1-1-1997

Securities Market and Securities Regulations in China

Fengxia Dai
University of Georgia School of Law

SECURITIES MARKET AND SECURITIES REGULATIONS IN CHINA

Fengxia Dai

SECURITIES MARKET AND SECURITIES REGULATIONS IN CHINA

by

FENGXIA DAI

LL.B. East China Institute Of Political Science And Law, 1984
LL.M. East China Institute Of Political Science And Law, 1987

A These Submitted to the Graduate Faculty of the University of Georgia in Partial Fulfillment of the Requirements for the Degree

Master of Laws

ATHENS, GEORGIA
1997

SECURITIES MARKET AND SECURITIES REGULATIONS IN CHINA

BY

FENGXIA DAI

Approved:

Major Professor

5/24/1997

Date

Chairman: Reading Committee

5/24/1997

Date

Approved:

Dean of the Graduate School

May 30, 1997

Date

TABLE OF CONTENTS

CHAPTER 1

THE EVOLUTION OF THE SECURITIES MARKET AND THE SECURITIES REGULATIONS IN CHINA

One of the most important events in China's economic reform and legislative activity has taken place at a time when its economic reform enters its second decade: in December 1990, China opened its first national securities market--the Shanghai Securities Exchange.[1] This was soon followed by the issuance in November 1991 of the first special shares denominated in foreign currencies (the US dollar in the Shanghai stock exchange and Hongkong dollar in the Shenzhen stock exchange) and sold only to overseas investors.[2]

This important step in the development of China's securities industry indicates a strong commitment by the Chinese authorities to the two key components of the nation's economic reform program, i.e., economic systemic reform and opening to the outside world. The initial

---

1. "The Establishment of Shanghai Exchange," *People's Daily* (Overseas Edition), Sep.19, 1992, p.3.

2. "The First Special Share Issued," *People's Daily* (Overseas Edition), Jan.15, 1992, p.1.

success of the special shares extended to foreign investors also shows that China, with a relatively strong success of the special shares extended to foreign investors also shows that China, with a relatively strong economic performance and a huge market potential, is rapidly regaining the confidence of foreign businesses and economic performance and a huge market potential, is rapidly regaining the confidence of foreign businesses and investors,[3] many of whom became doubtful after the events in June 1989 despite having spent years cultivating ties there.

China is a large developing country with a socialist ideology currently undergoing a period of reform and transformation. The foundation of its securities market is invariably influenced by three important factors--economic and social development, socialist ideology and systemic reforms.

China's securities markets and securities regulations contain some unique characteristics. For those who are interested in China's economic law or in entering China's securities market as investors, it is essential to have an overview and understand the history and fundamental features of the securities market and securities regulations of China.

---

[3]. "The Second Foreign Investment Boom in Shanghai," *People's Daily* (Overseas Edition), Jan.16, 1992, p.3.

A.Securities Market in China: Its Death and Rival

1. Its Earlier Demise

Once the home of the largest securities market in Asia, China essentially eliminated the role for debt and equity securities in her economy after the Communist take-over in 1949. The swift elimination of the securities market in China was apparently based mainly on ideological grounds, although private ownership of means of production was allowed to continue, albeit on a very limited scale, until the beginning of the Cultural Revolution in 1966. However, the process of the socialist transformation that lasted through the end of the 1950's had in a more fundamental way made the securities market both economically and financially unnecessary.

a. An Anathema to Socialist Ideology

For many years, stocks had been considered in orthodox communist theory a prominent feature of the capitalist system whereby a capitalist may hold ownership of businesses, receive profits, and thereby exploit the working class.[4] It is thought to be the ultimate symbol of the parasitic nature of the decadent capitalist world. Allowing individuals to acquire an equity interest in a publicly-owned enterprise under the socialist system was thought by

---

[4]. Xu Dixin, *Dictionary of Political Economics*, (1980), p.40.

many to undermine the system of public ownership, thus running counter to China's prevailing socialist ideology.

