacency and resignation to the point of stagnation.

## **2.2 The Role of Law in Different Stages**

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<sup>8</sup> Robert C. Hsu, *Economic Theories in China, 1979-1988* 35 (1991).

China's legal system prior to 1978 was devoid of any economic legislation.<sup>9</sup> China had no contract law, tax codes, and corporation codes. Such laws, though fundamental in the Western societies, were unnecessary to China because all economic agreements entered into were between government units. If one party breached a contract, any damages ordered would be paid from one government fund to another, a rather meaningless exercise, which the Chinese avoided. If the party breached the agreement and the government felt that the breach affected central planning, private enforcement under a judicial proceeding was unnecessary since the government could simply order specific performance. The method sufficed in the planned economy where production units were under direct government control.

In 1978, the rules changed. After experiencing governmental control for over thirty years, Chinese enterprises were suddenly called upon to produce market efficiency. The first effort to implement elements of a market system was directed at attracting foreign investment. As early as 1979, soon after China decided to "open its door" to the rest of the world, China enacted a set of joint venture laws enabling foreign investors to invest in China by joint venturing with Chinese entities.<sup>10</sup> The joint ventures law was the first introduction of private ownership in China since 1949. Though the Chinese

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<sup>9</sup> Gu Ming, Recent Development in Chinese Economic Legislation, 21 U.S. L. Rev. 271 (1987); see generally, Cohen, *supra* note 1.

<sup>10</sup> See Sino-Foreign Equity Joint Venture Law of 1979.

partner of the joint venture was almost always a government entity, at least the portion of the joint venture's assets owned by the foreign party was in private hands.

Pressure from the foreign investors led to enactment of further legislation allowing for forms of business such as cooperative joint ventures and the wholly owned foreign enterprises.<sup>11</sup> The creation of these wholly owned foreign enterprises meant that at least a small portion of China's economy became completely owned and managed by foreign private parties. Though the percentage of such foreign enterprises was so small, it was an important policy change. In addition, China also established various special economic zones along the coastal regions to encourage investment and trade.<sup>12</sup> The zones provided flexible forms of investment to foreign investors and lower tax rates. Most of the zones have been very successful economically. Investment by Hong Kong, Taiwan, Macao is especially found in these zones.

Reflected in these past economic laws is the delicate balance of allowing some independent decision making on the enterprises level to achieve maximum operating efficiency while giving up the minimum amount of political control. The economic laws in China are typically designed to facilitate activities the government wishes to

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<sup>11</sup> See Wholly Owned Enterprise Law of the People's Republic of China of 1986; Sino-Foreign Contractual Joint Venture Law of the People's Republic of China of 1988.

<sup>12</sup> For background information, see Owen D. Nee, Jr., *China's Special Economic Zones and Fourteen Coastal Cities, Legal Aspects of Doing Business with China* 1986.

encourage without relinquishing the right that would limit state power.<sup>13</sup> As we can see, Chinese laws tend to contain, paradoxically, provisions, which are vague and broadly drafted, accompanied by detailed restrictions. The former gives maximum room for interpretation by bureaucrats, which can vary as government policy changes. The latter allows the government to prohibit activities, which it deems to be harmful.<sup>14</sup>

Some of the economic legislation did achieve a great accomplishment in the past twenty years. However, the question is whether the same success can be achieved when the scope of the marketization is expanded to individual domestic enterprises.

### **2.3 Creating a Socialist Market System**

China is one of few countries in the world, which still professes adherence to communism.<sup>15</sup> Of these countries, China is the only one with any significant economic power. Recognizing that continued adherence to the rigid, centrally planned economic system of the traditional Communism would not induce the desired type of progress and growth, China has embarked on a path to create a “socialist system with Chinese characteristics” or “socialist market economy,” which essentially consists of injecting

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<sup>13</sup> Han, *supra* note 2, at 456.

<sup>14</sup> For example, specific laws encouraging foreign investment would detail the sectors of economy which foreign investment is encouraged but be vague as to the benefits foreign investors would receive when investing in those sectors. See, Law on Encouragement of Foreign Investment. Often, laws are broad policy statements which promise unspecified “relevant regulations” to clarify the ambiguities. Until such regulations are issued, interpretation of any ambiguities is left to the bureaucrats who are in charge of the enforcement.

<sup>15</sup> Other communist countries include Cuba, North Korea, and Vietnam.

certain market aspects into a planned economy.<sup>16</sup> To China, it does not matter that the socialism and market system are two contradictory terms. The Chinese leadership would like to keep the facade of socialism, as it is the basis on which the Chinese Communist came to power, while adopting as much of capitalism in substance as it can in the economic sector.

While China has taken steps to transform its economy from one that is planned to one that is driven by market forces, that process is far from complete. Vestiges of the planned economy and its instruments remain and continue to control significant portions of the Chinese economy today. Some commentators advances the idea that China's decision to change its system signals the end of Communism and represents solid proof of the superiority and basic correctness of western capitalism.<sup>17</sup>

However, China's change is remarkably different from the changes occurring in the former Soviet Union and various eastern European countries. For example, China's decision was self-made, not forced by the collapse of the previous system. China was able to perceive the need for transformation and to take measures to implement changes at a relatively early stage.<sup>18</sup> Another major distinction between China's transformation

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<sup>16</sup> Bill Brugger, *Democracy and Organization in Chinese Industry-New Direction in China: Dilemmas of Modernization* (1985), at 62-63.

<sup>17</sup> Zhou, *supra* note 3, at 14-15.

<sup>18</sup> Richard Portes, *From Central Planning to a Market Economy*, in *Making Market: Economic Transformation in Eastern Europe and the Post Soviet States* (1993), at 20-36.

and that occurring in Eastern Europe and Russia is that China's change, at least nominally, focuses only in the economic sphere. Politically, China continues to adhere to Marxist/Maoist doctrines.<sup>19</sup> Especially, the recent bankruptcy of Russian economy further convinced the Chinese leadership that the gradualism is better than the "cold turkey."

To avoid the appearance of abandoning socialism, China initially called its new system a "commodity production economy" and later changed the label to a "socialist market economy."<sup>20</sup> Some scholars may be interested in debating whether China is maintaining a socialist economy with unique Chinese characteristics as its leaders declared, or whether China has become capitalist and is simply continuing outdated political rhetoric for the convenience of those in power. Other may simply adopt Deng Xiao Ping's most famous pragmatic slogan: "It does not matter what color the cat is, so long as it catches mice." This attitude allows the Chinese leaders to maintain a pretense that they have not abandoned the principles upon which the Communist Party was founded while implementing reform measures, which look more and more, like capitalism.

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<sup>19</sup> Peter M. Lichtenstein, *China at the Brink* 80 (1991), at 11.

<sup>20</sup> The label "commodity production economy" or "commodity economy" was used early in the reform process in 1983 and 1984 to avoid antagonizing the more conservative factions of the communist party. In 1992, after the Fourteenth Party Congress, when the reform movements were more secure, the use of term "socialist market economy" was adopted. Apparently, the purpose of introducing the market mechanism into a socialist system is to make the planning more efficient and flexible, not change the system to a



## 2.4 The Harmonization of Laws and Economy between Hong Kong and China

Due to its willingness to embrace the capitalist principles with regard to those investment vehicles, China has allowed its economy to elevate itself and sustain a high level of growth for more than a decade. However, the country needs additional infrastructure improvements and the industries need more capital for maintaining its remarkable growth rate in the new millennium. In 1997, Hong Kong became part of China, it offered China a great opportunity not just to utilize Hong Kong's market to attract more foreign capital inflow but also demonstrate China's commitment of building its market economy.

In order to maintain Hong Kong and the world's confidence, the Basic Law of Hong Kong Special Administrative Region (SAR) guarantees that Hong Kong will enjoy "a high degree of autonomy" and will be a separate "system" with in a single country.<sup>21</sup> In fact, China has worked very hard to make sure that the system works because China intends to sell this model to Taiwan. The Basic Law elaborates that Hong Kong's autonomy extends so far as to allow for continuity of Hong Kong's economy, society, and law. Moreover, it provides that the previous capitalist system and way of life shall

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capitalist economy.

<sup>21</sup> Article 158 of the Basic Law.

remain unchanged for fifty years.<sup>22</sup>

Examining this question two year after Hong Kong's return to Chinese sovereignty, there is little doubt that the official assurances of continuity have blossomed into the preservation of most of Hong Kong's legal system and the continuation of Hong Kong's economic and political activities. Despite the indications of continuity, one must note that Hong Kong's legal system has changed since July 1, 1997. A lot of changes have brought Kong Kong's system into a closer alignment with the one in China.

What parts of the Hong Kong legal system has been changed and will be changed in the coming years? The law amended in the SAR's first year were confined to those touching upon the civil liberties and the limitations of government power, areas that fall under the rubrics of constitutional law, civil law, labor law, and immigration law. Commercial law, however, has remained virtually untouched since then. Most of them still follow the British common law rules. That is the reason why people believe that Hong Kong is the same as usual.

The changes suggest a pattern of accelerating harmonization of Hong Kong legal system with the one in China. A process that has been well planned and carefully carried out by those leaders in Beijing. I would argue that no commercial laws in Hong

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<sup>22</sup> Id., art. 5.

Kong can immune from the harmonization process. As such, we can foresee that the commercial law will be significantly converged into China's legal system in the coming decade.

### **3. The Motivation and Ideological Issues behind the Current Reforms**

#### **3.1 Enterprise Models in China during the 1980s**

China has moved gradually but decisively to facilitate private enterprise. Nevertheless, most of the economy remains public owned. Official doctrine holds that public ownership remains the basis of the socialist market economy system of China.<sup>23</sup> Though the reforms have privatized many small businesses, usually by sale or lease to managers and workers, the leadership still rejected large-scale privatization of the sort occurring in Eastern Europe and persisted that the large state enterprises remain under public control. First, mass privatization would likely produce an undesirable concentration of capital in private hands, especially foreigners. Second, given the difficulties of valuing state assets, the dangers of shortchanging the state are great. Third, the distributive and allocative consequences of stock trading by masses of

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<sup>23</sup> Article 6 of the 1982 Constitution.

uninformed citizens in informationally inefficient market are likely to be undesirable. Insiders and speculators would grow rich at the expense of ordinary citizens and the stock market would not play a useful role in corporate monitoring. Fourth, China lacks a developed system of tax collection and the social conventions that support it. At least until it can develop these things, the revenues of the state enterprises are the most plausible forms of government finance.<sup>24</sup>

In the tradition of most Communist legal systems, China continues to distinguish between two types of public ownership. “State ownership,” which in Chinese jargon is synonymous with “ownership by the whole people,” gives ultimate control to the central government. “Collective ownership” involves association with lower level of government and connotes, in theory, control over the enterprise by its participants.<sup>25</sup> The large-scale, capital-intensive, urban economy tends to take the form of state-owned enterprises (“SOEs”). They are between 100,000 and 200,00 of them. Many small-scale urban enterprise and most rural enterprises have tended to take the form of collectives. Since the dramatic agricultural gains of the early reform years, the most dynamic growth has been in rural industry—the “township and village enterprise” (“TVEs”). There are between one and two million of them.

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<sup>24</sup> William H. Simon, the Legal Structure of the Chinese “Socialist Market” Enterprise, 21 J. Corp. L. 267, 269 (1996).

<sup>25</sup> See, supra note 21, Articles VI-VIII.

In both sectors, the reforms of the 1980s produced enterprise structure that combined familiar features of Western business institutions with features reflecting the pre-reform socialist economy. Aside from public ownership, perhaps the most distinctive of these latter features are: First, the models express an ambiguous and perhaps paradoxical conception of enterprise governance that, in comparison to the formal Western corporate model, combines an exceptional degree of managerial power with an exceptional degree of worker participation. Second, these models retain from the pre-reform era a conception of the enterprise as a relatively encompassing community and the worker's participation as a form of membership, as opposed to a narrowly contractual employment relation. Third, they presume or require a relatively high degree of internal finance and income reinvestment.

