Securitization of State Ownership: Chinese Securities Law

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SECURITIZATION OF STATE OWNERSHIP: CHINESE SECURITIES LAW

Minkang Gu*
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INTRODUCTION .................................................. 116
I. THE HISTORY OF CHINESE SECURITIES MARKETS AND REGULATION ............................ 117
II. POPULAR ATTITUDES TOWARD SECURITIES ................ 120
III. DEVELOPMENT OF NATIONAL SECURITIES LAW: A WORK IN PROGRESS .............................................. 121
   A. The National Stock Rules Issued by the State Council ... 121
   B. Delay in Formulating National Law, and Resulting Problems ........................................ 122
   C. Western Influence on Chinese Securities Law .......... 123
   D. Retention of Control by the State ..................... 124
IV. THE MOTIVATION OF CHINESE SECURITIES LAW ....... 124
   A. Restructuring State-Owned Enterprises ................ 124
   B. Limited Privatization .................................. 126
   C. Corporatization ....................................... 126
   D. Securitization ......................................... 127
V. CLASSIFICATION OF SHARES ................................ 127
   A. Classification Based on Ownership .................... 128
      1. State shares (Goujia Gu) ......................... 128
      2. Legal person shares (Faren Gu) ................. 128
      3. Individual shares (Geren Gu) ................... 130
      4. Foreign capital shares (Waizi Gu) ............ 130
   B. The Problems of Classification .................... 130
      1. The Convertibility of Different Shares ........... 130
      2. Voting Powers or Rights of Different Shares ... 131
   C. Comments on Share Classification .................. 131

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VI. **The Future of Chinese Securities Markets** ........... 133
   A. *The Involvement of Professionals* ........................ 133
   B. *The Possibility of Merger and Acquisition* .............. 134
   C. *Preparing Financial Statements According to International Accounting Standards* .......................... 135
   D. *Securities Fraud and Insider Trading* .................... 136
   E. *Golden Share—A New Way to Control State-owned Enterprises in China?* .......................... 137
   F. *Issuance of Shares Based on Market Mechanisms Without Government Approval* .......................... 138

**Conclusion** ................................................... 139

**Introduction**

The ongoing reform of China's economic system towards increased reliance on market mechanisms has generated dramatic growth in many sectors, including the creation and vigorous development of securities markets. An observer might easily conclude that China is moving in the direction of a western-style market economy, but that conclusion would fundamentally misconstrue the motivation and effect of the reforms. China's government seeks neither to abandon nor to dilute its commitment to state ownership of the means of production—the foundation of a socialist society—but rather desires to enhance the operation and productivity of state-owned enterprises.

The extent and rapidity of growth of China's securities market is evidenced by facts concerning Shanghai and Shenzhen, the world's youngest stock exchanges:

- 296 listed companies as of April 1995
- more than 360 products trading
- daily trading volume over RMB 18 Billion (approximately US $2 billion)
- weekly trading volume over RMB 60 Billion at the exchanges' peak swing
- over 20 million Chinese participants in the securities markets, a number that grows by more than 10,000 people per day

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Securities markets in other Asian countries have achieved comparable levels, but never in so short a time. The process required more than twenty years in Japan and Hong Kong, and more than thirty years in Korea and Taiwan.4

The legal framework for this burgeoning securities market is also developing, but at a slower pace. China is still in the process of drafting a national securities law.5 This legislation, when promulgated, can be expected to reflect a strong influence of U.S. securities law. China has accepted an offer from the U.S. Securities Exchange Commission to provide technical advice,6 and the overall intent is to meet international standards of securities regulation in order to attract more foreign investment. Nevertheless, an imported model of regulation will produce different results when it is superimposed on China’s unique economic system and ideology.

Part I of this article establishes the scope of analysis and defines the Chinese use of the term “security,” which is more limited than under American law. Parts II and III briefly examine the history of Chinese securities laws and the understanding of securities by the Chinese people. Part IV focuses on the government’s motivations in establishing the securities markets. Part V discusses the distinctively Chinese approach of classifying shares according to the characteristics and nationality of permitted shareholders. Part VI addresses the future development of Chinese securities markets. The conclusion reflects on the significance of western forms of securities ownership and regulation in the Chinese economic and ideological context.

I. THE HISTORY OF CHINESE SECURITIES MARKETS AND REGULATION

Securities law in China, as in the United States, is intended to regulate the issuance and subsequent trading of stock, while penalizing fraud and helping investors make well-informed investment decisions in a fair, equal, open and honest stock market. Corporate, rather than securities, law deals with matters of internal corporate governance—a point not always understood by outside commentators.7

5. The project is assigned to the Standing Committee of the National People’s Congress. See Han, *supra* note 3, at 10–11.
7. See Matthew D. Latimer, *Gilding the Iron Rice Bowl: The Illusions of Shareholder Rights In China*, 69 WASH. L. REV. 1097, 1105–06 (1994). The article criticizes China’s current securities regulations for failing to protect shareholders’ rights to elect directors, to vote on extraordinary corporate matters or to remove directors for cause. The criticism is not
A key element delineating the scope of securities regulation is the definition of the term "security." In China, the term refers only to stock (or shares) and bonds. Shares represent ownership, or equity, in a corporation, and bonds are a debt obligation owed by the corporation to others. This narrow interpretation (which probably comports with the average person's assumptions of the meaning of "security") is far less inclusive than the U.S. interpretation, which includes puts, calls, options, and such vague and encompassing concepts as "investment contracts" and "participations in a profit-sharing agreement." China's narrow definition reflects the fact that its securities laws are still at an early stage. Consistent with the Chinese usage, this paper will focus only on stock and bonds.

The concept of "stock" was first recognized in China in the late nineteenth century (in the late Qing Dynasty), two or three hundred years later than in western countries. The first securities law was the Law of Stock Exchanges issued in 1914 by the Northern Warlords' government. The most complete securities law in pre-communist China was promulgated in 1929 by the Guomindang government. Establishment of the People's Republic of China (PRC) in 1949 brought major changes in securities as in all other fields. During the first

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well-founded; such matters are outside the scope of securities regulation.