As for public debt, there was less ideologically-based animosity toward it. In fact China issued some government bonds in the 50s and incurred a substantial amount of external debt--mainly to the former Soviet Union. Trading those bonds, however, was strictly forbidden. Indeed public debt was regarded as some kind of aberration--tolerated but not encouraged--to meet national contingencies, most notably those associated with the Korean War and post civil war reconstruction. By the mid-1960s, China, barely recovered from her bitter experience with Soviet pressures over her debt, was able to declare itself free from both internal and external debts.[5]

b. Changes In Basic Ownership Structure

Contrary to the popular belief, the communist revolution in China did not eliminate private ownership overnight. Officially, there have been in existence three types of ownership: state-owned entities, collectively-owned

---

[5]. Because of the needs for economic recovery after the civil war and for the Korean War, China started to issue government bonds in January 1950 and borrowed from the Soviet Union in the first five years US$200 million and 500 million rubles. When the relationship between the two Communist giants began to sour in the earlier 60s, the Russians exerted economic pressures on the Chinese over debt repayment at a time of great economic difficulties in China due to the failed Great Leap Forward movement. A determined China managed to pay off all its debts to the Soviet Union on January 1965 and subsequently declared itself free from internal and external debt. *A Chronological History of the People's Republic of China*, (Beijing: China Economic Publishing House, 1994). Bo Yibo, *Some Major Events and Decisions and Personal Reflections*, Vol 1, (Beijing: CPC Party School, 1991), p.300.

entities, and individually-owned entities. Mao envisaged a gradual process called socialist transformation, in which over an extended period of time, private ownership would be phased out through state and collective ownership. This was to be achieved through outright confiscation or purchase. By the end of the Cultural Revolution, private ownership had almost disappeared. Both state-owned and collectively-owned entities were established by means of administrative order in accordance with the state plan and had, therefore uniform organizational structures. The property of the state-owned entity belonged to the public who were represented by the state. A collective entity was owned by its employees. The equity in both entities could not be sold or transferred.[6]

c. State Planning And Monopoly On Finance

As state ownership became predominant, almost every aspect of economic activity came under state control through economic planning, including finance. Financial demands of state and collective entities were met through state budgetary appropriation. In return, all their profits were handed over to the state.[7] Under such circumstances, entities didn't need to worry about capital formation or liquidation for their productive activities. This system of strict economic and financial planning essentially

---

[6]. *Zhonghua Renmin Gongheguo Xianfa* (PRC Constitution)1978, Art 5-8

[7]. Liu Hongru, "Development in the Reform of China's Banking and Financial Systems," *Journal of Chinese Law,* Issue 2, 1987, p.323.

eliminated the need for financing through money or capital markets.[8]

2. Economic Reforms and the Rebirth of Securities Market

Economic reforms and ideological liberation commencing in 1978 resulted in the rebirth of securities markets in China.

a. Securities Market--A Logical Outcome Of Reforms

By decollectivizing agriculture and introducing the responsibility system, agricultural production surged.[9] Greatly encouraged by the success in agriculture, which exceeded everyone's expectation, the government tried to duplicate it by introducing the responsibility system into city enterprises. Like in the rural areas, this reform naturally led to the creation of a free commodity market where the price reflects the value of the product.[10]

At the same time, financial reforms changed the old system in which the state collected all the profits from enterprises and provided their financing through appropriation. Enterprises instead retained part of their profits after fulfilling their contractual obligations.

---

[8]. Id.

[9]. "Communiqué of 3rd Plenary Session of the 11th Chinese Communist Party Central Committee," *People's Daily*, Dec. 24, 1978, p.1.

[10]. "Decision on Economic Reform," *Xinhua Monthly*, Nov.10, 1984, p.24.