### **3.2 Limited Privatization (Corporatization) and Gradualism**

In most countries, a policy of privatization shifts control over industries and production from the state sector to private hands. The state relinquishes ownership by sale of entire enterprises to investors, typically in the form of shares. In the short term, the government enjoys the liquidity of the cash received; in the long term, it reaps the advantage of greater efficiency and improved management that results when industry is

freed from close governmental control and subjected to the rigors of the market.<sup>26</sup> This form of privatization is neither a motivation for, nor consistent with, the intent of recent reforms in China. The 1993 Corporation Law repeatedly reaffirms China's commitment to socialism. Indeed, the 1993 Corporation Law's very first pronouncement is the purpose of "maintaining the social economic order and promoting the development of a socialist market economy."<sup>27</sup>

China's program is not privatization of the sort experienced by the former Soviet Union and the communist Eastern Europe. A better description of it is "corporatization," a more limited reform. Corporatization entails restructuring state enterprises, adopting the corporate form, and instituting stock ownership and trading without necessarily relinquishing the state's controlling interest in the means of production.<sup>28</sup> A critical feature of corporatization is the Chinese government's retention of majority ownership in state enterprises that it has converted to the corporate form.<sup>29</sup> By retaining this stake, the government preserves the Marxist-Leninist principle of ownership of the "means of production by the people," as represented by the state. On the other hand, sale of minority shares in these corporations allows the government to

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<sup>26</sup> William C. Philbrick, *The Paving of Wall Street in Eastern Europe: Establishing the Legal Infrastructure for Stock Markets in the Formerly Centrally Planned Economies*, 25 *L. & Pol'y Int'l Bus.* 565, 577 (1994).

<sup>27</sup> Article 1 of the Corporation Law of 1993.

<sup>28</sup> Qian Xuefeng, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 *UCLA Pac. Basin L. J.* 91, 92 (1993).

<sup>29</sup> Robert C. Art and Gu Minkang, *China Incorporated: The First Corporation Law of the People's Republic*

siphon off the private capital into the state enterprises without ceding ultimate control.

As we mentioned, China's focus was the economic reforms, which could further assure the leadership of the Chinese Communist Party instead of any kind of political reforms, which might encourage Chinese people to take over the power from the Chinese Communist Party. As such, China's economic reforms were carefully designed and carried out. Its priority was to maintain control, then to increase the efficiency of the economy and improve the living standard of its people. When we saw the bankruptcy of the Russian economy, we have to give credit for China's approach. Yet, we encourage China to increase the scale of its economic reforms and further engage the political reforms once it gains more confidence of its achievement.

This policy of corporatization supports several goals of the Chinese government. First, it channels the massive private savings of Chinese citizens into productive ventures. Second, it may diminish the potential threat that private financial resources pose for the government. Third, it will improve management of state enterprises, which suffer from chronic low productivity, inefficiency, and poor management.<sup>30</sup> The Chinese government can still regulate the economy, but as a sovereign implementing policies of general application rather than as an owner micro-managing individual enterprises.<sup>31</sup>

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of China, 20 *Yale J. Int'l L.* 273, 282 (1995).

<sup>30</sup> *Id.*

<sup>31</sup> Donald C. Clarke, *What's Law Got to Do with it? Legal Institutions and Economic Reform in China*, 10

The full potential of corporatization can be realized only if the Chinese government permits market forces to operate with their full rigor and accepts certain painful consequences, like unemployment and dislocation. Subsidies must be removed and economically unlivable state enterprises must be permitted to fail. Until that happens, managers and corporations will lack the incentives to improve efficiency and productivity as the reforms envision.

### **3.3 The Private Enterprise as a Supplement to the State Industry**

Authorizing private enterprise presents greater difficulty to a socialist state than modifying the organizational form of state enterprises because private business potentially conflicts with the socialist ideology. During the 1980s, China resolved this conflict by distinguishing between “individual” enterprises and “private” enterprises. Individual firms were based essentially on a person’s own labor although they might sometimes employ a few workers without changing their nature. On the contrary, private firms heavily relied on hired labor and as such raised serious issues of worker exploitation.<sup>32</sup>

This ideological difficulty was finally resolved at the Communist Party’s National Congress in 1987. Zhao Ziyang, the then General Secretary, advanced the theory that

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UCLA Pac. Basin L. J. 15, 16 (1991).

<sup>32</sup> Alison W. Conner, To Get Rich is Precarious: Regulation of Private Enterprise in the People’s Republic of China, 5 J. Chinese L. 9, 10 (1991).



China was in the “primary stage of socialism,” which began in the 1950s and was expected to last one hundred years thereafter. In this stage, the main goal is to develop production to meet the material needs of the people, Public ownership must predominate, but a private sector may contribute production and employment that the state cannot currently provide.<sup>33</sup> The 1988 Constitution adopted this pragmatic view and thereby legitimized profit-seeking private enterprises.<sup>34</sup>

Today, thousands of small businesses operate throughout China. Traders run shops on small lanes and busy streets. Self-employed merchants sell goods from stalls in specialized markets, from rented counters in state-owned department stores, and at market fairs.<sup>35</sup> These businesses account for a substantial share of commerce in which larger and state-owned enterprises are not engaged. For example, many small businesses in Beijing transfer goods from Fujian and Guangdong to the north or from rural areas to the cities by purchasing wholesale and distributing within local communities.<sup>36</sup> In previous decades, the government would have classified many of these kinds of activities as “speculation” or “profiteering” and would have subjected them to criminal

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<sup>33</sup> Art & Gu, *supra* note 29, at 286.

<sup>34</sup> Article 11 of Constitution amended April 1988 provided: “That the state permits the private economy to exist and develop within the limits prescribed by law. The state protects the lawful rights and interests of the private economy and exercises guidance, supervision and control of it.”

<sup>35</sup> Shi Xianmin, *The Classification of Private-Owned Small Businesses in Beijing*, 15 Soc. Sci. in China 95 (1994).

<sup>36</sup> *Id.* at 100.

prosecution.<sup>37</sup>

Moreover, the Chinese government has encouraged individuals and private firms to buy small state-owned enterprises and become full owners.<sup>38</sup> The enterprises placed for sale are ones that the government deems itself unable to manage successfully. Though significant, this program of selling selected small state-owned enterprises must be kept in perspective. It does not evince a current policy or goal to privatize the bulk of Chinese economy. Instead, it reflects an intention to permit the co-existence of private ownership as a supplement to state ownership, which will continue to play the leading role in the Chinese economy.

## **4. Re-building A Modern Corporation Law**

### **4.1 The Purpose of the 1993 Corporation Law**

The modern system of corporation originated in Europe and was introduced into China only at the beginning of this century. It is beyond the scope of this note to examine in detail the history of China's attempts at corporate law-making, which

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<sup>37</sup> Article 118 of the Criminal Code of the People's Republic of China provided that whoever makes a regular business of smuggling or illicit speculation, smuggles or speculates in huge amounts or is the ringleader of a group that smuggles or engages in illicit speculation shall be sentenced to fixed-term imprisonment of not less than three years and not more than ten years, and may concurrently be sentenced to confiscation of property.

<sup>38</sup> Art & Gu, *supra* note 29, at 275.

commenced in 1904, with the promulgation by the Qing Dynasty of a company law.”<sup>39</sup> Before World War II, the Chinese corporate system followed the civil law system. In 1946, the corporation law was rewritten to follow the American model. This statute, with its many amendments and revisions, is still in effect in Taiwan.<sup>40</sup> In China, however, all of the laws of the Nationalist government (KMT regime), including the corporation law, were replaced by the Common Programs of the Chinese People’s Political Consultation Conference in 1949, after the founding of the People’s Republic of China.<sup>41</sup>

There are many reasons why China has decided to enact a national corporation law. The ultimate ideological goal is to unite Western capitalist corporate structures with existing Chinese enterprises while retaining and promoting the “socialist market economy.”<sup>42</sup> However, it does not envision a replacement of the state sector by private enterprises.<sup>43</sup> The pragmatic purpose of corporation law is to allow the government to remove itself from the micro-management of enterprises. By removing itself from the day-to-day affairs of a corporation, the government hopes enterprises will become more

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<sup>39</sup> Nicholas C. Howson, *China’s Company Law: One Step Forward, Two Steps Back? A Modest Complaint*, 11 Colum J. Asian L. 127, 135 (1997).

<sup>40</sup> Wu, Yizhou, *The Law of Corporation* (1980), at 4.

<sup>41</sup> Song Yongxin, *Some Special Features of the Organs of Governance of Chinese Business Corporations*, 24 Cap. U. L. Rev. 207 (1995).

<sup>42</sup> See *supra* note 27, art. 1.

<sup>43</sup> Howard Gensler, *Company Formation and Securities Listing in the People’s Republic of China*, 17 Hous. J. Int’l 399-400 (1995).

productive and efficient by the ensuring competition.

The second goal of the corporation law is to keep the means of production in the hands of the people, who are represented, namely, by the Chinese government. It underscores the important point that the corporation law is not an effort or willingness by the Chinese government to encourage or allow enterprise privatization, such as that occurring in the former Soviet Union and Eastern Europe. Under the corporation law, the Chinese government will still maintain the ultimate control and majority ownership of the largest enterprises.<sup>44</sup>

In sum, the motives behind the earliest efforts in the late nineteenth century and the current reforms seem to be the same. China always intends to create a tool to promote her industrial development. As part of a more generalized legal reform, China intends to conform the Chinese industrial organizations and relationships with perceived Western norms and structures. To use corporate entities today, China not only intended to compete with Japan as the case in the Qing Dynasty, but also intends to provide a more suitable and recognizable receiving entity for foreign capital investment and Chinese capital accumulation as a result of economic reforms. The aims and means of the 1904 and 1994 projects are not too different.<sup>45</sup>

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<sup>44</sup> Art & Gu, *supra* note 29, at 273-275.

<sup>45</sup> William C. Kirby, *China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China*, 1 *J. of Asian Studies* 43 (1995).

## 4.2 The Types of Corporation

The corporation law provides two basic forms of corporations, which correspond roughly to the British distinction between the Limited Company (Ltd.) and the Public Company (p.l.c.) or the American distinction between the closely held corporation (close corporation) and the public corporation (including the listed corporations).<sup>46</sup> The Chinese terms are You Xian Ze Ren Goung Si or Limited Liability Corporation (“LLC”) and Gu Feng You Xian Gong Si or Limited Stock Corporation (“SLC” or Joint Stock Company).<sup>47</sup> However, the Chinese term of “Limited Liability Corporation” must be distinguished from the same term as it is used in American legislation. Many American states have authorized a new form of business organization, which they label a “limited liability company”, in order to permit business to qualify for some tax benefits that partnerships typically receive while retaining the corporation’s protection of investors.<sup>48</sup> An American LLC, unlike a Chinese LLC, is not considered incorporated and enjoys extensive discretion to establish its own internal governance structure.

The limited Liability Company form in China is generally for smaller business, defined in terms of the number of investors and amount of registered capital. However,

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<sup>46</sup> Art & Gu, *supra* note 29, at 275.

<sup>47</sup> Article 2 of the Corporation Law (1993) provides that for the purpose of this law, the term “corporations” shall mean limited liability corporations and limited stock corporations established pursuant to this law within the PRC.

<sup>48</sup> Soloman et al., *Corporations Law and Policy*, at 145, 4<sup>th</sup> Edition (1998).

a state institute or department that wishes to corporatize one of its enterprises without relinquishing any ownership or control can also adopt the LLC form. In general, the Chinese LLC must have between two to fifty shareholders<sup>49</sup> and a minimum registered capital ranging from 100,000 to 500,000 RMB, depending on the type of business, unless other regulations set a higher standard.<sup>50</sup> An SLC typically is larger than an LLC. It may have any number of shareholders but must have registered capital of at least ten million RMB.<sup>51</sup> In addition, SLC may distribute stock through either the “promoter method” or the “share float method.”<sup>52</sup> In the first option, the promoters purchase all the shares by subscription; in the second choice, the company offers shares to the public, but the promoters must still purchase thirty-five percent of the stock.<sup>53</sup> Under either method, promoters have to retain their stock for three years.<sup>54</sup>

Both vehicles are available to convert state enterprises to the corporate form. When the sole investor in an LLC is from a state investment company or department, the LLC is termed a “wholly state-owned company”<sup>55</sup> and is relieved of certain organizational requirements normally applied to LLCs. For example, the institute or department may dispense with shareholder meetings, directly appoint and change

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<sup>49</sup> See supra note 27, art. 20.