10. The US Securities Exchange Act of 1934 (the "Exchange Act") provides the definition of security as follows:

[any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, prereorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but . . . not . . . currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.]" 15 U.S.C. § 78(c) (1994).


12. Ch`eng & Bo, Securities Law, supra note 8, at 8.

13. Id. at 9.
several years, throughout much of the 1950s, the government permitted securities exchanges to continue operations. In 1959, however, the securities system was eliminated. In 1978, important ideological changes were adopted by the Communist Party at the 3rd Plenary Session of the 11th Central Committee. The following year the decision was made to reopen securities markets and, in December 1990, the first securities exchange was established in Shanghai.

Since 1986, many securities rules and regulations have been released. Principal provisions include the Interim Rules Concerning the Management of the Bank of the People’s Republic of China (issued November 7, 1986), the Notice Concerning Strengthening Management of Stock and Bonds (March 1987), the Interim Methods of Management of Stock Companies (1990), the Interim Methods Concerning Management of Business of Stock Exchanges (1990), the Interim Methods Concerning Management of Stock Exchange Inter-provinces (1990), and the Interim Rules Regarding Management of Stock Issuance and Trade (1993).

Much of the most important regulation was implemented at the local level. The Provisional Measures of Shanghai Municipality for Administration of the Issue and Trading of Shares [Shanghai Measures] were promulgated on November 26, 1990. The Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares [Shenzhen Measures] were promulgated by the government of the Shenzhen Special Economic Zone on May 15, 1991. These two local laws played a very important role until the issuance of the Interim Rules Regarding Management of Stock Issuance and Exchange of April 22, 1993.

The effort to create a national securities law began in July, 1992, when a drafting group was established by the Standing Committee of the Chinese People’s Congress. As of the end of 1996, final legislation had not yet been issued.

14. Id. at 10.
15. Id. at 10.
17. CHENG & BO, SECURITIES LAW, supra note 8, at 10.
18. Id. at 10–11.
20. Id. at 8 & 12 n.5.
21. CHENG & BO, SECURITIES LAW, supra note 8, at 11.
II. POPULAR ATTITUDES TOWARD SECURITIES

Although stock has been used in some form in China for some time, the people at large did not have an opportunity to become familiar with the term until 1979. In all likelihood, therefore, a long period of time will be necessary for the Chinese people to develop a satisfactory understanding of stock and the securities markets. Current popular attitudes are unsophisticated in a number of important respects:

1) One issue is China's fundamental orientation and attitude towards commerce. Historically, policies, ideology, and attitudes have "regarded farming as superior to business" (zhong nong qing shang). The goal was not to develop efficiencies and profit through trade but rather to "close the door and be self-contained" (bi guan zi shou). The commodity economy was underdeveloped. In this socio-political and economic context, securities and securities trading had no place.

2) Popular interest in purchasing stock has been overwhelmingly motivated by the prospect of rapid appreciation in market value, rather than by long-term fundamental analysis. One commentator opines that 99% of private investors are oriented towards speculative profits. Investors rarely inquire into the stock issuer's economic condition, operations, or future prospects, apparently assuming that the government will not allow an enterprise to fail. Dividends do not enter into the analysis. Attention is directed solely to short-term fluctuations in price.

3) The concept and level of risk associated with securities are not well understood. Focusing exclusively on the prospect of speculative profits, investors fail or refuse to recognize the corresponding risks. They assume, based on their socialist experience, that the government will protect the people from suffering, including the loss of profits.

4) Securities law is not widely understood, contributing to many violations on the stock exchange.  

23. HE, LEGAL CULTURE, supra note 11, at 143-149.
One consequence of these attitudes is a lack of attention to corporate governance. Investors who focus solely on short-term profits, rather than long-term investment, are not likely to consider themselves owners of the corporation or to exercise their rights as shareholders. They may lack motivation to vote, to supervise the board of directors and to pursue any wrongdoing that may occur through derivative actions, as happens in the United States. The shareholders’ rights provided by the first national corporation law will have little practical meaning, and the discretion of state appointed managers likely will be unchecked.

III. Development of National Securities Law: A Work in Progress

Efforts are being made to regulate securities markets at the national level, rather than continuing to rely exclusively on the municipal regulations of Shanghai and Shenzhen. To date, the effort has resulted in "rules" issued by the State Council, but not the more permanent and authoritative "law" which is promulgated by the National People’s Congress.

A. The National Stock Rules Issued by the State Council

The People’s Bank of China (PBOC) made the first national effort to regulate the exchanges, taking a decentralized approach. The PBOC delegated regulation of each of the regional exchanges to the appropriate regional branches of the bank.24

The decentralized approach was a failure in a number of respects, damaging investors’ confidence in the legitimacy of the markets.25 The different markets drafted their own regulations and created "parallel systems for trading, clearing, and settlement.”26 Widespread fraud occurred, leading to serious public disturbances in the case of Shenzhen in 1992.27

As a result, new agencies were created to supplant the PBOC in this field. The new State Council Securities Committee (SCSC) and the China Securities Regulatory Commission (CSRC)28 were authorized to regulate securities markets throughout the country, including the Shanghai and

25. Id. at 420.
27. Citizens in Shenzhen rioted after blunders in the issuance of forms prevented them from applying to purchase shares. Tarbutton, supra note 1, at 420.
Shenzhen exchanges and several smaller, informal exchanges which had appeared elsewhere.\textsuperscript{29} The provisions currently in effect are the Interim Rules Regarding Stock Issuance and Exchange (the "Interim Rules").\textsuperscript{30} The Interim Rules form the foundation for future national legislation, still in its infancy.\textsuperscript{31} The ideological principles enunciated in the Interim Rules clarify that Chinese securities markets are not based on western-style market orientations. Instead, the purposes stated are to promote development of the socialist market economy, to establish and develop a unified and highly effective stock market, to protect the interests of investors and of the public, and to promote the development of a national economy.\textsuperscript{32} The Interim Rules reiterate the leading position of socialist public ownership, and specify that securities ownership or trading shall not infringe upon state-owned assets.\textsuperscript{33}

Specific rules in support of these goals provide an example of the distinctive Chinese characteristics of the law, despite its apparent similarity to U.S. law. For example, no single person is allowed to hold more than 0.5% of the outstanding common shares of any listed company. If that limit is ever exceeded the company can, with the consent of the China Security Supervisory Committee, buy back the excess shares at either the original price or the market price, whichever is lower.\textsuperscript{34} Under this rule, substantial changes in control of corporations are virtually impossible, and hostile takeovers are out of the question.