Financial institutions also gained more autonomy from the government.[11]

To improve management accountability, enterprises have been experimenting with ownership structure, mainly throughout the so-called "shareholding" system. The property of the entity selected for the experiment, also called "joint-stock company", is divided up in percentage terms into "state shares", "collective shares" and "individual shares", subscribed to and owned respectively by the state, business entities and private individuals. Joint-stock companies can sell "collective shares" to their own employees and other institutions, and "individual shares" to the public.[12]

In addition to the above reform measures, the government started to issue treasury notes nationwide to cover its deficit resulting from misguided economic

---

[11]. As mentioned earlier, under the old system, capital requirements of state and collective entities were met through state budgetary appropriation. They in turn handed over all profits to the state. Entities were not independent legal persons, in fact, they were part of the government. During the early period of economic systemic reform, the relationship between business entities and the government became a contractual one. An entity would receive a budgetary appropriation from the government and send its profits to the government according to the terms of a contract it had signed with the government. Any extra profits above the contracted amount would be retained by the entity. As the capital needs of the entity wewe met only partially by the state, financial institutions were allowed to provide loans to such entities, although the state still strictly controlled the overall availability of funds through a quota system and by setting interest rates. Liu Hongru, supra note 6.

[12]. "The Shareholding System in Shenzhen," *Daily of the Shenzhen Special Economic Zone*, Dec.3, 1991, p.3.

endeavors in the late 70s.[13] From 1981 to 1988, around 145 billion yuan Renminbi worth of treasury bonds were issued. Despite government's initial prohibition, an informal market emerged from the bond trading.[14]

Many of the changes in the reform of the economic system such as the emergence of the two-tier pricing system and a commodity market, of new sources of capital supply and demand beyond state control, and of informal trading in government bonds pointed to the re-establishment of a securities market in China as their logical outcome.

b. Overcoming the Ideological Barrier

In introducing economic reform in China, the Chinese Communist Party leadership in 1978 also adopted a pragmatic approach to socialist ideology under the slogan "seeking truth from facts".[15]

To clear the way for a securities industry in China, Chinese economists in the early 80s developed new theories to justify issuing shares in a socialist economy. They

---

[13]. In 1978 China launched a crash modernization program that called for major investments and large-scale imports of foreign equipment and technologies. The program later known as "rash foreign advance" resulted in a record budget deficit of 17 billion yuan in 1979 and 12.7 billion yuan in 1980, and serious balance of payment difficulties. The government had to revive the government bond program by issuing in January 1981 4.87 billion treasury bills. The program has continued to today. *A Chronological History of the PRC*, supra note 5, p.1607, 1475. *China Statistics Yearbook--1981*, (Hongkong: HK Economic Herald, 1982), p.395.

[14]. "Deepening Reform of the Financial System," *People's Daily* (Overseas Edition), Oct. 9, 1991, p.3.

[15]. "Decision on Economic Reform," supra note 9.

quoted Karl Marx, who said that the stock company is a form by which the capital becomes the property of the organized working people.[16] This quote by Marx is used as the theoretical legal basis to justify the role of stocks in a socialist economy. Furthermore, they reasoned that the issuance of shares is part of the advanced business management of the capitalist system, and like other management skills in the capitalist world, it can be used to the advantage of socialism.[17]

Chinese economists pointed out that by holding shares in a company, an employee becomes a real master of the company and will have a much stronger sense of responsibility. The general public that hold stocks will help promote a tighter supervision of the company's operations and promote greater accountability. In short, issuing shares assures more efficiency and enhanced productivity.

As to its negative side from a socialist point of view, some economists stressed that shareholding does not necessarily negate public ownership. Security regulations, properly drafted, would ensure that the state, in most instances, remained the majority shareholder. In any case, it was argued, a partial dilution of state ownership would also diminish the business risks of the state.

---

[16]. Deng Bing, "Stock Economy Is not a Capitalist 'Patent'," *Economic Daily*, Dec. 9, 1986, p.3.

[17]. Id.

Similarly to safeguards in market operations designed to prevent wild speculations and possible disruption of trading, securities regulations could be drafted to impose a ceiling on the rate of return from stock trading so that the possibility of it creating a privileged class of rich stockholders would be minimized.[18] These theoretical explorations helped gain an audience among members of the leadership and establish a favorable outlook in the general public toward stocks and joint-stock companies.