<sup>50</sup> Id., art. 23.

<sup>51</sup> Id., art. 73 & 78.

<sup>52</sup> Id., art. 74.

<sup>53</sup> Id., art. 74 & 83.

<sup>54</sup> Id., art. 174 & 83.

directors, hire or dismisses managers, and make key decisions concerning merger, division, dissolution, and issuance of securities.<sup>56</sup> Thus, a wholly state-owned LLC is essentially an administrative unit of a government agency, clothed in a corporate form.

A state-owned enterprise that converts into a SLC need not meet the usual requirement of five promoters. Nevertheless, it still must use the share float method.<sup>57</sup> The promoter in this instance would be the pre-existing enterprise, contributing its assets rather than cash. In such case, the stock offering requirement serves to draw additional capital into the enterprise from the private sector.

In order to be a listed company, a SLC, in addition to general requirements, must also met the followings. First, its registered capital must be at least 50,000,000 RMB, and this minimum capital must be fully subscribed. Second, stock issuance must have been approved by the securities administration department. Third, it must have been in business at least for three years. Fourth, no major unlawful acts may have been committed by the company within the last three years. Finally, it must not have made a false statement in any financial report for three years.<sup>58</sup>

### **4.3 Basic Structure under the Corporation Law**

The structure of a company under China's Corporation Law is very similar to that of

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<sup>55</sup> Id., art. 64.

<sup>56</sup> Id., art. 65-69.

<sup>57</sup> Id., art. 75.

a traditional limited liability corporation in the United States. Significantly, the Corporation Law adopts the familiar principle that a corporation is a legal person, an entity, which enjoys civil rights and owes civil obligations to the full extent of its assets.<sup>59</sup> Shareholders are explicitly protected from liabilities beyond their capital contribution.<sup>60</sup> The corporation, as a legal entity, has the added Chinese characteristic of a human “legal representative.”<sup>61</sup> Generally, the legal representative is the chairman of the board of directors or president of the corporation.<sup>62</sup> The legal representative serves as an agent for the Chinese corporation in that he can act on behalf and bind the corporation.

The reasons for adopting the legal representative are numerous. First, the legal representative appears intended to provide some amelioration for the limited liability of the Corporation Law. The possible rationale is that since the legal representative can be punished for the corporation’s wrongs, she will strive to prevent those wrongs. Thus, if the improper action occurs an actual person is punished, not a faceless corporation. As such, the legal representative appears to represent a compromise between socialism and limited liability.<sup>63</sup> We can also find the same concept in Taiwanese corporation law. In Taiwan, the chairman of the board of directors is the legal representative. If the

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<sup>58</sup> Gensler, *supra* note 43, at 426.

<sup>59</sup> See *supra* note 40, art. 3.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*, art. 45 & 113.

<sup>62</sup> Art & Gu, *supra* note 29, at 294.

<sup>63</sup> Gensler, *supra* note 43, at 421.



company violates any laws or regulations which contain criminal punishment, the chairman will be the one who receives the punishment unless she can prove that there is another actual wrong doer.

The shareholders' meeting is comprised, not surprisingly, of all the shareholders. In LLC, it is called the "shareholders' meeting," but, in SLC, it is known as "the shareholders' conference," which shall be held annually.<sup>64</sup> The only difference is that the latter is much larger than the former. Every corporation normally has a shareholder' meeting (or conference). Nevertheless, a wholly state-owned LLC does not have a shareholders' meeting. Apparently because there is only one shareholder, there is no need to have such an organ. Instead, the functions and powers of the shareholders' meeting are to be exercised by the authorized investment institution or department.<sup>65</sup> Such powers may also be delegated to the board of directors by special authorization of the State Council if the corporation is large in size and being operated well.<sup>66</sup> In addition, foreign investment corporations usually have only two joint venturers (a wholly foreign-owned enterprise may have only one investor). Each party has the right to appoint and replace its own directors to the board. Moreover, joint venture corporations have a statutorily limited business scope and are required to have a joint venture

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<sup>64</sup> See supra note 27, art. 41 & 102.

<sup>65</sup> Id., art. 62.

<sup>66</sup> Song, supra note 41, at 210.

agreement that stipulates the mutual obligations of the investors. Therefore, it is not necessary to have a shareholders' meeting to represent the investors' interests.<sup>67</sup>

The directors are elected or appointed at the shareholders' meeting. Corporation Law requires the board to have three to thirteen directors for LLCs and five to nineteen for SLCs.<sup>68</sup> The board of wholly state-owned corporations has between three and nine directors.<sup>69</sup> The wholly state-owned corporation also must have representatives of its own employees on the board who are to be elected by the employees themselves.<sup>70</sup> There is no such requirement for non-state-owned corporations. The board shall have the chairman and also have one or two vice chairmen, who are to be elected by a majority of the board.<sup>71</sup> However, the Corporation Law allows small corporations to have one executive director rather than a board.<sup>72</sup> The executive director may at the same time be the manager as well. Once the directors are elected or appointed, the shareholders' meeting can only remove them for cause.<sup>73</sup>

Manager (or general manager) is appointed by the board of directors. She is under the board's control and is responsible to the board.<sup>74</sup> Her main function is to oversee the

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<sup>67</sup> Article 6 of the Sino-Foreign Equity Joint Venture Law; Article 2 of the Wholly Foreign Owned Enterprises Law.

<sup>68</sup> See supra note 27, art. 45 & 112.

<sup>69</sup> Id., art. 68.

<sup>70</sup> Id.

<sup>71</sup> Id., art. 45 & 113.

<sup>72</sup> Id., art. 51.

<sup>73</sup> Id., art. 44 & 113.

<sup>74</sup> Id., art. 46 & 112.

daily production and operation of the corporation. The term “general manager” is equivalent to the president or CEO in the American corporation law. Theoretically, the “manager” shall be a collective of corporate officers, including deputy managers, treasurer, secretary, etc. However, curiously, according to the 1993 Corporation Law, the manager seems to be a single person.

The last corporate organ is the supervisory committee, which has no counterpart in American corporations but does in some European countries. It is borrowed from the civil law system. The Corporation Law of Taiwan has similar provisions for “supervisors.”<sup>75</sup> It is likely that this statutory organ may have been borrowed directly from the Taiwanese statute. A supervisory committee is a separate independent institution whose basic function is to supervise other organs of the corporation to correctly exercise their powers.<sup>76</sup> It contains three members and most of them are elected from the shareholders by the shareholders’ meeting.<sup>77</sup> However, the 1993 Corporation Law requires the committee to have a certain percentage of employee representatives elected by and from the employees.<sup>78</sup> Small corporations may have one or two supervisors instead of a full committee.<sup>79</sup> Wholly state-owned LLC have no

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<sup>75</sup> Articles 216-227 of the ROC (Taiwan) Corporation Law.

<sup>76</sup> See *supra* note 27, art. 54.

<sup>77</sup> *Id.*, art. 52.

<sup>78</sup> *Id.*, art. 52 & 124.

<sup>79</sup> *Id.*, art. 52.

supervisory committee. This is probably because the management of those corporations is under constant surveillance by the investment institution or department.

#### **4.4 The Internal and External Challenges**

##### **4.4.1 The Internal Challenges**

###### **4.4.1.1 Board's Duty of Care and Loyalty**

The Corporation Law states that both directors and supervisors owe fiduciary duties to the corporation and subject to liabilities for breach.<sup>80</sup> Further, it provides that the corporate official, including directors, supervisors, and manager, must abide by the company's articles of incorporation and must perform their duties sincerely and diligently with loyalty and honesty.<sup>81</sup> The duty of care espoused by the Corporation Law is the weakest part. The inherent weakness stems from the absence of any explanation about what sincerely and diligently and with loyalty and honesty mean. It only provides the language but goes no further. Since there is no case history, one must critically question how this language's substance will be defined.

In addition, directors, supervisor, and manager are prohibited from engaging in any acts harmful to the interests and benefits of the corporation, and any profits derived from

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<sup>80</sup> Id., art. 63.

<sup>81</sup> Id., art. 59.

such acts will be appropriated by the corporation.<sup>82</sup> The corporation Law continues by codifying a specific rule against self-dealing. The following activities are specifically listed as forbidden under the Corporation Law. First, there must be no lending of the corporate funds to the management. Second, no corporate assets may be deposited in personal accounts of the directors or others. Third, the corporation assets may not be used to guarantee individual debt. Fourth, directors or corporate officials may not operate a competing business. Fifth, officers may not reveal corporate business secrets. Finally, corporate officials are prohibited from concluding agreements or conducting other transactions on their own behalf or on other people's behalf with her corporation. With this language, the Corporation Law develops a duty of loyalty.

Notwithstanding the foregoing, significant mitigation of the prohibition of self-dealing exists in the Corporation Law. Through the appropriate language in the article of incorporation, a corporation can opt out of all these prohibitions of self-dealing. Moreover, a self-dealing act may be approved at a shareholders' meeting. Yet, it leaves whether shareholder approval must be given ex post or ex ante uncertain. The ability of shareholders to approve self-dealing becomes more menacing upon realizing that the government will remain the majority shareholder.

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<sup>82</sup> Id., art. 61 & 123.

#### **4.4.1.2 Relationship between the Board of Directors and the Shareholders'**

##### **Meeting**

The Corporation Law specifies that the shareholders' meeting is intended to be the most powerful authority in the corporation.<sup>83</sup> While theoretically the shareholders in any private enterprise are the owners, and as such, in control of the enterprise, in larger corporations in the United States such control has long passed from the owners to the management. Unlike the American model, the Corporation Law vests the power to determine the corporate policy and investment plans in the hands of shareholders,<sup>84</sup> as opposed to the board of directors.

What makes the Chinese corporate structure differ so sharply from that of the United States' corporations? Perhaps it is because in the overwhelming majority of business corporations in China, the state is and will continue to be the majority shareholder. The main concern of the legislators was how to protect the state property from being encroached upon by the management, a phenomenon that has become quite popular in recent years.<sup>85</sup> For example, to form a joint venture with a foreign company, management might intentionally undervalue the state assets and receive some personal benefit from the foreign company. Or, they might use corporate fund to facilitate their

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<sup>83</sup> See, supra note 27, art. 37.

<sup>84</sup> Id., art. 38 & 126.

<sup>85</sup> Song, supra note 41, at 213.

own businesses.

Theoretically, the corporation is a legal entity distinguished from the shareholders and represented by the board. If all of the major decisions are made by the shareholders directly, how do we differentiate between the corporation and the shareholders? How do we justify the limited liability of the shareholders? On top of that, there is a conflict of interest between the shareholders and creditors of the corporation. Facing the conflicts, the law should always favor the creditors. The neglect of adequate protection of the creditors will inevitably cause serious consequences.

Finally, to switch the power from the management to the shareholders is not practically feasible. It is impossible to frequently convene the shareholders' meeting to make decisions for business operations. Even if the shareholders' meeting is in session, it would be very difficult for the shareholders to make business decisions. Most shareholders are non-professionals, and most of them, especially in public corporation, are not interested in specific business operations. As time goes on, such defects in the Corporation Law will more and more obvious.