B. Delay in Formulating National Law, and Resulting Problems

Development of national securities law (as distinct from rules)\textsuperscript{35} has yet to reach fruition. The effort began in July 1992, and since then has produced more than 10 drafts.\textsuperscript{36} Various reasons have been offered to account for the delay. Some people thought that municipal regulations already in operation were

\begin{itemize}
  \item 29. Tarbutton, supra note 1, at 420.
  \item 31. Spencer, supra note 26, at 31.
  \item 32. Interim Rules, supra note 30, art. 1. The authors translated all the relevant provisions of the Interim Rules and will be responsible for the translations.
  \item 33. Interim Rules, supra note 30, art. 4.
  \item 34. Interim Rules, supra note 30, at Art. 46. This provision does not apply to holders of B-shares or H-shares from foreign countries and from Hong Kong, Macao and Taiwan areas.
  \item 35. The words "law" and "rule" are different in the sense that law is promulgated by the National People's Congress, and preempts rules which are usually issued by the State Council.
\end{itemize}
adequate, and that a national law in this field would be premature.\textsuperscript{37} Another important view has been that "it was better to delay than to try to regulate imperfect markets with imperfect rules."\textsuperscript{38}

Delay, however, has caused difficulties, including machinations used by foreigners to circumvent local regulations. One example is found in the automotive industry, in which foreign companies found their entry into the Chinese market seriously impeded by red tape. Japan's Isuzu Motors and Itochu Corporation solved the problem by buying 25\% of the outstanding shares of Shanghai-listed Beijing Lightbus Company.\textsuperscript{39} The shares purchased were officially intended only for domestic "legal persons" (institutions), but the foreign corporations nevertheless accomplished the purchase.\textsuperscript{40} Ford Motor Company, unable so far to build its own vehicles in China, is pursuing a somewhat similar approach. Ford is seeking control of Jiangling Motors Corp., which is listed on the Shanghai exchange, by buying up to 80\% of its B class of shares, which are reserved for purchases in hard currency.\textsuperscript{41}

The absence of a national securities law facilitates this type of activity. As stated by one western securities broker in Shanghai, almost anything is possible because, to a large extent, stitching together a market deal depends on a creative reading of local regulations, and on how well the case is presented to securities authorities.\textsuperscript{42} Though local rules may intend ownership of legal person shares to be limited to domestic institutions, they do not clearly prohibit purchase by foreigners.\textsuperscript{43}

C. Western Influence on Chinese Securities Law

In many respects, Chinese securities law will be similar to U.S. securities law and will be easy for U.S. lawyers or brokers to practice. One important basis for this conclusion is the ongoing cooperation between the U.S. Securities and Exchange Commission and the China Securities Regulatory Commission. On April 28, 1994, SEC chairman

\textsuperscript{37} Id.
\textsuperscript{38} Id. However, that comment is contrary to China's general practice of drafting experimental law (sometimes called drafting law) first, then correcting the imperfect parts and issuing formal law. The Interim Rules promulgated by the State Council are probably intended to be the experimental law.
\textsuperscript{40} Id.
\textsuperscript{41} Id.
\textsuperscript{42} Id.
Arthur Levitt signed a Memorandum of Understanding with his Chinese counterpart, advising Beijing securities regulators on developing Chinese financial markets. This conclusion also is consistent with traditional Chinese patterns of adopting Western concepts but adapting them to suit China's needs.

D. Retention of Control by the State

Although the national securities law, when it is ultimately promulgated, will utilize U.S. concepts and structures, certain key factors will produce distinctly different consequences. The main issuers of securities will be the government, state banks and state enterprises, and those same entities will also be the main holders. Shares reserved for ownership by the state and by domestic legal persons (institutions) will dominate within state-owned enterprises, leaving the shares held by individual investors in a secondary role. Through means such as these, joint stock companies will retain a socialist characteristic.

IV. THE MOTIVATION OF CHINESE SECURITIES LAW

A. Restructuring State-Owned Enterprises

Articles discussing Chinese securities law commonly assume that the intention is to privatize the state-owned enterprises. That premise cannot be supported. Privatization has usually been regarded as the opposite of the process of nationalization. It is often believed that privatization of state enterprises reflects the predominance of capitalist thinking, whereas nationalization is a sign of socialist development. This analysis may accurately characterize the reforms in many countries such as the former Soviet and Eastern

44. Harverson, supra note 6, at 6.
46. CHENG & BO, SECURITIES LAW, supra note 8, at 14.
47. Individuals and private enterprises may not promote joint-stock companies; the shares held by individual investors may not exceed 0.5% of the outstanding shares of the company.
48. CHENG & BO, SECURITIES LAW, supra note 8, at 14.
50. Baev, supra note 9, at 1 n.127.
Europe nations.\textsuperscript{51} In contrast, different motivations and ideological imperatives exist in China. Securities markets in China do not remove enterprises from state control, or promote capitalism in a Western sense. Their effect and purpose is to preserve and enhance the socialist order in a number of ways.