These proposed economic reforms and their concomitant ideological liberation made the central government recognize the necessity of creating a securities market. First, a securities market would help joint-stock companies standardize their business activities and accounting practices, since joint-stock companies that wanted to sell their shares on the securities market were required to go through assessment of their assets, management and finances, and their business activities would be put under society's supervision. Second, the securities market would help develop capital markets.[19] With the establishment of securities exchanges, transactions of bonds and shares would be facilitated and the flow of funds

---

[18]. Id.

[19]. "China Needs Securities Market," *Guangming Daily*, Dec. 17, 1988, p.1.

accelerated. Third, the securities market would provide people with additional channels for the disposal of their money.

As a result of some long-time preparations, the first securities market was officially opened on August 5, 1986 in Shenyang, a large industrial city in northeast China. By the year's end, Shanghai, Beijing, Wuhan and Guangdong opened their own securities markets.

3. The Development of The Securities Market

The development of China's securities markets can be divided into three stages: the opening of securities trading--from the beginning of 1984 to the end of 1986; the establishment of securities markets--from the beginning of 1987 to the end of 1990; and the development of a comprehensive securities market system--from the beginning of 1991 to present.[20]

a. The Opening of Securities Trading

This stage can be regarded as a preparatory phase for creating securities markets. As discussed earlier, the experiment in the shareholding system began in 1984. The enterprises that were selected to become joint-stock companies were allowed to sell their shares to their employees. These shares with fixed dividends and duration

---

[20]. "Shanghai to Internationalize its Securities Market," *The Xinhua General News Service*, Dec. 13, 1991, available in *LEXIS*, Item No: 1213112.

employees. These shares with fixed dividends and duration were prohibited from being issued to the public.[21]

During this period, government treasury notes were the main securities available to the public. Holders of the notes were allowed to used them as securities or cash them at banks through discounting.[22]

The establishment of the securities market in the largest cities marked the end of the preparatory stage and the beginning of the development stage.

b. The Establishment and Development of Securities Markets

This stage was very important to China's securities industry. Some key measures necessary for the creation of a comprehensive securities market were adopted and some important goals were accomplished.

After 1986, a number of large and medium-sized state-owned entities were allowed to issue stocks or bonds to the public. With three securities listings by 1990, the Shanghai securities market led the whole country.

With the development of securities markets, many securities institutions came into being. There were nearly 40 securities corporations and 400 trust and investment

---

[21]. "Enterprises and Employees Share the Same Fate," *People's Daily* (Overseas Edition), Jan. 26, 1987, p.3.

[22]. *Commercial Laws and Business Regulations of The PRC*, (Hongkong: Tai Dao Publishing Limited, 1985)

corporations conducting business in China's largest cities by 1990.

A nationwide network of information on the securities was established. With this network, securities institutions could regularly exchange information on the prices of securities, on the volumes of transactions and on reserves.

An automated quotation system was set up in December 1990. This computerized nationwide network now connects 18 major securities institutions and trust and investment corporations located in Shanghai, Shenyang, Wuhan, Guangzhou, Haikou and Beijin. It promotes standardized management in the securities markets.

c. The Development Of A Comprehensive Securities Market System

The securities industry in China entered a new era in 1990. Two significant events symbolize the new era.

(1) The establishment of the Shanghai Securities Exchange. The Shanghai Securities Exchange was opened on December 1990. As the first national securities market, its establishment marked Shanghai's transformation from a regional securities exchange center to a national securities exchange center.

The Shanghai Securities Exchange is organized along the same lines as the New York Stock Exchange. It is a non-profit, independent legal entity with a membership system.

Access to membership is restricted to those institutions which have been approved by the People's Bank of China (thereafter PBC)--the nation's central bank--to handle securities business.[23]

As a national securities market, the Shanghai Securities Exchange allows enterprises all over the country to list their stocks or bonds. Twenty-five financial organizations from Beijing, Shanghai, Anhui, Shandong, Jiangxi, Zhenjiang and Hainan became its members. Within one month of its establishment, the Shanghai Securities Exchange enjoyed a monthly trade volume as high as 350 million yuan, setting a new monthly record for China's securities market.[24]

The economists in China and abroad pointed out the significance of the establishment of Shanghai Securities Exchange to China's economy. First, the Exchange paves the way for a national securities system by allowing people around the country access to non-local markets.[25] Second, a national securities market could assist further experiments in price reform by easing inflationary pressures, as the flow of money would be steered toward investment rather than

---

[23]. Shanghai Foreign Investment Commission, *Guide to Investment in Shanghai* (1991)

[24]. "Shanghai Securities Exchange Enjoys Good Business," *The Xinhua General News Service*, Feb.24, 1992, available in *LEXIS* Item No: 0201220.