#### **4.4.1.3 Function of the Supervisory Committee**

Though the supervisory committee is required for SLC<sup>86</sup>, it is unclear on when it will

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<sup>86</sup> See, supra note 27, art. 124.

be needed for LLC. The law states only that a LLC of a “relative large” scale requires such a committee.<sup>87</sup> How the Chinese authority will define it remains uncertain. Yet, when such a committee is required, it has considerable power over management. As its name indicates, the committee possesses the power to supervise and investigate many aspects of the corporation’s affairs, including its financial affairs. Moreover, the supervisor has the power to convene the shareholders’ meeting and may attend the board meeting as non-voting delegates. Most interestingly, it can be also delegated other powers as stipulated in the articles of incorporation.<sup>88</sup>

China’s hesitancy to relinquish administrative control over its enterprises explains the creation of such a powerful supervising body. By creating it and giving it broad powers, the government can continue to influence the operation of the larger corporations through placement of administrative bureaucrats in the committee even when it loses its controlling interest in the corporations. Since the Corporation Law does not required that the supervisors have any expertise or understanding of the corporation’s business, the type of problems encountered when bureaucrats were directing the production and operational aspects of the Chinese enterprises could well reproduce in the new LLCs.<sup>89</sup>

Most surprisingly, the Corporation Law is lack of any meaningful restrictions on the

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<sup>87</sup> Id., art. 52.

<sup>88</sup> Id., art. 54.

<sup>89</sup> Han, *supra* note 2, at 479.



supervisors' activities. Article 59 requires that directors, supervisors, and manager do not profit personally from the positions by acceptances of bribes or other illicit gains. However, the prohibition of directors and manager from engaging in activities which constitute embezzlement or conflicts of interest, in articles 60 and 61, does not extend to supervisors. If China intended the supervisors to monitor the activities of the management; it has neglected to watch the monitors.

#### **4.4.1.4 Protection of the Minority Interest**

As long as there are majority and minority shareholders in a corporation, there will exist a possibility that the majority will take advantage of its majority position to serve its selfish interest at the expense of the minority interest. If the minority interest cannot be adequately protected, corporations will soon lose their attraction to individual investors. In the long run, the majority interest will also be injured because the overall interest of the corporation will suffer irreparable damages from the lack of investment. Almost all modern statutes have some devices or arrangement to provide protection to the minority interest. For example, cumulative voting for election of directors, higher quorum requirements for shareholders' meetings and board of directors' meeting, higher percentage of votes required for adoption of certain resolutions, and the shareholders' voting trusts and voting agreements, etc.

Conspicuously, the Corporation Law does not afford much protection to the minority shareholders. Especially, the Corporation Law does not recognize the cumulative voting in election of directors. Any person or persons holding a simple majority of total voting shares can elect all of her candidates to the board.<sup>90</sup> Such a straight voting method will almost inevitably lead to a majority-dominated board, precluding any representation of the minority interests on the board.

In addition, super majority votes for certain kinds of corporate matters may prevent the minority from the oppression of the majority. However, such protection is made meaningless by the voting procedure itself. Under the Corporation Law, the simple majority or super majority votes are based not on the total voting shares, or any required quorum, but on the shares presented at the shareholders' meeting.<sup>91</sup> Therefore, no matter how many total outstanding shares exist, even if only three shares are presented at the shareholders' meeting and two of them vote for it, the resolution is legally effective. We have no idea why the most common procedural quorum requirement is missing. Yet, we are quite sure that such missing will render the whole section totally unreasonable and unworkable.

#### **4.4.2 The External Challenges**

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<sup>90</sup> Song, *supra* note 41, at 215.

<sup>91</sup> See *supra* note 27, art. 106 & 107.

#### 4.4.2.1 Administrative Control

Article 67 of the Corporation Law states that the assets of a state wholly owned company would be under the supervision of the government authorized investment body or departments.<sup>92</sup> Presumably, the law intends that whichever state agency originally owned the corporation before it converted into LLC will have the ability to supervise and administer its activities. This provision entirely defeats the original purpose for enacting the Corporation Law—to allow corporations to make responsible economic decisions relying upon the market rather than political factors.

China's administrative organs clearly lack the information necessary to properly decide the variety, quantity and price of products, and how much to allocate to the Chinese and international markets.<sup>93</sup> The separation of these enterprises from the state administrative organs was intended to allow the enterprises to operate autonomously. Article 67 potentially defeats these purposes. An alternative view would be that Article 67 perfectly accomplishes the government's goal of keeping control.

In practice, the degree of supervision could vary vastly from enterprise to enterprise. But as long as such interference is possible, the enterprise will not be able to function independently whether it remains a "state-owned enterprise" or become a separate

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<sup>92</sup> Han, *supra* note 2, at 486.

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

incorporated LLC. The one exception is that when a large state-owned corporation has demonstrated good business circumstances and sound business management, it may be empowered to exercise rights of ownership of assets by the State Council.<sup>94</sup> However, it is unclear when a corporation will be considered to have demonstrated sufficiently sound business management and judgment so that it will be allowed to freely exercise the rights of ownership. Even if such a corporation obtains its rights, there is nothing in the law to prevent the State Council or the administrative organizations which are in charge of the corporation from suddenly retracting these rights or exercising them on behalf of the corporation. Since this privilege to exercise the rights of ownership is only limited to large scale corporations, most of the medium-sized, state-owned corporations will remain under the direct control of the administrative organs.

#### **4.4.2.2 Conflicting Orders**

Despite provisions in the Constitution to the contrary, the confusing and often overlapping lines of authority remains a problematic issue facing China's enterprises.<sup>95</sup> Every Chinese enterprise must respond to the orders of several administrative organs at any given time. It always suffers from multiple administrative orders. Moreover, these bureaucrats rarely have the expertise or incentive to properly supervise the various

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<sup>94</sup> See, *supra* note 27, art. 72.

<sup>95</sup> Article 16 of the PRC Constitution provides that a state-owned enterprise shall have power to make its own decisions.

enterprises for which they are responsible since their expertise is administrative, not technical or managerial. Coordination among these administrative agencies is also notoriously poor.

Unfortunately, the Corporation Law does not make any attempt to streamline these various administrative organs. As a consequence, enterprises have developed a philosophy that government orders should be circumvented and not followed.<sup>96</sup> Any cohesion in planning and coordinating the various administrative agencies is lost by the efforts of the enterprises to avoid these top-down orders.

#### **4.4.2.3 Political Control**

In almost all aspect of the Chinese soceity, political control is of paramount importance because control ensures stability and perpetuation of those people in power. Without control, there is a fear that the booming economy and introduction of Western ideas may well corrupt the Chinese people.<sup>97</sup> By carefully controlling change, the Chinese Communist Party hopes to maintain its power. The question is, will the Party continue to support these changes in the long run if its grip begins to loosen? In the past, when a program or particular legislation enjoyed sustained support from the Party, changes were brought about rapidly.<sup>98</sup> Similarly, when there is a shift in government

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<sup>96</sup> Han, *supra* note 2, at 488.

<sup>97</sup> Lichtenstein, *supra* note 19, at 72.

<sup>98</sup> Susan Young, *Private Business and Economic reform in China*, at 15-16, (1995).

policy and the support is withdrawn, the demise of the program can be equally rapid.<sup>99</sup>

Chinese society has traditionally followed orders from the top, and the people are used to massive and sometimes 180 degree changes from one program to another.<sup>100</sup>

If China, due to changes in leadership or policy, decides to revert to a more communist system and abolish private ownership, the owners of the private corporations will undoubtedly lose much. Such change has already happened once before in the recent Chinese history. After the Communist Party takeover of mainland China after 1949, officials purported to allow private ownership. Many capitalists stayed in China believing in the government's support of private ownership.<sup>101</sup> However, as the Chinese Communist Party strengthened its hold on China in the early 1950s, such private holdings were systematically seized and converted to public ownership.<sup>102</sup> Bearing this in mind, the new class of entrepreneurs and capitalists in China should be cautious. Until the government marched irrevocably down the path to privatization, the dangers of losing one's investment are always a nightmare.

#### **4.4.2.4 Interpretation of Law**

For any law to be effected in China, it must be enforced by the bureaucrats who

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<sup>99</sup> Id., at 76.

<sup>100</sup> Han, *supra* note 2, at 490.

<sup>101</sup> Frederick C. Teiwes, *Politics & Purges in China: Rectification and the Decline of Party Norms 1950-1965*, 87-108, (1979).

<sup>102</sup> Id.

interpret and apply the law. Because of China's cautious approach to legislation, laws are often drafted to reflect its broad policy, and specific interpretation is left to the bureaucrats. This practice allows shifts and adjustment of policy without the need to amend the law. If the bureaucrats support the Corporation Law, they can make the formation and operation of corporations relatively smooth and efficient. On the other hand, if the bureaucracy decides that such a law is undesirable, for whatever reason, it can, through various bureaucratic means, make the registration of a corporation and its operation extremely difficult.

Application can be misplaced, requests for more details can be made repeatedly, and rejection can be groundless. As such, successful operation of these newly created corporations will operate effectively depending largely on the officials responsible for interpreting and applying the Corporation Law. Even if the central government does not totally reverse policy and reassert control of these newly corporatized enterprises, interference by bureaucracy could easily stifle, and ultimately kill, maturing corporations just learning about the market system.

## **5. Re-emergence of the Stock Market**

### **5.1 From Mao to Deng, to Market**

Stock markets existed in China from the late 19<sup>th</sup> century until the 1920s, from the

1930s until 1949, and from 1949 until 1952. Unfortunately, none has ever grown into an independent institution strong enough to survive China's political turmoil.<sup>103</sup> For instance, during the 1940s, the Shanghai Securities Exchange was the largest stock market in Asia and more influential and internationally supported than that of Hong Kong<sup>104</sup>.

However, the 1949 Communist takeover caused its abrupt demise. Under the rule of Chairman Mao, the Chinese Communist Party believed that capitalist stock markets contributed to corruption, bureaucracy, and smuggling.<sup>105</sup> Though Mao and his supporters had used tightly centralized control with some degree of success in restoring China's ailing post-war economy in the 1950s and 1960s, post-Mao leaders of the Chinese Communist Party realized that such strict rule had stifled the country's economic development over time. After the greatest disaster in the history, the Cultural Revolution, the Chinese Communist Party reinstated Deng Xiaoping to the Party's leading position.<sup>106</sup> Thus, in the late 1978, the Chinese Communist Party, under the leadership of Deng, announced its "open door policy," under which the Chinese Communist Party would simply focus its attention on economic development, rather than

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<sup>103</sup> Qian, *supra* note 28, 62, 64.

<sup>104</sup> Francis A. Lees & K. Thomas Liaw, *Foreign Participation in China's Banking and Securities Market* 54, 61-62 (1996).

<sup>105</sup> Ann P. Vandeveld, *Realizing the Re-Emergence of the Chinese Stock Market: Fact or Fiction?*, 30 *Vand. J. Transnat'l L.* 579, 582 (1995).

<sup>106</sup> Although elderly Deng had officially retired in November of 1989 and was in poor health, he was,



class struggle.

Deng's economic reforms sought three main objectives: (1) to decentralize the economy; (2) to bolster reliance on market forces and on material incentives as a means for achieving desired economic behavior and resource allocation; (3) to encourage foreign investment.<sup>107</sup> The Chinese government has gradually implemented economic reforms in the form of experiments at both local and national levels.

Its first step was to overhaul its financial sector by allowing state-controlled bank to allocate financial resources more efficiently.<sup>108</sup> Prior to 1979, the banks in China acted merely as the government cashiers. The transformation of Chinese banking sector inevitably led to the re-emergence of its financial market.<sup>109</sup>

China represents the first known example of a centrally planned economy supporting a securities market.<sup>110</sup> China's financial market re-emerged primarily as a result of the decentralization and rationalization of investment activities and the increase in the financial autonomy of enterprises. Debt securities first appeared in China in 1981 when China issued government bonds to finance its budget deficit.<sup>111</sup> In the latter half of the

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nevertheless, considered the paramount leader in China until his death on February 19, 1997.

<sup>107</sup> Mei Xia et al., *The Re-Emerging Securities Market in China*, 22 (1992).

<sup>108</sup> In 1984, the People's Bank of China was restructured to serve as the country's central bank, playing a dominant role in creating and implementing monetary policies.

<sup>109</sup> Vandeveld, *supra* note 106, at 579, 582.