First, the securities system enhances both the financing and the management of state-owned enterprises. One of the main purposes of the system is to absorb money from Chinese citizens, which is then channeled into productive enterprises controlled by the state.\textsuperscript{52} Further, allowing private stockholders some participation in selecting directors and managers of these enterprises is intended to increase managerial accountability, efficiency, and profitability. The state also includes employees among those permitted to own equity in an enterprise, hoping thereby to increase their incentive to perform well and to enhance productivity.\textsuperscript{53}

Second, stock markets represent an experiment in modernizing the socialist economy. Commentators have noted support for this strategy from the highest authority, Deng Xiaoping. In 1992, Deng addressed the issue as follows:

Are securities and the stock market good or bad? Is there any danger in adopting such things? Do they exist exclusively in capitalism? Can they also be adopted in a socialist system? People are allowed to consider such matters further, but resolute action must be taken to experiment with such things.\textsuperscript{54}

To underline the message that experimentation did not represent an embrace of capitalism, Deng stated: "We can always close it if it does not prove to be conducive to our socialist market economy."\textsuperscript{55} Similarly, an official of the commission charged with development of the securities industry was careful to distinguish between use of securities and privatization in the liberal or western sense.\textsuperscript{56}

\begin{footnotes}
\item[51] See, e.g., ROMAN FRYDMAN AND ANDREZEJ RAPACZYNSKI, PRIVATIZATION IN EASTERN EUROPE: IS THE STATE WITHERING AWAY? 10 (discussing privatization, including the reintroduction of the institution of property, as a step away from socialist systems and their inherent inefficiency).
\item[53] Bersani, supra note 45, at 303.
\item[54] Id. at 301 (quoting Deng Xiaoping, on his January 1992 tour of Southern China). See also Qian, supra note 49, at 84 n.88.
\item[55] Gao, supra note 2, at 274.
\item[56] Liu Hongru, Vice Minister of the State Commission for Restructuring the Economic System stated that establishing a securities industry is desirable, but that is not to be confused with actually pursuing privatization. Qian, supra note 46, at 83.
\end{footnotes}
Third, the government, through various ministries, continues to own sufficient stock in enterprises to maintain control. This factor has critical practical importance. In fact, the purpose of legal person shares was to retain ownership of key shares in government-related institutions and to serve as a barrier against privatization. The stock that is sold to individuals does not preclude continued government control.

B. Limited Privatization

The policy of drawing in private investors, without ceding control of state-owned enterprises, has been aptly termed "limited privatization" (or partial privatization). With a bit of innovative thinking, the approach can be reconciled with the socialist ideology that requires ownership of the means of production by the state. As one insightful commentator has explained, "as long as the state retains a controlling interest in the enterprise, no assets have been sold; rather, private capital has been brought under state control." To some extent, the effect of limited privatization has parallels in other countries, including developed countries with economic systems and ideologies distinctively different from China's. It is common throughout the world for governments to share with their private sectors ownership of industries that are critical to the national economy and defense, yet to retain substantial government control.

C. Corporatization

Securities markets are natural adjuncts to a broader program of transforming existing state enterprises from subdivisions of the government into separate corporate entities (with partial government ownership). This process of "corporatization" is reflected in China's first national corporation act, enacted fairly recently. The Corporation Law of the

57. Nikkel, supra note 52, at 517.
59. Bersani, supra note 45, at 306.
60. Id. at 306.
61. Governments often control "strategic industries in energy, telecommunications, defense, transport and other sectors of national priority." Baev, supra note 9, at 12 and n.44. Baev cites statistics on government ownership of equity stock in electrical companies in developed countries. More than 75% belong to the state in the European countries of Austria, France, Norway, Switzerland, Britain, and the Netherlands, and also in New Zealand, Australia, and Canada. Between 25% and 75% belong to the state in Belgium, Denmark, Italy, Germany, Spain, Sweden, and the United States. Id.
People's Republic of China provides the legal framework for restructuring the organization and management of state-owned enterprises. Corporatizing is intended to remove the state from detailed management of business operations, creating business entities that can be better managed, more competitive, and more productive.

D. Securitization

"Securitization" is the next logical step in the program to improve the efficiency, financing, and management of state enterprises. Securitization consists of dividing into many smaller units an asset that is too large or too regulated to be plausibly transferred as a whole. One advantage of this process is that the smaller units can then be readily traded in primary and secondary markets. One example is a huge loan to buy a high-rise building that is too large to be sold except to a handful of major financiers. If the loan is divided into thousands of bonds, however, it can be sold to small investors, who are attracted to them in part because the bonds can readily be resold.

In the case of state-owned enterprises, the first step is to convert an enterprise that was organized as a governmental unit into a joint stock company, or to corporatize. The company can then issues shares to gain additional capital.

The next step might be to privatize by selling the majority of shares to the public. This step, however, is not inevitable or necessary. "Securitization" is distinctly different from "privatization." A state-owned enterprise could, for example, issue shares only to its employees, or could sell some shares to the public but retain a majority interest. If, after securitization, effective control remains with the government, the enterprise remains socialist.

V. Classification of Shares

In Western countries, large corporations routinely establish two or more classes of stock, such as common and preferred shares. The difference among classes relates to dividend expectations, voting rights, and rights on liquidation. In China, stock is also divided into classes, but in a distinctive manner. Classification is used for the ideological purpose of

63. Id.
64. Id.
65. Baev, supra note 9, at 5 & n.2.
66. Id. at 5.
67. Id. at 6.
68. Id.
maintaining the leading role of government in the economy by having state and public organizations hold the majority of shares.\(^{69}\)

A. Classification Based on Ownership

Several classes of stock are established on the basis of the characteristics of the investors for which the shares are intended.