[25]. "Financial Reform: New Impetus to Opening Policy," *The Xinhua General Overseas News Service*, Dec. 24, 1990, available in *LEXIS*, Item No: 1224076.

consumer spending.[26] Third, an active securities market would help establish market mechanisms in the economy. It would encourage the absorption of inefficient enterprises by healthy ones and enable the government to get out of the practice of bailing-out enterprises.[27] Lastly, establishing a standardized securities exchange was the first, though very important, step for China to draw on the experiences of overseas financial institutions such as a stock exchange in an effort to promote its modernization program.

(2) The issuance of B shares to foreign investors.

In order to attract overseas investors to China's burgeoning securities markets, a special B class of foreign currency denominated shares were issued to overseas investors. The first of this special class of shares--B shares--was issued in November 1991 at the Shanghai Securities Exchange by Shanghai Vacuum Electronic Device Limited Co., which was the biggest quoted company in Shanghai. The Shenzhen Securities Exchange, the other national securities market set up later in 1991, issued about 200 million yuan worth of B shares to overseas investors in December 1991.

The B share is a special class of Chinese shares denominated in foreign currencies--US dollar in the Shanghai exchange and Hongkong dollar in the Shenzhen exchange. It can only be sold to foreign investors and overseas Chinese

---

[26]. Id.

[27]. Id.

buyers and traded in foreign currencies.[28] Even though a Chinese enterprise can issue both Chinese Renminbi-denominated A shares available only to Chinese investors and foreign currency-denominated B shares, the two classes of shares are traded in two separate markets, thus insulating the Chinese securities markets from fluctuations in the international financial markets.

The issuance of B shares has greatly influenced China's policy of attracting foreign investment. Securities investment is a practice familiar to many foreign businessmen. Therefore it was hoped among Chinese leaders that it would gain easy acceptance by foreign investors.[29] Issuing B shares also symbolized the establishment of a pluralistic structure in China to attracting foreign investment. It now includes such investment forms as equity joint ventures, contract joint ventures, wholly foreign-owned enterprises and securities investment.

Besides absorbing foreign investment, the issuance of B shares allows foreign investors to know the credit worthiness of listed Chinese enterprises. This in turn helps Chinese enterprises to participate in the world economy.[30]

---

[28]. "China Issues B Shares," *China Business and Trade*, Vol. 6, Issue 19, Nov. 5, 1991.

[29]. Id.

[30]. When issuing B shares to foreigners, enterprises must rearrange their internal systems, including financial and management systems, by following the standard international practices. And the enterprises which issue B shares would place their business management and economic activities under the scrutiny of foreigner and Chinese

B. The Structures Of Securities Markets

The structures of securities markets in China is similar to those of developed countries. The markets can be divided into distribution and trading markets.

1. The Distribution Markets

The activities in the distribution markets concentrate on distributing securities. Distributing securities to the public must be approved by the Securities Commission of the State Council (thereafter SCSC) or the Securities Commission of Shanghai (thereafter SCS) or the Securities Commission of Shenzhen (thereafter SCZ).

The participants in the distribution market include the issuer of securities, institutions engaged in the securities business and investors. The issuer can offer securities to the public by itself or through a securities institution. The securities institution acts as an underwriter or an agent of the issuer in the market. Investors includes individuals and enterprises.[31]

---

investors. These changes help the enterprises reorganize along the lines of international businesses, making it easier for them to participate in the world economy. see "A New Way to Attract Foreign Investment," *People's Daily* (Overseas Edition), Jan. 16, 1992, p.3.