<sup>110</sup> Young, *supra* note 99, at 19.

<sup>111</sup> Tan Lay Hong, *Capitalism in the People's Republic of China?: A survey of the Re-Emerging Securities and Financial Market*, 16 *Company Law.*, 73 (1995).

1980s, the national economic policy reforms led to the emergence of joint-stock companies and stock issuance.<sup>112</sup>

After the opening of the first over-the-counter (OTC) stock exchange in Shenzhen on August 5, 1986, other regional markets quickly develop in Beijing, Chongqing, Shanghai, Tianjin, and Wuhan.<sup>113</sup> The subsequent emergence of the national securities exchanges in Shanghai and Shenshen occurred on December 19, 1990 and July 3, 1991, respectively.

## 5.2 The Market Participants

Various types of business enterprises compose China's economic system. The non-stock business forms currently operating in China include state-owned enterprises (SOEs),<sup>114</sup> collectively owned enterprises (COEs),<sup>115</sup> private enterprises<sup>116</sup>, and foreign investment enterprises (FIEs).<sup>117</sup> Under the 1993 Corporation Law, stock companies may exist in two forms, LLC and SLC. These stock companies are owned by

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<sup>112</sup> *Id.*, at 75.

<sup>113</sup> Benjamin R. Tarbuton, *China—A National Regulatory Framework for the PRC's Stock Markets Begins to Emerge*, 24 *Ga. J. Int'l & Comp. L.* 411, 414 (1994).

<sup>114</sup> SOEs make up a small percentage of total enterprises, but produce a majority percentage of China's national production. Most large SOEs are manufacturing enterprises supervised for the most part by ministries in Beijing, while the more numerous medium and small-sized SOEs may be owned by the central or local government, or jointly by both.

<sup>115</sup> Most COEs are partnership sponsored by local government whose participating partners are responsible for raising capital, but many COEs reorganized as semi-SOEs in the late 1950s and early 1960s.

<sup>116</sup> Few private enterprises that survived nationalization in the early 1950s were small service operations, such as barber shops and street vendors located primarily in eastern and southern China.

<sup>117</sup> FIEs have exploded since the enactment of China's Foreign Investment Law in 1979. Most FIEs are organized as either equity or contractual joint ventures, but foreign companies have also established wholly foreign-owned enterprises.

shareholders, managed under the board of directors, and characterized as limited liability enterprises. While LLC may privately issue stock, only SLC can access the stock markets if it meets certain qualifications under the Corporation Law.

Both national and foreign investors may participate in the Chinese stock markets. However, they must purchase different type of shares. Chinese individuals can own A-Shares of a company, while foreign investors can only purchase B-Shares.<sup>118</sup> Besides the difference, legally speaking, A and B shareholders enjoy the same rights.<sup>119</sup> Yet, in reality, the A shareholders are lack of sufficient information for their investment while the B shareholders are lack of liquidity of their shares. Moreover, upon the regulatory approval, Chinese companies may also list their stock on foreign exchanges. They may either list H-Shares on the Hong Kong Stock Exchange, or issue N-Shares for trading on the New York Stock Exchange.<sup>120</sup>

Unfortunately, there is no regulation indicating how the holders of A, B, H, and N Shares may exercise their rights. In particular, it makes no mention of whether they vote in common with all other shareholders or whether they vote by classes. If the minority shareholders do not vote as separate classes, or receive some other form of protection, they will always be outvoted and will have few meaningful rights. The

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<sup>118</sup> Foreign investors include foreign residents and foreign investment corporations both inside and outside China.

<sup>119</sup> Vandeveld, *supra* note 106, at 586.

Chinese government, owing 51% or more of the stocks, could elect all of the directors and control all corporate decisions.<sup>121</sup>

China's system of classifying shares is understandable in light of the government's intention to avoid privatization, but leaves the owners of many classes of shares in an uncertain and problematic situation. Trading only within each class, however, will eventually destroy the incentive of individuals and foreign investors to invest more money in the securities markets. Those investors cannot foresee how the majority shareholders, namely the government, will treat their minority position, and will recognize that they have neither protection nor voice in the decision-making process. In addition, because the leaders of those enterprises are usually selected by the majority, they will be responsible only to the government instead of the shareholders. If they abuse their power, the minority shareholders will be unable to remove them from their positions.

Along with the economic benefits of the securities markets come many risks and costs, including market cycles, loss of control over the financial system, and the potential occurrence of fraud and insider trading.<sup>122</sup> Hard data is not presently available to measure the prevalence of insider trading in China because insider trading has not been

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<sup>120</sup> Cohen & Lange, *supra* note 1, at 362.

<sup>121</sup> Song, *supra* note 41, at 215-18.

<sup>122</sup> Mei Xia et al., *supra* note 108, at 12-3.

prosecuted to any significant degree under China's current laws. However, news reports reveal that insider trading is not uncommon.<sup>123</sup> The cultural weight placed on personal relationship (*guanxi*) in China encourages insider trading between those persons having connections within government agencies or issuing companies. For instance, in August of 1992, citizens rioted in the streets of Shenzhen because there were not enough stock applications available due to official impropriety.<sup>124</sup>

### **5.3 The Evolvement of the Current Legal Framework for the Stock Market**

Since 1979, China has undergone a major transformation of its legal system, characterized by one commentator as a shift from "policy and propriety" to "codified law and legal institutions."<sup>125</sup> Within this general transformation, the legal framework supporting the securities market has evolved from a regional to a national base of laws, rules, and regulations. Until the enactment of provisional national securities laws and the Corporation Law in 1993, the central government and municipalities compete for control over emerging financial markets, resulting in confusing and potentially contradictory regulatory measures.<sup>126</sup>

In fact, the open door policy introduced in 1979 did not envision an efficient,

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<sup>123</sup> See Foo Choy Peng Assesses the First Year 's Work of the Stock Exchange's General Managers, S. China Morning Post, Sep. 15, 1996; What's News: Business and Finance, Asian Wall St. J., Jan. 21, 1997.

<sup>124</sup> David Holley & Christine Courtney, Would-Be Capitalist Riot in China Protests, L.A. Times, Aug. 11, 1992.

<sup>125</sup> Art & Gu, *supra* note 29, at 274.

<sup>126</sup> K. Matthew Wang, Securities Regulations in China and Their Corporate Finance Implications on the

capitalist stock market. The primary motive of the central government behind the development of an equity market was to raise capital to support China's ailing state enterprises and to cure inflation by decreasing consumer spending through the channeling of personal savings into capital investment.<sup>127</sup> Hence, China's securities laws mirror its desire to effectuate economic modernization without relinquishing state control.

In 1983, the State Council officially recognized the issuance of corporate stock to employees of collective enterprises as well as the reorganization of SOEs into shareholding entities.<sup>128</sup> By late 1986, under the supervision of local branches of the People's Bank of China (PBOC), government in Beijing, Guangdong province, and Xiamen special economic zone had passed separate regulations defining the concept of stocks and prescribing the eligibility requirements for issuing stocks.<sup>129</sup> Next year, the State Council promulgated the first national securities regulation entitled "Interim Regulations Governing the Issuance of Bonds for State-Owned Enterprises" (1987 Interim Regulation). It authorized the SOEs to issue bonds and conspicuously lacked any reference to stock issuance.

Following the promulgation of the 1987 Interim Regulation, the State Council

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State Enterprise Reform, 65 *Fordham L. Rev.* 1221, 1235-36 (1996).

<sup>127</sup> *Id.*, at 1240-41.

<sup>128</sup> Chen Jianfu, *Securitisation of State-Owned Enterprises and Ownership Controversy in the PRC*, 15 *Sydney L. Rec.* 59, 60-61 (1993).

<sup>129</sup> The PBOC was authorized to regulate stocks, bonds, and negotiable instruments, and to administer the PRC's financial markets under Art. 5, Sec. 11 of the Interim Regulations of Banks of 1986.

released the Directive of the State Council on Reinforcement of Administration on Stocks and Bonds (1987 Directive). It set force only three circumstances under which enterprises could issue stock: (1) issuance by COEs, subject to control by the national government; (2) issuance by SOEs, which had issued public stock prior to 1987 Directive, upon PBOC approval; (3) issuance through horizontal investments between enterprises.<sup>130</sup>

In the early 1990s, two national stock markets emerged under different regulations promulgated by the local PBOC branches in Shanghai and Shenzhen.<sup>131</sup> The first national stock exchange opened in Shanghai on December 19, 1990, under the Provisional Measures of Shanghai Municipality for Administration of the Issue and Trading of Shares (Shanghai Measures).<sup>132</sup> The Shenzhen Stock Exchange began trading on July 3, 1991, under the Provisional Measures of Shenzhen Municipality for Administration of Issue and Trading of Shares (Shenzhen Measures)<sup>133</sup>. Both exchanges subsequently issued regulations with regard to the issuance of B-Shares to foreigners.<sup>134</sup>

In October of 1992, due to fraud and abuse problems associated with the lack of unity between the Shanghai and Shenzhen Measures, the State Council Securities Committee (SCSC) and China Securities Regulatory Commission (CSRC) replaced the

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<sup>130</sup> Vandeveld, *supra* note 106, at 590.

<sup>131</sup> The regulatory differences reflect the lack of cooperation between Shanghai and Shenzhen branches of the PBOC, which controlled the stock exchanges.

<sup>132</sup> See 1 *Encyclopedia of Chinese Law* 355-59 (Chris Hunter et al., ed., Asia Law & Practice Ltd., 1993).

<sup>133</sup> *Id.*, at 295-96.

<sup>134</sup> Tarbuton, *supra* note 114, at 411, 418.

PBOC in regulating China's securities industry.<sup>135</sup> Then, the SCSC promulgated the Interim Regulations on the Issue and Trading of Shares (1993 IRITS) on April 22, 1993. This was China's first attempt to create a national securities law.

In December of 1995 and May of 1996, the CRSC promulgated national regulations and detailed rules respectively governing the issue of B-Shares. Under these recent national rules, B-Shares may be issued to foreign legal persons or institutions, individuals, legal persons and institutions in Hong Kong, Taiwan, and Macao, or Chinese citizens living outside China, and other approved by SCSC.

Furthermore, in the late June of 1996, the SCSC promulgated rules governing the underwriting of A-Shares issues. These rules specified detail requirements for underwriters in this industry. These rules, no doubt, had indicated China's efforts to establish a unified national legal framework for its securities law.

After operating the securities markets in China without a formal national legislation for eight years, China passed its first national securities law on December 29, 1998. Following its enactment, China engaged in a massive campaign and education of the new securities law for a period of six months. The 1998 Securities Law finally entered into force on July 1, 1999.

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<sup>135</sup> Significant fraud and abuse occurred under the decentralized leadership of the PBOC, prompting citizen riots in Shenzhen on August 10, 1992. This outbreak was the most serious public disturbance in China since the 1989 crackdown on the pro-democracy movement in Beijing.



## **5.4 The Basic Structure of the 1998 Securities Law**

The 1998 Securities Law has 214 articles in twelve chapters. Originally, we could see a lot of reflections of US securities law in its draft. Unfortunately but not surprisingly, the final enactment was a compromise of the current status and the international standard. Most of them are simply borrowed from the existing rules included in the ISRIT and other SCSC regulations. As such, it will be more realistic if we view the 1998 Securities Law as a stepping stone rather than a cornerstone. In this section, we would like to give a brief introduction and a preliminary examination of its main provisions.

### **5.4.1 General Principles**

The legislative purposes are stated in article 1 as to standardizing the issuing and the trading activities. It also guarantees the lawful rights and interests of investors, and safeguards the social and economic order as well as the public interests. Most importantly, the law emphasizes its function of promoting the socialist market economy. Therefore, the state has the responsibility to assure that any issuing and trading activities is governed by the principles of openness, fairness, and justice.<sup>136</sup>

The law will only focus the issuing and trading of the stocks, company bonds, and

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<sup>136</sup> Art. 3 of the 1998 Securities Law.

other securities determined by the State Council. With regard to the issuing and trading of the state treasury bonds, they will be subject to a separate legislation in the future.<sup>137</sup>

The understanding among the drafters was that the term “other securities” might include the financial bonds, the bonds of investment funds, and the convertible debentures.<sup>138</sup>

Article 6 states that the securities industry shall be operated and regulated separately from the banking, the trust, and the insurance businesses. Apparently, the drafters foresaw that China still had a long way to go to solve the problems and build a healthier stock market. Hence, they did not want to see that banks, trusts, and insurance companies all involving in such a risky business.