1. State shares (Goujia Gu)

One class of stock, labelled state shares, is both issued and held by government entities. When a state-owned enterprise issues securities, a portion must be held by either a government organization or by a holding company authorized by the government.\(^{70}\) Detailed measures adopted in 1994 designate how state assets can be exchanged for state shares in merger or reorganization situations.\(^{71}\)

2. Legal person shares (Faren Gu)

Legal person shares are owned by entities created or recognized by law, as opposed to natural persons. There are five types:

(a) State-owned legal person shares

Shares that are owned not by the state directly, but rather by an entity that is itself owned by the state, are labelled state-owned legal person shares.\(^{72}\) For example, trust and investment companies, or securities companies, own this type of stock.\(^{73}\)

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69. Fang, supra note 58, at 201.

70. Id. at 202.

71. On November 3, 1994, the Interim Measures for Administering the Rights of State Shares in Joint-Stock Limited Liability Companies (Gufen Youxian Gongsi Guoyou Guquan Guanli Zanxing Banfa) provided that state shares may be obtained by transfer of state assets. Fang summarized the circumstances as follows:

(1) a state enterprise absorbs and merges into a joint-stock company; (2) a joint-stock company's accumulated capital exceeds the net book asset value of a state enterprise by 50%; (3) a state enterprise's autonomous operating capital is completely or largely transferred to a joint-stock company; or (4) state shares are the initial shares offered by a company subscribed to by a state investment organization.

Id. at 130.

72. Id. at 204.

73. As explained by one commentator, the only difference between state shares and state-owned legal person shares is that the "holder of state shares must be a government organization or a company with governmental functions; the holder of state-owned legal person shares may not be a governmental organ." Id.
(b) Collective enterprise legal person shares

Collective enterprise legal person shares are a class of shares held by collective enterprises, of which there are three types. One type of collective enterprise is owned by a local government. A second type has assets derived from the state but, for policy reasons, is deemed not to be owned by the state. Collective enterprises of the third type use capital invested by individuals but attach themselves to a supervisory administrative department for purposes such as gaining tax benefits, licenses or other benefits available only to public enterprises.74

(c) Private enterprise legal person shares

Private enterprise legal person shares constitute another class of stock that is available to private enterprises that enjoy the status of legal persons. Such enterprises are limited liability companies financed entirely by private individuals.75

(d) Foreign invested enterprise legal person shares

Some shares are available to foreign-owned enterprises that have received legal person status. Currently three types of shares are authorized, each regulated under different laws.76

(e) Institutional legal person shares

A further category of shares is owned by institutions with legal person status that have raised funds from individuals. Examples include trade unions, the Communist Youth League, and the Women's Federation.77

74. Id. at 205.
75. Id. at 206.
77. Fang, supra note 58, at 207.
3. Individual shares (Geren Gu)

When shares are held by individual Chinese citizens, they are termed individual shares. These are further divided into "internal employee shares" (neibu zhigong gu), which are available to the employees of the issuing company, or "public individual shares" (shuihui geren gu), which are offered to the general public. 78

4. Foreign capital shares (Waizi Gu)

Foreign capital shares, which include B shares and H shares, 79 are denominated in foreign exchange and intended to be held only by foreign investors. B shares are denominated in U.S. dollars in Shanghai and Hong Kong dollars in Shenzhen. H shares are listed on the Hong Kong or foreign stock exchanges. 80 Finally, N shares are listed in New York Stock Exchange and presumably can be owned by anyone who can buy on that market. 81

Originally, one reason for establishing separate classes for Chinese citizens and foreigners was that Renminbi (the Chinese currency) were not freely convertible into hard currency. 82 That rationale no longer applies. Another reason was to limit the percentage of any corporation's stock that foreigners could own.

B. The Problems of Classification

The establishment of multiple classes of stock within a single corporation raises questions of corporate governance that are important, but as yet poorly answered. Information or regulations explaining the relative rights of different classes is sparse.

1. The Convertibility of Different Shares

China's security rules and regulations do not have clear provisions explaining whether shares of one class can be converted into shares of a different class, either by the corporation or by the holders of the securities. As one author has pointed out, usually the only listed company shares that

78. Id. at 210.
79. Id. at 311.
80. Spencer, supra note 26, at 28–29.
81. Performance of N stocks on the New York Stock Exchange has been disappointing. SEC Chairman Warns that U.S. is Cautious About Chinese Firms, WALL ST. J., Oct. 25, 1996, at B14A.
82. See Gao, supra note 2, at 12.
are transferable are individual shares.\textsuperscript{83} Companies that are governed by local governments cannot freely convert legal person shares into individual shares, because doing so is considered a special privilege (though some companies apparently have converted shares surreptitiously).\textsuperscript{84} As of February 1994, only 14 companies had received permission from the Shanghai exchange to convert their shares into individual shares.\textsuperscript{85}

There is no evidence that conversion in the opposite direction, from individual shares into legal person shares, is allowed. Nor is it likely that shares held by foreign investors can be converted into legal person shares or state shares. The Interim Rules are silent on this issue.

2. Voting Powers or Rights of Different Shares

Unfortunately, the Chinese corporation act does not indicate how the holders of A, B, H, and other stock classes may exercise their rights. In regard to voting rights, U.S. corporate practice is that each class votes separately, and a majority of each class is necessary to approve major decisions. China might follow the U.S. model, or instead treat all shares, regardless of class, as one large constituency. The statute is silent on the issue.\textsuperscript{86}

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 State, owning 51% or more of the stock, could elect all of the directors and control all corporate decisions.\textsuperscript{87}

C. Comments on Share Classification

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. The issues involved include control within the corporation and the relation of each class to the others. Interestingly, Beijing University economics professor Li Yining once proposed the trading of three classes of shares

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\textsuperscript{83} Fang, \textit{supra} note 58, at 212.