[31]. Interim Banking Control Regulations of the PRC, Jan.7, 1986, available in *LEXIS*, Chinalaw No: 318.

The market's style is that of an the over-the-counter market with more than 700 securities counters now functioning in China.

2. Trading Markets

While trading markets focus on the trading of securities, securities trading dwells on buying and selling of securities at the securities exchange market or at the securities counter. Trading markets include the securities exchange and over-the-counter transactions.

The securities exchange plays an important role in trading markets. The issuer, who is going to trade securities on the securities exchange, must apply to the exchange and receive the approval from the State or local Securities Commission before its securities can be listed on the exchange. Over-the-counter trading of securities must also be approved by the State or local Securities Commission.

There are two securities exchanges in China now Shanghai Securities Exchange and Shenzhen Securities Exchange.

CHAPTER 2

SECURITIES REGULATIONS IN CHINA

With the rapid growth of the securities industry in China, both state and local governments have introduced rules to guide and regulate the securities business. Since there is not a unified securities law in China now, these regulations have played an important role in regulating securities activities in China.

Current regulations can be divided into three areas: regulations on securities authorities; regulations on securities markets; and regulations on securities businesses.

A. Regulations On Securities Authorities

Regulations relating to securities authorities include principally the following: interim regulations on banking; provisional regulations for the control of financial trust and investment institutions; regulations governing foreign banks and joint Chinese-foreign banks in special economic zones of the PRC; provisional regulations on securities companies.

1. The Regulatory Authority

Different from the practice in the United States, the People's Bank of China, as the nation's central bank, played the role as the regulatory authority for securities until December, 1992.

With rapid development of securities-related businesses, the central government of China soon recognized that it was both urgent and important to strengthen the supervision of the securities market on the macro level. In December, 1992, the Chinese cabinet--the State Council--announced the establishment of a national securities watchdog--the State Council Securities Commission.

Since December 1992, the State Council Securities Commission has replaced the People's Bank of China to become the supreme securities regulatory authority in China.

a. The Structure of the Securities Commission

As the name implies, the Securities Commission is a department of the central government. The chairman of the Securities Commission, a ministerial-ranking post in the central government, is to be appointed by the Primer subject to the normal confirmatory action by the National People's Congress.

As an administrative agent of the central government, the Securities Commission is different from the other administrative agents in that it has so far not established its counterparts in local governments.[32]

So far, only the cities of Shanghai and Shenzhen have established securities commissions that are responsible only to their respective mayors. The State Council Securities Commission can make suggestions to the two local Securities Commissions, but it can not give administrative orders to the two local securities commissions.

With respect to power, the State Council Securities Commission controls securities activities taking place in the nation, excluding Shanghai and Shenzhen. The Shanghai and Shenzhen Securities Commissions are in charge of the securities businesses in their respective localities.

b. The Work of the Securities Commission

According to current regulations, the principal responsibilities of both the central and local securities commissions include the following: formulate regulations and policies in relation to the securities markets; supervise and control the securities markets and enforce securities laws.

Rulemaking: The securities commissions' rule-making power derives from the certain sections of the

[32]. The Chinese administrative system separates executive authorities into central government and local governments. Each department in the central government would normally have its counterpart in local governments. The Ministry of Foreign Trade and Economic Cooperation under the State Council, for instance, has its counterparts in local governments as provincial Commissions of Foreign Economics. The departments of local government are responsible both to the

securities-related regulations that specifically empower the securities commissions to promulgate rules that have the force of statutory provisions. Because of the difference in the scopes of power, regulations or policies formulated by the State Council Securities Commission can be carried out throughout the nation while the local securities commission can only draft local regulations that do not conflict with the regulations and policies promulgated by the SCSC.

The securities commissions have also promulgated a number of interpretive rules that are designed to aid issuers and investors in complying with the statutory requirements.[33]

Control and supervision: Much power of the securities commission are reflected two areas. First,they exercise control and supervision over the securities exchanges. The securities commissions have the power to decide whether the securities exchanges can handle the trading of particular securities; they can decide whether the issuer of certain stocks or bonds has the necessary qualifications; and they can control and supervise all institutions that are in charge of securities registration,

---

administrative leaders of the local government and to their counterparts in the central government.