The CSRC, as the organ of under the State Council, shall have the authority to exercise the centralized and unified supervision and regulation power over the stock market. It may also establish and authorize its power to local branches.<sup>139</sup> As a result, the two-tier structure of the SCSC and the SCRC as well as the co-regulation framework by both the local and central governments has been replaced by a single vertical system.

#### **5.4.2 Securities Issuing**

Any public issuing of the securities must be either authorized or approved by the

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<sup>137</sup> Id., art. 2.

<sup>138</sup> Ming Pao, Dec. 30, 1998, at B15; Zhongguo Gaiye Bao, Oct. 24, 1998, at 5.

<sup>139</sup> See, supra note 137, art. 7.

CSRC in advance.<sup>140</sup> The CSRC shall establish an examination committee to review the issuing. The members of the committee shall include both the CSRC's representatives and the outside experts. Members shall have the right to vote for the examination opinion but it shall subject to CSRC's final approval.<sup>141</sup>

Article 13 stipulates that the documents provided by the issuers must be true, accurate, and complete. The professional firms and professionals who produce the prospectus are under a legal duty to ensure the same standards. Any change of the issuer's operation or profit after the issuing is answerable by the issuer, and any investment risk caused by such a change shall be borne by the investors themselves.<sup>142</sup> Apparently, the drafters were very concerned about the fraudulent activities, which were quite common in the past. Yet, the law does not define it clearly. We hope that the court will set some rulings for it later.

In addition, CSRC and other authorities concerned have the right to take actions to correct their own mistake.<sup>143</sup> An authorization of issuing shall be revoked if CSRC later finds that the decision was not to comply with the laws and regulations. If the issuing is yet made, it shall be suspended. If the securities have been issued, the holders of the securities are entitle to claim the money (issuing price) plus interest form the issuer.

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<sup>140</sup> Id, art. 10.

<sup>141</sup> Id, art. 14 & 15.

<sup>142</sup> Id., art. 19.

The underwriting arrangement may be either in the form of best effort or firm commitment.<sup>144</sup> Also need to note is that if the face value of the securities to be issued exceeds RMB50 million, an underwriter syndicate must be formed.<sup>145</sup> The underwriting period may not exceed ninety days. The underwriter shall file a sales report with the CSRC with fifteen days if the expiration of the underwriting period.<sup>146</sup>

### **5.4.3 Securities Trading**

Securities to be traded must be legally issued ones and any trading of listed securities must be conducted on the stock exchanges.<sup>147</sup> The law is silent on the over-the-counter market. Moreover, the securities must be purchased on spot transactions.<sup>148</sup> No securities company is allowed to provide finance or lending with their clients for trading.

According to the law, the staff of the securities exchanges, the securities companies, the securities registration, the settlement institutions, and the officials of the securities regulatory authorities may not engage in the trading. Any stocks already owned by these persons prior to the implementation of the law must be transferred in accordance

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<sup>143</sup> Id., art. 18.

<sup>144</sup> Id., art. 21 & 22.

<sup>145</sup> Id., art. 25.

<sup>146</sup> Id., art. 26 & 27.

<sup>147</sup> Id., art. 32.

<sup>148</sup> Id., art. 35.

with the law.<sup>149</sup> Article 39 further provides that the institutions that produce auditing reports, asset appraisal reports, or legal opinions for an issuer shall not purchase or sell the stocks concerned during the underwriting period and six months thereafter; nor shall they purchase or sell the stocks concerned during the period from the date on which the issuer's appointment for the service is accepted to the fifth day of the publication on the issuing documents concerned.

Shareholders are required by the law to notify the issuers within three days when their holdings reach five-percent of the issuer's outstanding stocks.<sup>150</sup> In turn, the company shall file a report within three days to the CSRC and the securities exchanges. Any profit of a short swing made by a five-percent shareholder from the trading within six months shall belong to the company and should be recovered by its board of directors. Nevertheless, a securities company which holds five-percent or more of the outstanding shares of the company under a firm commitment arrangement is exempted.<sup>151</sup>

#### **5.4.4 Listing Procedures and Standards**

Listing of any company must be authorized by the CSRC.<sup>152</sup> The application forms specified in Article 45 include a listing application, relevant resolutions of the shareholders' meetings, articles of incorporation, business registration, financial and

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<sup>149</sup> Id., art. 37.

<sup>150</sup> Id., art. 41.

<sup>151</sup> Id., art. 42.

accounting report audited by accredited institutions, legal opinions, recommendation letter of the securities company, and the latest prospectus. The stock exchanges shall make arrangements to list the company that has received the authorization from the CSRC within six months of the receipt of its application forms according to Article 46 of the 1998 Securities Law. In addition, the company is required to publish the trading date approved, the top ten shareholders and their respective holdings, and the names of the directors, supervisors, managers, and other senior officers of the company as well as their respective holdings.<sup>153</sup>

#### **5.4.5 Continuous Disclosure**

Any listed company shall be under a legal duty of continuous disclosure. Under the law, a listed company must file with the CSRC and the stock exchange, and publish its mid-term report within two months at the end of its first half accounting year. It must also publish its annual reports within four months of the end of the accounting year. A mid-term report shall include the major litigation in which the company is involved, the change of the stocks or bonds, and the important matters proposed at the shareholders' meeting.<sup>154</sup> An annual report shall further cover the relevant information of the directors

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<sup>152</sup> Id., art. 43.

<sup>153</sup> Id., art. 48.

<sup>154</sup> Id., art. 60.

and other senior officers, the top ten shareholders, and their respective share holdings.<sup>155</sup>

Moreover, Article 62 requires a company to file and publish a special report with explanation when any major event occurs that may have an impact on the price of the stocks and is unknown by the public investors. The major categories of these events are: (1) significant change of the company's operation policy and business scope; (2) its important investment or decisions of asset purchase; (3) its conclusion of any important contract which may have significantly affect the company's assets, liabilities, interests, and operation result; (4) its incurring of major debts or default of major debts; (5) its significant deficit or major loss that exceeds ten percent of its net assets; (6) significant change of the external environment of the company's business operation; (7) change of the chairman of the board of directors, one-third of the directors or the managers; (8) major change of the holdings of the shareholders who own five percent or more of the company's outstanding shares; (9) any decisions of the company to reduce its capital, merger, spin-off, dissolution, or bankruptcy application; (10) its involvement in any major litigation or the court's order to annul any resolution of the shareholders' meeting or the board of directors; and (11) other matters required by other laws or regulations.

Thus, listed company is responsible for the truthfulness, accuracy, and completion of

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<sup>155</sup> Id., art. 61.

its disclosures and shall ensure that there is no false record, misleading statement, or significant omission.<sup>156</sup> The company and the underwriters shall be liable for any loss of the investors caused by such violations. And, the responsible directors, supervisors, and managers shall be held jointly liable as well.<sup>157</sup>

#### **5.4.6 Insider Trading and Fraudulent Conduct**

The law prohibits the insider trading, market manipulation, making and spreading the false information, and any other fraudulent conduct against the investors.<sup>158</sup> Article 68 defines that the following persons as insiders: (1) the directors, supervisors, managers, deputy managers, and other senior officers; (2) the shareholders with five-percent or more share holdings; (3) the senior officers of the company's holding company; (4) the staff who have access to the inside information by virtue of their positions in the company; (5) the staff of the securities regulatory authorities and the other staff under legal duty to administer the securities trading; (6) the staff of the intermediaries, the securities registration, the settlement institutions, and the securities service firms that are involved in the company's trading under their legal duties; and (7) other persons prescribed by the CSRC.

In addition to the information specified in Article 62, Article 69 further requires the

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<sup>156</sup> Id., art. 59.

<sup>157</sup> Id., art. 63.

<sup>158</sup> Id., arts. 5, 67, 71, 72, 73.



disclosure of the following inside information: (1) the company's plan to distribute dividends or increase capital; (2) the significant change of its share holding structure; (3) the significant change of the debt security; (4) the major mortgage or sales of the company's major operational assets or scrapping of its assets exceeding thirty percent in total at one time; (5) the potential major liability to be borne by the senior officers of the company under the law; (6) any take-over plan of the company; and (7) any other information that the CSRC believes to have notable impact on the price of the stocks.

The insiders and other person who obtain inside information are prohibited from purchasing or selling the securities of the company, or tipping others to trade the securities.<sup>159</sup> Article 71 prohibits the unlawful manipulation of the market. The unlawful manipulation of the market includes but not limit to the following situations: (1) manipulating the securities price, individually or conspiratorially, by taking the advantage of the superiority of capital, holdings or information, or by consecutive trading; (2) affecting the price or volume by trading at the prearranged time, price, or means between the conspirators; (3) affecting the price or volume through the self-dealing and trading without change of ownership.

#### **5.4.7 Acquisition of a Listed Company**

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<sup>159</sup> Id., art. 70.

Article 78 sets out two ways for investors to acquire the target companies, the acquisition by tender offer and the acquisition by agreement. An investor must file a written report with the CSRC and the stock exchange and publish it within three days when his holding reaches five percent of the target company's outstanding shares. The investor is further required to make a filing and publication for her holding fluctuation of every five percents. Once the investor's holding reaches thirty percent of the target's outstanding shares, if the investor intends to carry on the acquisition, a tender offer then must be made to all shareholders. Yet, the CSRC may exempt such a requirement, which would release the state from the mandatory purchase due to its heavy holdings of most of the listed companies.<sup>160</sup>

Before any tender offer is made, the acquirer must submit its acquisition report to the CSRC and the stock exchange. The report must contain detail information with regard to the purpose, quantity, terms, and fund involved in the acquisition.<sup>161</sup> The tender offer shall be published fifteen days after the submission of the acquisition report. The tender off shall be valid for at least thirty days but no longer than sixty days.<sup>162</sup> At the end of the period, if the acquirer reaches 75 percent of the target's outstanding shares, the trading of the target's stocks will be terminated. If the acquirer successfully acquires

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<sup>160</sup> Id., art. 81.

<sup>161</sup> Id., art. 82.

<sup>162</sup> Id., art. 83.

90 percent of the target's outstanding shares, the remaining shareholders are entitled to sell their shares to the acquirer on the same terms and conditions of the tender offer.<sup>163</sup>

Alternatively, the acquirer and the shareholders of the target company may, by agreement, transfer the shares of the target company in accordance with the law and regulation concerned. Once they reach the agreement, the acquirer must file a written report to the CSRC and the stock exchange within three days and publish it at the same time. The agreement will not be enforceable until the publication is made.<sup>164</sup>

#### **5.4.8 Securities Exchange**

Article 95 requires that the securities exchange should be a non-profit legal entity. Its function is to provide with the investors a centralized venue for collective securities trading by bidding. Any establishment or dissolution of an exchange must be approved by the State Council and the adoption or revision of its articles must be approved by the CSRC.<sup>165</sup> Articles 99 and 100 further provide that a council and a general manager who will be the head of an exchange shall be appointed by the CSRC. Moreover, Articles 101 and 102 disqualify certain persons to be in charge of the exchange and to be employed by the exchange.

The duty of the exchange is to safeguard the fair-trading by bidding and promptly

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<sup>163</sup> Id., art. 87.

<sup>164</sup> Id., art. 89.