\textsuperscript{84} Observers of the Shanghai exchange have stated that as of November 13, 1992, the first thirteen companies listed on the exchange “had surreptitiously put 30 million yuan worth of state and legal person shares into circulation. The way in which the Shanghai exchange gave local companies special privileges and concealed the news from the mass of investors received criticism from the news media.” Fang, \textit{supra} note 57, at 213 n.142 (citing Ping Wei, \textit{Hushi liutong panzi jiujing duoda} [In Fact How Large is the Circulation in Shanghai?], \textit{Zhengquan Shichang Zhoukan} [Securities Market Weekly], 1992, no. 18, at 18).

\textsuperscript{85} Fang, \textit{supra} note 58, at 213.

\textsuperscript{86} Art & Gu, \textit{supra} note 62, at 301.

\textsuperscript{87} See Song, \textit{supra} note 22, at 215–18.
in three separate securities markets, defined by characteristics of investors. Legal person shares, for example, would be traded only among legal persons. 88

Trading only within each class, however, would eventually destroy the incentive of individuals and foreign investors to invest more money in the securities markets. Those investors cannot foresee how the majority shareholder(s), namely the government, would treat their minority position, and would recognize that they have neither protection nor voice in the decision-making process. Furthermore, because the leader of each enterprise is usually selected by the majority holders, he will be responsive only to the government instead of all the shareholders. If he were to abuse his power, the minority shareholders would be unable to remove him from his position. 89 The purposes of economic reform (i.e., decentralization, deregulation, high productivity, high efficiency and good management) would be defeated.

Fortunately, there is some good news. China has unveiled legislation that tends to dismantle the dichotomy between shares reserved for citizens and those reserved for foreigners. Instead, the law allows up to 35% foreign ownership. 90 Regardless of the limitations of current law, there is hope that foreign investors can participate in China’s A share market as well as B and H share markets, and may be able to improve their position in relation to the majority. 91

Moreover, practical factors may adequately protect the interests of foreign shareholders, even when the law does not provide them with substantial rights. The Chinese majority shareholders may select foreign

88. Under this proposal, if a company’s shares were all state shares, trading would be limited to state investment organizations. If a company had both state shares and public organization shares, trading could occur among state investment organizations, among public organizations, and between the two types of shareholders. If a company had state shares, public organization shares, and individual shares, then trading should be confined to the respective categories of shareholders. Qian, supra note 49, at 212 (citing Li Yining, Guoyou Qiye Zai Gongyouzhi Jichushang Shixian Gufenzhide Tujing [The Path for State Owned Enterprises to Realize the Share System on the Basis of Public Ownership], GAIGO [REFORM], 1991, no. 1, at 158.

89. See Julia Leung & Craig S. Smith, Some Chinese Factory Bosses Live It Up: Economic Transition Gives Managers Wide Autonomy, WALL ST. J., Mar. 15, 1994, at A21 (quoting Liu Shiyi, Vice Mayor of Shunde, China: “Many state factories have become an empire, with the general manager as the emperor who is accountable to nobody.”).

90. Schutz Lee, China move blurs distinction between local, foreign shares, BUS. TIMES, Aug. 16, 1994, at 1. But see Market Maturity in China, WALL ST. J., Sept. 30, 1996, at A16 (reporting the announcement by the China Securities Reporting Commission that restrictions allowing B-share ownership only by foreigners will be revived).

91. Initially, foreigners would be allowed to buy only A shares that also had B and H share listings. Dede Nickerson, New Hope for A-share Sales, S. CHINA MORNING POST, Aug. 7, 1995, at 3.
managers because of their greater expertise.\textsuperscript{92} In the view of some foreign investors, the superior technology that they contribute dissuades the majority shareholder from taking unfair advantage of its position with regard to voting.\textsuperscript{93} Foreigners who are in the minority within an enterprise may negotiate for special agreements, and may even be in control in a practical sense.\textsuperscript{94}

VI. THE FUTURE OF CHINESE SECURITIES MARKETS

In order to further develop Chinese securities markets, the government must not only accelerate its efforts to draft a national securities law, but must also standardize the management of securities markets. A number of issues require attention.

A. The Involvement of Professionals

Though they lack detail, the Interim Rules require professional documentation in areas such as asset valuation, auditing reports and legal opinions in a company's application for permission to issue shares.\textsuperscript{95} The CSRC has acted to specifically authorize many individual firms to provide these services,\textsuperscript{96} and the CRSC and other agencies have issued a number of regulations defining their qualifications.\textsuperscript{97}

The CSRC provides no rationale for why a licensed lawyer, accountant, appraiser, or auditor should need further permission to prepare the


\textsuperscript{93} WOLFGANG G. FRIEDMAN \& JEAN-PIERRE BEGUIN, JOINT-INTERNATIONAL BUSINESS VENTURES IN DEVELOPING COUNTRIES 385 (1971).

\textsuperscript{94} Id.

\textsuperscript{95} Interim Rules, supra note 30, arts. 13.8, 13.9 & 13.10.

\textsuperscript{96} The British Broadcasting Company (BBC) reports that the agency has “authorized 74 accounting firms, 172 law firms, 82 capital assessment firms, and many asset-management and investment consultancy organizations to standardize the operation and listing of public companies.” BBC Summary of World Broadcasts, BRITISH BROADCASTING CORPORATION, Dec. 20, 1995, available in LEXIS, News Library, Curnws File.

documents required by the Interim Rules. The focus should instead be on promoting high standards and penalizing malpractice by these professionals. Accordingly, the rule should be that any licensed professional may be involved in securities markets, subject however to sanctions by the government or malpractice actions by his clients.

B. The Possibility of Merger and Acquisition

Certain transactions that are routine in Western economies and that contribute to the vigor and efficiency of the economy are all but impossible under Chinese conditions. Mergers, acquisitions, tender offers, and corporate takeovers all have potential for restructuring allocation of resources and improving management of enterprises. Those transactions are largely dependent, however, on alienability of ownership in enterprises. In China, state shares and legal person shares, which comprise the preponderance of all outstanding stock, are critical impediments to alienability. Though one enterprise might buy some of the outstanding stock of another on the securities markets, it cannot possibly buy enough to take control.