[33]. The Provisional Regulations on the Administration of the Issue of and Trading in Securities by the State Council (thereafter the Provisional Regulations), promulgated by the State Council in December, 1992, Art. 5.

clearance and transfer. Second, they also control and supervise securities businesses in general.

The securities commissions control the issuance of securities by deciding whether the application to issue securities should be approved and whether the form and contents of the prospectus have met appropriate requirements. The securities commissions supervise securities companies by deciding the policy for underwriting groups' activities.[34]

Enforcement: The securities commissions are responsible for enforcing the securities regulations and have the authority to punish any violations through administrative or economic means.[35]

B. Regulations On Securities Markets

Securities markets, as in the case of any other commercial market, include five basic elements: securities exchanges which are the locations for conducting business transactions; issuers who are sellers; investors who are buyers; securities which are commodities; broker/dealers who are agents between buyers and sellers.

Although the current securities regulations in China are primitive, they nevertheless contain sections on

---

[34]. The Provisional Regulations, supra note 33, Art 15.

[35]. The Provisional Regulations, supra note 33, Art 30, 34, 69, 74.

regulating the five basic elements in the securities markets.

1. Securities Exchanges

There are two national securities exchanges--the Shanghai Securities Exchange and the Shenzhen Securities Exchange. The differenc between two securities exchanges dependents on the difference between two areas.

The major business of the securities exchanges is to provide a centralized securities market for securities and related services. Securities that have been approved by the state or local securities commission can be listed on these securities exchanges.

The structure of securities exchange management includes: the Membership Meeting; Board of Directors; Chairman and Vice-chairman and General Manager and Vice-General Manager.

The Membership Meeting. The Membership Meeting represents the highest authority of a securities exchange. The membership requirements, which are essentially the same in Shanghai and Shenzhen, include: the candidate that applies to be a member must be a securities company; the securities company must have more than Renminbi (RMB) 1 million yuan in registered capital; the securities company must have made profits over two consecutive years before it makes the application to become a member.

Besides these three fundamental requirements, there are two procedural requirements: approval by the securities commissions and paying of membership fees.

Board of Directors. The Board has jurisdiction over daily business activities and is responsible to the Membership Meeting. The Shanghai Securities Exchange has nine directors, among of whom six are members; the Shenzhen Securities Exchange must have no less than nine directors, among of whom no more than six can be member directors.

Chairman and Vice-Chairmen. Chairman and vice-chairmen are nominated by the Directors and must receive the approval of the state or local securities commission.

General Manager and Vice-General Managers. Managers are in charge of daily business operations.

Securities exchanges are non-profit and self-regulatory organizations that are controlled by the securities commissions and supervised by other related departments within the government.[36]

2. Securities

Securities in China's securities market now can be divided into two groups: stocks and bonds. Stocks are issued by the entities which have been approved to transform into joint-stock companies from state-owned or collective

[36]. Chen Tao, *Asia Securities Markets*, (Shanghai: Great Encyclopedia House, Jan. 1992), pp.344-347.

entities or foreign- invested entities. Bonds can be subdivided into government bonds and enterprise bonds, bank bonds.

a. Stocks

Stocks are defined as a part of capital investment in an enterprise.[37] The holders of stocks are entitled to participate in and supervise the management of an enterprise according to the provisions of the articles of association.

In the early stage of securities markets in China, stocks include basic stocks and stocks of limited duration. The former simply refers to common stocks that can not be returned to the issuer; the holders of the latter, however, will either retain their stocks or have the issuer redeem them after a fixed period of time expires. With the development of securities businesses, limited duration stocks disappeared and there left only one kind of stock--the general basic stock.

The general basic stock can be divided into four kinds according to the holder's position.

State stocks: Such stocks are owned and held by the state only and the stocks represent the fixed assets and working capital invested by the state in a given enterprise. The State Asset Administration of the State Council is the designated representative of the State, holding the state's stakes in such corporations.