<sup>165</sup> Id., art. 96.

publish the trading conditions.<sup>166</sup> The exchange is also empowered to suspend, resume, or terminate the listing of any stocks. It shall also monitor the trading and report to the CSRC any abnormal trading, and supervise the disclosures of the listed companies.<sup>167</sup> In addition, the exchange is also authorized to establish, but subject to the CSRC's approval, the trading rules, membership provisions, and other working procedures for its employees.<sup>168</sup>

#### **5.4.9 Securities Company**

A securities company, which may be organized in the form of either the LLC or SLC. But, it must be examined and approved by the CSRC.<sup>169</sup> Under Article 119, the securities company is divided into two categories: the multi-function securities company (MFSC) and the securities brokerage company (SBC).

An MFSC is entitled to operate in the securities brokerage, securities underwriting, and other businesses approved by the CSRC while an SBC is only entitled to engage in the business of securities brokerage.<sup>170</sup>

Article 141 provides that a securities company may only accept the sales order backed with the real securities on the client's account and purchase the order backed with

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<sup>166</sup> Id., art. 107.

<sup>167</sup> Id., art. 110.

<sup>168</sup> Id., art. 113.

<sup>169</sup> Id., arts. 117 & 118.

<sup>170</sup> Id., arts. 129 & 130.

the real fund on the client's capital account. In other words, it may provide neither financing nor lending for the client's trading. Moreover, funds from the banks are prohibited from flowing into the securities market.

#### **5.4.10 Securities Registration and Settlement Institution**

A securities registration and a settlement institution (SRSI) shall be a non-profit seeking legal entity according to Article 146 of the 1998 Securities Law. It provides the service of centralized registration, trust, and the clearing for securities trading for the investors. Article 147 further provides that the SRSI must have its own capital of no less than RMB200 million.

For the sake of safe operation, the SRSI must set a settlement risk fund for the purpose of compensating any losses caused by technical breakdown, operational mistake, and force majeure.<sup>171</sup>

#### **5.4.11 Securities Trading Service Institution**

According to Article 157 of the 1998 Securities Law, the professional investment consulting firms and the credit appraisal firms may be established according to the terms and approval from the CSRC. In order to be a specialist of those firms, a person must have both special knowledge and experience of two or more years.<sup>172</sup> The professional

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<sup>171</sup> Id., art. 154.

<sup>172</sup> Id., art. 158.

investment consulting firms or the credit appraisal firms and their staff shall be held jointly liable for their violation of the law.<sup>173</sup>

#### **5.4.12 Securities Trade Association**

A securities trade association is defined by Article 162 as a social legal person of self-discipline in the securities business. All securities companies are required to join the association and its member of assembly shall have the supreme power.

Its functions under Article 164 are as follows: (1) assisting the CSRC to educate and organize the members to abide by the laws and regulations; (2) protecting the lawful interests of its members and conveying members' suggestions to the CSRC; (3) providing its members with information service; (4) mediating the disputes between its members, and between its members and the clients; (5) formulating the rules for its members and organizing training program for its members; (6) supervising and inspecting its members' conducts and disciplining the violators; (7) carrying out other functions authorized by the CSRC.

#### **5.4.13 The Securities Regulatory and Administrative Authority**

Since the two-tier regulatory structure has been merged into a single organ under the State Council, the CSRC became the exclusive authority in charge of the securities

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<sup>173</sup> Id., art. 161.

market regulations and administration. To further strengthen the CSRC, Article 171 states that in the course of the CSRC's enforcement, the entities and individuals under investigation must be cooperative, must hand out relevant documents and materials faithfully, and may not refuse, hinder, or conceal. Where any activity under investigation is likely to constitute a crime, the CSRC shall refer the case to the judiciary.<sup>174</sup>

Certain provisions are also set out to prevent the CSRC from abusing its power. Article 169 requires that the CSRC's staff to show the authorization documents while exercising their enforcement and to keep the commercial secrets learned confidentially. Article 172 further provides that the regulations and working procedures adopted by the CSRC shall be promulgated and its investigation results and discipline decisions shall be published.

#### **5.4.14 Criminal Liabilities and Administrative Sanctions**

Criminal liabilities are common in the 1998 Securities Law. In general, issuing securities without the approval, any serious violations of the disclosure obligation, establishing a securities company without permission, insider trading, manipulating the market, illegally operating a securities company, the SRSI, or the STSI will all receive

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<sup>174</sup> Id., art. 173.

criminal punishment, which further refers to the provisions of the Criminal Law.

Administrative sanctions in the form of warning, order to correct, mandatory disposition, fine, confiscation, disqualification, business suspension, revocation of business license, order to close down, and other administrative disciplines are employed in the 1998 Securities Law. Most of the penalties may be imposed against the corporate, institutional, or individual violators. One article worth noting is that Article 210 allows the parties concerned to petition the CSRC for reconsideration or to file a legal action to the court against the CSRC's sanction.

## **5.5 The Positive Implications and the Unsettled Issues of the 1998 Securities**

### **Law**

#### **5.5.1 The Positive Implications of the 1998 Securities Law**

Though a full assessment of the 1998 Securities Law is still premature at this juncture, a preliminary evaluation based on the text might be able to assist us in obtaining a general picture of it and to help us understanding and closing the gap between the current law and the international standards.

To begin with, we would like to say that the adoption of the new law itself deserves a celebration. It demonstrates China's firm commitment to develop a stable and orderly market economy. A further development of China's securities market will have a



significant impact on its effort to gradually privatize its national economy.<sup>175</sup> The law no longer requires public issuing as a precondition of listing specified in the 1993 Corporation Law and the IRSIT, which has been subject to certain quantity requirement and scrutiny based on the state industrial policy.<sup>176</sup> According to the drafters, such a change is intended to enable the private enterprises to have access to the capital market through public listing. It facilitates the market privatization of the SOEs and levels the ground for the private enterprises to compete with the SOEs.

The 1998 Securities Law also marks a new stage of the market development based on a uniform national law. A centralized regulatory framework with a single regulatory structure is settled. As a result, the powers shared by 14 state organs as well as local governments are now exclusively belong to the CSRC. It not just cuts the red tape and improves the efficiency but also reduces the non-transaction costs. Most importantly, a unified regulatory regime is very crucial for China to deal with the financial crisis.

In addition to those provisions that are restated in the 1998 Securities Law from the existing regulations, the 1998 Securities Law emphasizes its focus on how to prevent a financial turmoil and a bubble economy on the securities market. To this end, several walls are either preserved or built up. For example, it maintains the status quo in

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<sup>175</sup> Xian Chu Zhang, *The Old Problems, the New Law, and the Developing Market: A Preliminary Examination of the First Securities Law of the People's Republic of China*, 33 *Int'l Law*, 983 (1999).

<sup>176</sup> Article 152 (1) of the 1993 Corporation Law and Article 30 (1) of the IRSIT (1993).

separation of A and B shares. China's concern is that, given the infant and weak condition of its securities market, A share market is apparently not ready for opening up to the foreign investors. Some Chinese leaders argue that the isolation of its domestic securities market and the inconvertibility of its currency should be credited for the fact that China has not been seriously affected by the Asian financial crisis in 1997. Having said that, it by no means suggests that the separation of securities market is perfect. Given the size of the B share market, the foreign investors often find that their shares are lack of liquidity. If China wants to create a healthier securities market and further integrates with the international financial market; it needs to lift the restriction in the future.

Moreover, the 1998 Securities Law blocks the banks, the trusts, and the insurance companies from participating in the securities market. Also, it requires that all trading be conducted on spot transaction and the public funds and the SOEs are prohibited from being involved in the securities speculations, and the securities companies are forbidden from financing or lending any money to the clients. All these restrictions might not be common in other countries; they clearly reflect China's deep concern of the potential bubble economy. Again, these controls do have their positive effects now; it might be a potential hurdle if China wants to further develop its market economy.

The protection of the investors' interests is improved with the tightened administrative monitoring and sanction. On the other hand, the domination of the government branches has been weakened by introduction of the professional role in the examination. Therefore, the market risks associated with government intervention could be reduced. Under the IRSIT, though an issuer is required to make a statement on the cover of its prospectus to guarantee the truthfulness, the accuracy, and the completeness of the documents, it may keep certain events in dark if it has good reason to believe that the disclosure will damage its interests. The 1998 Securities Law abolishes such exception and hence improves the quality of disclosure. Meanwhile, the liability imposed against the violation of disclosure is increased. For instance, the penalties for an issuer's violation of the disclosure obligation include a fine of up to RMB600,000 and RMB300,000 against the issuer and responsible person respectively, or even subject to criminal liabilities.

Some notable changes are made with regard to the stock issuing, the listing, and the acquisition rules. As far as the stock issuing and listing are concerned, the government approval based on substantive scrutiny has been replaced with the CSRC's authorization scheme prior to its enactment, although the concept is not defined in the law at all. The 1998 Securities Law changed this system. Many drafters believed that the

authorization scheme should be introduced as a means to reduce the government's intervention and improve the transparency of the issuing and listing process. Drafters also pointed out that unlike the registration system in the United States and other countries, the CSRC had been conducting the substantive examination of all issuing and listing application. Yet, it had not been subject to any liability for its errors. Though the real effect is hard to assess now, at least, the 1998 Securities Law surely represents a positive trend toward a more market freedom and less government control.<sup>177</sup>

The new law also brings the acquisition rules closer in line with the normal market operation by deleting the mandatory price of the tender offer and restriction on the unsuccessful acquisition. The report and publication interval is stretched from 2 % to 5%. A cap of sixty days is placed on tender offer period and any change of the tender offer terms must be approved by the CSRC. The 2 % interval was original borrowed from the United States.<sup>178</sup> Some Chinese scholars argued that under the rule, an acquirer with 5% holding must file reports and publications thirteen times (2% X 13) before reaching the 30% threshold, not to mention about the repeated pausing of trading during the reporting period. To avoid the high cost of acquisition on the securities market and to improve the optimum allocation of resources, the drafter decided to relax

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<sup>177</sup> Xian, *supra* note 176, at 1005.

<sup>178</sup> Securities Exchange Act of 1934, 15 U.S.C. Sec. 78m(d)(1) (1988).

the requirement. In addition, the acquisition by agreement is finally allowed as an alternative means. It was designed to improve the liquidity of the state and the legal person shares between different states-owned entities in an environment that trading of these shares on an open market is not permitted.<sup>179</sup>

Though these changes to some extent improve the market efficiency, I would argue that the primary reason for relaxing the requirement was to facilitate the take-over between the state-owned entities because the state was still the majority owner. Apparently, China intends to force those inefficient entities out of the market so that the state no longer needs to subsidize those entities. It might be too premature to assess the market reaction. Nevertheless, after the first wave of take-over between state-owned entities, we might be able to see an active private take-over movement in the near future.

The provisions of insider trading further illustrate the Chinese unique characteristics of the law. Unlike the IRSIT and the rules of other countries, the 1998 Securities Law adopts a wide statutory definition of insiders. With regard to the inside information, it also includes a catchall provision allowing the CSRC to add more when it is necessary.<sup>180</sup> Many believe that such a scheme with a heavy criminal punishment is necessary if China intends to solve the more and more serious corruption problem in the stock market.

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<sup>179</sup> Wang Lianzhou, *Securities Law of the PRC-An Annotation*, 2-3 (1999).

<sup>180</sup> See *supra* note 137, art. 62 & 69.

Finally, to further improve the quality of securities regulations, the 1998 Securities Law emphasizes the due procedures of law. Though the detailed procedures need to be further specified, I would argue that this is a big step for China that it allows the people to challenge the government's decision.