Serious economic problems may force changes in these policies. Foreign investors might be permitted to buy or merge with Chinese enterprises as an expedient means of entering the Chinese market or expanding their operations. In the absence of a national securities law, some municipalities have permitted or even facilitated such transactions.

The difficulty with freely permitting acquisition of Chinese firms is ideological: the danger of undercutting the Marxist-Leninist principle of ownership of the means of production by the people, as represented by the state. Unless the Chinese government is willing to drop this key

98. Qian, supra note 49, at 92.
99. As stated by one commentator, “faced with a chronic budget deficit, worrisome inflation and slower growth, China must make some tough decisions.” Hong Kong: xxx “not a lender”, UPI, Dec. 27, 1995, available in LEXIS, Nexis Library, Curnws File [hereinafter, Hong Kong].
100. Id.
101. The Wall Street Journal reported that “some provinces have sold off entire state factories to foreign investors.” One city in Fujian province, for example, sold 41 factories to a tycoon for Singapore in a single transaction. National assets are often sold to joint ventures controlled by foreigners. Craig S. Smith, China Is Revitalizing State Sector, Starting at the Factory Level, WALL ST. J., Mar. 26, 1996, at A12.
102. As stated in Article 6 of China’s 1982 Constitution, “the basis of the socialist economic system of the People’s Republic of China is socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people.” XIANFA [CONSTITUTION], art.6 (P.R.C.), translation available in LEXIS, Intlaw Library, Chinalaw File.
ideological tenet, the western-type merger, acquisition or takeover will remain problematic.

When a state-owned enterprise cannot succeed on its own, China has two alternatives. One is to further develop the joint venture, which has been termed the "Chinese approach to M&A." The Chinese side would contribute state-owned assets, and the foreign coventurer would contribute cash. The other alternative is to allow investors to acquire small state-owned enterprises. Both of these choices are preferable to bankruptcy, in that they are more likely to minimize unemployment, a very serious and dangerous problem.

Until and unless Chinese law explicitly allows foreign companies to merge with or acquire Chinese enterprises, their options to invest in China are limited. They can either seek to circumvent the rules, or they can establish wholly foreign owned companies, which are expressly allowed.

C. Preparing Financial Statements According to International Accounting Standards

At present, international standards for preparing disclosures to potential investors may or may not apply, depending on the class of stock

103. Ownership of the means of production may be seen as a primary justification for the existence of the state. Privatization would therefore undercut the ideological basis of the government. Bersani, supra note 45, at 305.
104. See Hong Kong, supra note 99.
105. Id.
106. Guanyu Chushou Guoyou Xiaoxing Qiye Chanquan de Zanxing Banfa [The Interim Measures Concerning Sale of Title of Wholly State-owned Small-size Enterprises] (issued February 19, 1989). These measures, issued by the Committee of System Reformation, the Ministry of Finance and the Administrative Bureau of State-owned Property, provide: "Buyers can be wholly state-owned enterprises, or collectively-owned enterprises, or 'Joint Ventures, Wholly Foreign-owned Enterprises and Chinese-Foreign Contractual Joint Ventures,' or private enterprises, or partnerships and individuals." The enterprises placed for sale are ones that the government deems itself unable to manage successfully. They fall mainly into three categories: (1) enterprises that are insolvent or near bankruptcy; (2) businesses that are suffering from losses or earning minimal profits over an extended term; or (3) those selected for sale "to perfect the structure of industry."
107. One analyst stated the situation in stark terms:

China needs fresh flows of foreign investment to keep state-sector reforms from bogging down and rendering millions jobless. 'A Chinese Gdansk is what Beijing fears most,' says a Shanghai economist referring to the shipyard strikes that contributed to the fall of communism in Poland.

Smith, supra note 101, at A12.
being sold.\textsuperscript{109} For the sale of B and H stock, financial statements must meet international accounting standards; for sale of A stock, they need not be prepared in that manner.\textsuperscript{110}

A recent decision by the China Securities Regulatory Commission, however, may change this situation with respect to A shares. Fund management firms will be organized, with Chinese and foreign participation, seeking foreign investment in A shares.\textsuperscript{111} Foreign investors may not be willing to invest without sufficient information prepared in accordance with international standards.\textsuperscript{112}

D. Securities Fraud and Insider Trading

In the United States and other western countries, "securities fraud" and "insider trading" are well-developed legal concepts, with corresponding bodies of law that serve to enhance investor confidence in the market. China has adopted provisions very similar to those of the U.S. For example, the Interim Measures on Prohibiting Securities Fraud, promulgated by the State Council on September 2, 1993, provide detailed definitions of such terms as "insider" and "inside information".\textsuperscript{113}

\textsuperscript{109} Spencer, \textit{supra} note 26, at 29.

\textsuperscript{110} \textit{Id.}

\textsuperscript{111} Lee, \textit{supra} note 90, at 1.

\textsuperscript{112} See generally SEC Chairman Warns that U.S. is 'Cautious' about Chinese Firms, \textit{supra} note 81, at B14A (Arthur Levitt, Chair of the SEC "warned that U.S. stock-market investors will remain 'cautious' toward Chinese companies until they improve disclosure.").

\textsuperscript{113} Jinzhi Zhengquan Qizha Xingwei Zanxing Banfa [Interim Measures on Prohibiting Securities Fraud], \textit{RENMIN RIBAO [PEOPLE'S DAILY]}, Sept. 4, 1993, at 2 [hereinafter, the "Interim Measures"]. For example, the Interim Measures define insiders to include:

1. an issuer's directors, supervisors, senior management personnel, secretaries, typists and other staff who could obtain inside information based on their positions;
2. professionals such as lawyers, accountants, assets evaluation personnel and investment consultants; management and business personnel from securities exchanges; and other persons who could obtain inside information based on their business relationship with an issuer;
3. those who can exercise power of management or supervision based on laws and regulations, such as the staff of securities supervision departments and securities exchanges, the staff of the departments in charge of an issuer and from approval institutions, and the staff of economic management departments in charge of industry and commerce, and taxes;
4. those with access to inside information by their career and positions, or by their contractual or work relationship with an issuer, including journalists, editors of newspapers or magazines, hosts of radio and television and printing personnel;
5. all other persons who could touch inside information through legal channels.

Overall, the concept of insiders is quite broad. Still, it does not mention relatives of insiders. \textit{Id.}
The legal theories and interpretations behind these rules, however, are not well developed. For example, there is no clear statement of an insider’s fiduciary duty to disclose or abstain from trading, and there exists no misappropriation theory. China would benefit from more extensive borrowing from the jurisprudence of countries with a longer history of regulating securities trading.

China’s current effort to build a fair securities market should emphasize the elimination of what have been called “power shares”—a term not found in the official classification. Power shares reflect corruption on the infant stock market, which has not been sufficiently transparent. The procedure of issuing stock is not open enough, and inequitable trading often happens. One leading commentator states that “government agencies and high-level officials take advantage of their power to purchase stocks before the public can.”

E. Golden Share—A New Way to Control State-owned Enterprises in China?

One concept that may be useful to China is the “golden share”—a device that originated during the British privatization of state-held firms such as Britoil and Jaguar in the 1980s. When the Conservative government of Prime Minister Margaret Thatcher sold the two firms, the British Government retained a so-called “golden share” in each organization. This “golden share” allowed the government to outvote all other shareholders, even if the government did not otherwise own a controlling number of equity shares.

China’s government currently is seeking to reduce the proportion of the economy under state ownership while avoiding privatization. The government will likely be unwilling to allow the proportion of state ownership to decline below 50%, if that means, as it normally would, that the government loses control. In this situation, the golden share concept could provide a solution. The government could reduce its ownership to

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114. Under this theory, a person violates Rule 10b-5 when he misappropriates material, non-public information in breach of a fiduciary duty or similar relationship of trust and confidence, and uses that information in a securities transaction. See United States v. Carpenter, 791 F.2d 1024, 1028–29 (2nd Cir. 1986); S.E.C. v. Materia, 745 F.2d 197, 201 (2nd Cir. 1984); United States v. Newman, 664 F.2d 12, 17–18 (2nd Cir. 1981).

115. Qian, supra note 49, at 72.

116. Baev, supra note 9, at 20.

117. Zhou Xin & Dong Cunfa, First Woman Postdoc in Social Sciences in China, 39 BEIJING REV., Mar. 18–24, 1996, at 24. The important issue is how much the state can reduce its percentage ownership and still be considered publicly owned. This answer, however, is not provided. Id.
a minority position, thus permitting the firm to become a non-state enterprise, but still retain a measure of control. The firm would have more autonomy to operate its business, with attendant benefits of efficiency and market orientation, and the government would still maintain the principle of socialist public ownership.

F. Issuance of Shares Based on Market Mechanisms Without Government Approval

A reform that would be considered radical in China, though not elsewhere, would be to permit market factors, rather than extensive government regulation, to determine which companies can issue shares.8 To date, the Shanghai and Shenzhen exchanges list only about 300 enterprises.9

The Interim Rules sharply restrict and regulate access to the securities markets by imposing numerous conditions. For example, the company’s proposal must be consistent with the government’s industrial policy. Shares must be allocated according to these rules: at least 35% to the promoter; at least 25% to the public; and no more than 10% of the issue can be sold to employees or managers. Additionally, the value of the stock purchased by the promoter should be at least 30 million yuan.10

These requirements prevent many firms from entering the securities market and, more basically, hobble the operation of free market forces. One example of this problem is the impact on companies with favorable prospects for the future but current cash flow problems or other financial difficulties. In some cases, additional investment would permit the companies an opportunity to recover, and to avoid losses to their creditors, employees, and shareholders.11 Regulation that excludes those companies from the capital markets at the moment of their greatest need may sentence them to unnecessary failure, and worsen their losses.12

If Chinese securities markets are to achieve their potential for economic reform and efficiency, the government must reconcile itself to the freer operation of market mechanisms, and allow all firms that want to raise capital to negotiate with securities firms.13

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8. Spencer, supra note 26, at 29.
9. Id. at 28.
10. Interim Rules, supra note 30, art. 8.
11. Art & Gu, supra note 62, at 303.
12. Id.
CONCLUSION

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 laws implies movement toward western goals. The government of China intends only to restructure its state-owned enterprises to improve productivity.

Privatization as practiced in the previously communist countries of Eastern Europe and the former Soviet Union 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. 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 through its majority stock ownership.

As China's securities regulation develops (and when the National People's Congress promulgates the first national law on the subject), it almost certainly will superficially follow American and Western patterns. Nevertheless, the Chinese economy will continue to be dominated by state-owned enterprises, not by entrepreneurial, capitalist business in the Western sense. Western securities concepts and structures will be adapted to serve China's socialist purposes.

124. Excellent points are made by two analysts, who opined that:

[I]f China re-distributes its assets like in the former Soviet Union and the East European countries, the productive force in the country will be severely destroyed. Violent social chaos will be inevitable, and the economic reform will suffer a standstill or even retrogression.

Zhou & Dong, supra note 117, at 24.

125. The Amended Chinese Constitution provides that, "[t]he state permits the private economy to exist and develop within the limits prescribed by law. The private economy is a supplement to the socialist public ownership economy. The state protects the lawful rights and interests of the private economy and exercises guidance, supervision and control over it."

ZHOUGHUA RENMIN GONGHEGUO XIANFA [Constitution], art. 11 (P.R.C.), amended by P.R.C. Proclamation No. 8, Apr. 12, 1988. In fact, compared to the Constitution of 1978, the 1988 Amendment has changed and now sanctions private investment. Id. Further change in the Constitution to support privatization seems highly unlikely in the near future. See supra Part V.