### **5.5.2 The Unsettled Issues**

Despite the progress above, the breakthrough seems limited and falls short of many expectations. A lot of fundamental concerns are left untouched. According to Professor Li Yining's comments, there are at least eight critical issues that need to be settled in the next round. Those unsettled issues are: (1) the restriction on the transfer of the state and the legal person shares; (2) the transfer of the unlisted stocks; (3) certain irregular internal issuing of securities to the employees; (4) some other right issuing; (5) the separation of the A and B share markets; (6) the unequal prices among A, B, and foreign listed shares of the same company; (7) the listing of China funded company in Hong Kong; and (8) the appointment of the general manager of the stock exchange by the government.<sup>181</sup>

Though scholars argue for fair and equal treatment, the law still outlaws the SOEs in

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<sup>181</sup> The sudden bankruptcy of the Guandong International Trust and Investment Group (GITIG) and billion of losses by its two Hong Kong listed subsidiaries have really hit home of the corrupt operation of these mainland-funded companies in Hong Kong; Xian Chu Zhang, One Country, Two Separated Markets and Their Bumping Integration: Legal Issues Concerning Cross-border Listing of the Mainland-funded Companies in Hong Kong, 10 Aust. L. J., Corp. L., 47 (1999).

the securities market and provides that the B shares' issuing and listing shall be governed by another set of regulations of the State Council.<sup>182</sup>

It is further crippled by not providing securities with any definition. Thus far, it seems clear that the futures trading shall be governed by a separate law and the condition for the derivatives trading is yet ripe.<sup>183</sup> To the disappointment of many, the 1998 Securities Law fails to inaugurate the opening of the over-the-counter (OTC) market in China.

After the passage of the 1998 Securities Law, opening the OTC market seems to be on the CSRC's agenda. Shenzhen government declared that the State Council had approved in principle to establish a NASDAQ-type OTC market in Shenzhen after the OTC market in Hong Kong began to operate in October 1999.<sup>184</sup> The CSRC, however, quickly denied Shenzhen's claim by stating that China had no intention to establish any OTC market in the near future.<sup>185</sup> It looked like the conflict of interests and powers between the CSRC and the local government with regard to the securities market will still be going on after the passage of the 1998 Securities Law. But, actually, the development

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<sup>182</sup> Jackie Lo, *New PRC Securities Law Falls to Fully Unify Regulations of Securities Issues in China*, *China Law & Practice*, 21-24 (1999).

<sup>183</sup> Although several drafts of the Future Trading Law have been completed, the adoption of the law seems not in the immediate agenda of the legislature. In fact, the State Council, by a decree dated August 1, 1998, ordered to close 11 of 14 futures markets then in China and to suspend the trading of 23 of 35 commodity items in the market. The decree subjects the entire futures market to the regulation and supervision of the CSRC.

<sup>184</sup> Xian, *supra* note 176, at 1008.

<sup>185</sup> Ming Pao (Hong Kong), April 22, 1999, at B13.

of the OTC market in China is not only necessary, but also feasible. Especially, when China joins the WTO, the OTC market will soon become an international focus.

The most striking characteristic of the 1998 Securities Law, as observed by Professor Jiang Ping, the leading authority in civil and commercial law in China, is its restrictive and authoritarian character. All the rules are compulsory and leave no little room for their discretion. In deed, in addition to thirty-three articles with substantive penalties among 214 total articles, numerous places are occupied by the wording of authorization, approval, examination, review, supervision, prohibition, and forbidding. This emphasized the continuation of the heavy regulatory approach in the securities market in China, and contrasted that with the mixed system of public and private regulation found in the Western stock markets.<sup>186</sup> Hence, one could reasonably argue that, to a large extent, the law is still a product blended with a deep caution for developing market and rigid ideology.

The maintenance of government control over the securities market does raise some serious concerns. Unlike the SEC in the United States, which is an independent and nonpartisan organ responsible for the investor protection, the main function of the CSRC as a subordinate government instrument is to implement the government's financial

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<sup>186</sup> Roman Tomasic, An Overview and Assessment of the Draft Securities Law of the People's Republic of China, 3 Aust. L. J. Corp. L., 290 (1999).



policy.<sup>187</sup> Excessive government involvement and control have already harmed the normal function and mechanism of the market, such as the ownership discrimination in resource distribution, the government intervention to the market operation, the securities price distortion, and the decrease of market incentive and discipline on public issuing companies.<sup>188</sup>

The poor draftsmanship of the rules against the insider trading may prevent them from functioning well. For example, Article 69 states that the inside information is such an information as has not been disclosed, fails to define the term “disclosure.” In comparison, Article 64 defines the term “publication” as follows: to publish the information concerned on the newspapers, journals, or bulletins designated by the government authority. Thus, as the scope of the disclosure is not clarified in Article 69, the disclosure of the information to a small group of people may circumvent the operation of the 1998 Securities Law. Moreover, the tippees are not clearly included in the regime. Article 4 (3) of the Provision against Fraud explicitly forbids non-insiders’ trading on inside information. Yet, Article 70 only prohibits insiders and others who unlawfully obtain inside information from trading, or disclosing to others or suggesting others to trade. Without any precedent to judge the lawfulness of the acquisition of inside

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<sup>187</sup> Lois Loss and Loel Seligman, *Securities Regulations*, at 285-196, 3<sup>rd</sup> ed. (1989).

<sup>188</sup> Xian, *supra* note 176, at 1009.

information, we are not quite confident that the law may effectively stop such kind of fraudulent transactions.

The 1998 Securities Law fails to define numerous crucial concepts which gives the CSRC and the State Council plenty room of interpretation. This approach will inevitably lead to more government control on and involvement in the securities market. As China intended to introduce the market force to push itself more toward market economy, one might argue that too much government control and involvement would only offset its past efforts. In addition, the law also fails to set out its relation with many other existing regulations. In term of authority, the law should supersede the IRSIT as the previous interim enactment by the State Council. However, the new law does not deal with certain issues addressed by the IRSIT. As a result, some questions are still open at this moment. For example, according to Article 46 of the IRSIT, no individual may be allowed to hold a 0.5 % common stocks of any listed company. The new law, nevertheless, does not mention any thing about it. We are not sure yet whether it means that the individual no longer subjects to such restriction. A negative clue in Article 82 seems to suggest that an acquirer should be a legal person. The acquirer should report its name to the authority. Yet, the term used in Article 82 concerning the name is “Mingcheng.” In comparison, Article 23 uses “Xingming” to describe the name of a

nature person.<sup>189</sup> To date, the puzzle remains there. We hope that the legislature and the judiciary can solve it in the near future so that we can see a real privatization movement in China.

## 5.6 The Future of China's Stock Market

China's developing securities market can be properly understood only in the context of its underlying motivation, by carefully avoiding the mistake of assuming that adoption of western-style structures and law implies movement toward western goals. The government of China intends merely to restructure its state-owned enterprises to improve productivity.<sup>190</sup> Privatization as practiced in the former communist countries would be highly dangerous in China and is rejected. Through securitization, the government will reduce the percentage of state ownership in enterprises.

Somewhat paradoxically, the sale of equity interests to private parties is designed to enhance, not to dilute, the "socialist public ownership economy" established in the Constitution.<sup>191</sup> The policy is to attract private, and particularly foreign, investment and managerial skills to the enterprises, contributing to the development of the Chinese economy. The enterprises, however, will remain subject to ultimate control by the state

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<sup>189</sup> In Chinese, "Xingming" always refers to a nature person's name whereas "Mingcheng" means the name of a legal person.

<sup>190</sup> Gu Minkang & Robert C. Art, *Securitization of State Ownership: Chinese Securities Law*, 18 *Mich J. Int'l L.* 115, 138 (1995).

<sup>191</sup> Article 11 of the 1988 Constitution.

through its majority stock ownership.

As China's securities regulation evolves, it certainly will superficially follow the Western patterns, as we can easily smell from the newly born 1998 Security Law. Nevertheless, the Chinese economy will continue to be dominated by state-owned enterprises, not by entrepreneurial, capitalist business in the Western sense.<sup>192</sup> The Western securities concepts and structure will, once again, be adopted to serve China's socialist purpose.

China's stock markets have developed rapidly since the Shanghai Exchange opened on December 19, 1990 and the Shenzhen Exchange opened on July 3, 1991.<sup>193</sup> By December 29, 1998, there were 851 companies listed in the above two exchanges. The total market value of those listed companies was RMB1.96 trillion.<sup>194</sup> And, the total capitalization at the end of 1997 was RMB283.4 billion including RMB116 billion foreign investment.<sup>195</sup> Moreover, China funded companies have been successfully listed in some major foreign markets, including Hong Kong, New York, Singapore, and Sydney.

Nevertheless, China still has a long way to go before its stock markets develop into independent and internationally recognized exchanges. However, based on the swift rate of ideological, political, and economic changes since the advent of China's open door

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<sup>192</sup> Art & Gu, *supra* note 29, at 307.

<sup>193</sup> Xian, *supra* note 176, at 984.

<sup>194</sup> Renmin Ribao, Jan. 4, 1999.

policy in 1979, China has a great chance to truly realize the re-emergence of its stock market in the early part of the twenty-first century.

China's recent bid to join the World Trade Organization (WTO) proves that Chinese leaders still stick to the economic reforms and the market economy. However, several political and economic issues will affect the terms on which China will accede to the WTO. Generally, the regulatory entities may be expected to retain a vested interest in protecting their interests in the face of economic liberalization.<sup>196</sup> The People's Bank of China, long resistant to the internal pressure to allow the CSRC to oversee China's stock market, will almost certainly seek to consolidate its power as the most important regulator of China's financial market despite the foreign competition and the calls to deregulate the market.

Despite so many problems, internally and externally, behind China's joining of the WTO, I would argue that it is the most encouraging news for China and the rest of the world as well. China's participation in the WTO will not just fundamentally impact the world economy but will also critically affect China's developing stock market. Basic improvements in the efficiency, transparency, and liquidity of China's stock market will flow from the WTO membership. Specifically, the changes mandated by the WTO's

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<sup>195</sup> Renmin Ribao, Overseas Edition, Jan. 2, 1999.

<sup>196</sup> Michael E. Burke, China's Stock Markets and the World Trade Organization, 30 Law & Pol'y Int'l Bus., 321 (1999).

General Agreement on Trade in Services (GATS) will further liberalize the competition in China's financial and accounting services markets, increase the number of financial intermediaries, and as such foster the development of China's stock market.

## **6. Conclusion**

Apparently, the 1993 Corporation Law is an extensive piece of legislation intended to address the structural needs of Chinese companies so that they will have access to capital via stock exchanges. On the surface, it appears to provide a great deal. It promulgated how to set up a corporation; the rights and responsibilities of shareholders, and responsibilities of board of directors and the supervisory committee. It also codifies duties of care and loyalty under which corporate management must follow, albeit with varying degrees of success. However, the primary question remains, how will these Western structures, with their unique Chinese characteristics, be applied given the underlying socialist ideology and legal system in China.

For China to fully enjoy the fruits of marketization, it must allow companies to operate as independent economic units able to make decisions based on the well-being of the company, rather than other, extraneous factors. The government's role is to ensure the overall welfare of society, but when these public policy considerations are manifested

by micro-managing companies through existing bureaucratic lines, the result is a formula for inefficiency. Chinese companies must be able to make decision free from bureaucratic interference. Enterprises must be allowed to succeed or fail on their own, without government subsidy or interference.

China still had a long way to go before it develops an independent and internationally recognized stock market. However, based on the swift rate of ideological, political, and economical changes since the advent of China's open door policy in 1979, China is well positioned to truly realize the re-emergence of its stock market in the early part of the twenty-first century. China has already shown great accomplishments in rebuilding its stock market. The development of a world class stock market is within China's reach if its leaders continue to make steady gains in improving the efficiency and stability of its stock markets.

In 1997, Hong Kong became part of China's territory again. As of today, Beijing has worked very hard to maintain Hong Kong's economic prosperity and political stability. Though a harmonization of the legal and market systems has been launched by China to bring Hong Kong's system more close to its systems, I would argue that such a convergence will also re-shape China's legal and economic systems, too. This will offer China a great opportunity not just to utilize Hong Kong's market to attract more foreign

capital inflow but also demonstrate China's commitment of building its market economy.

Another positive clue is China's recent bid to join the World Trade Organization (WTO.) It proves that Chinese leaders still stick to the economic reforms and the market economy. Yet, both the internal and external challenges and pressures they have are tough and none of them is easy to be solved. Despite so many problems behind China's joining of the WTO, I would say that it is the most encouraging news for China and the rest of the world as well. Without any doubt, China's participation in the WTO will not just fundamentally impact the world economy but will also critically affect China's developing stock market in the coming years.



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