---

[37]. Guangdong Securities Regulations, promulgated by Guangdong Province on October 10, 1986, *East Asian Executive Reports*, May 1987, Art 9.

Company stocks: Companies and other institutions with an independent legal personality can become holders of such stocks.

Individual stocks: The holders of such stock are individual investors. Both company shares and individual shares can only be bought by the Chinese.

Special stocks: Such stocks are only issued to foreigners and Chinese living outside mainland China.[38]

The interest and dividends from stocks can be divided as "guxi" and "hongli". Guxi seems to be interest, because it is deductible as a business expense. Hongli simply refers to dividends paid on stocks in profit sharing.[39]

b. Bonds

The Guangdong and Xiamen regulations define bonds as an evidence of debt with a face value and date of payment. The State Council regulations regard bonds as "negotiable instruments". Bonds can be sold at any time through discounting.

All securities regulations impose a ceiling on the rate of return for bonds. The Guangdong Securities Regulations stipulate that the ceiling for an individual is 125% of the interest rate that banks are offering on time

---

[38]. Zhou Hei, *The Guide to Stock Trading*, (Shanghai: Shanghai Social Science Academy Publishing House, 1993), pp.8-9.

[39]. Guangdong Securities Regulations, supra note 37, Art 5.

deposits for the same length of time, and 120% for a business entity.[40] Xiamen's regulations allow up to 130% of the interest rate banks are offering on time deposits for the same length of time for both individuals and institutions. The State Council regulations increase the ceiling to 140% of the interest rate banks offer on time deposits for individuals. The standard applies to both individual and institution subscribers.

The rate of return of government bonds is imposed by the relevant government departments. As a principle, the ceiling on the rate of return is always set above the rate of interest offered by banks.

3. Issuers

Because securities can be separated into stocks and bonds, the issuers also can be separated into the issuer of bonds and the issuer of stocks.

a. The Issuer of Bonds

The issuers of bonds include the central and local governments which issue government bonds; the banks and other financial institutions which issue financial bonds; state-owned companies which issue enterprise bonds.[41]

---

[40]. Interim Regulations of the State Council on Administration of Enterprise Bonds (thereafter the State Bonds Regulations) promulgated by the State Council on March 27, 1987, *Tiajin Daily*, Apr. 5, 1987, p.4.

[41]. Id.

b. The Issuer of Stock

According to securities regulations, only a joint-stock limited company can issue stocks to the public.

The issuer of stocks should meet three basic requirements: its net capital constitutes more than 30% of total assets; patents and know-how can not exceed 20% of its net capital in the year before issuing stocks; the company has made profits for three consecutive years.

If a joint-stock limited company is going to issue stocks for the purpose of increasing assets, it should meet additional requirements: the usage of stocks issued is congruent with the prospectus and results in a return of profits; it can only take place 12 months after the last such issuance; and the company has not committed any serious infraction against the law since the last issuance.[42]

If a joint stock limited company is going to issue stocks for the purpose of setting up a new enterprise, it should meet addition requirements as follows:[43] the business area of the new enterprise does not contradict industry policy of the State; the sponsor should buy more than 35% of the total stocks issued and the 35% of the total stocks must worth more than RMB 30 million yuan; the stocks issued to the public must be no less than 25% of the total stock issue; the stocks reserved for its employees must be no more

---

[42]. The Provisional Regulations, supra note 33, Art.9.

[43]. The Provisional Regulations, supra note 33, Art 8.

than 10% of the public offer; the sponsor has not committed any serious illegal acts within three years before issuing the stocks.

4. Investors.

The investors in securities include institutions and individuals. At present, only stocks for individuals can be traded in securities markets.

Until the end of 1991, stocks on both the Shanghai Securities Exchange and the Shenzhen Securities Exchange were available only to Chinese institutions and individuals and were traded only in Renminbi. Following the first issue of B shares in February 1992, overseas investors entered the Chinese securities markets.

5. Securities Companies

Securities companies play the role of broker/dealer in the securities markets.

They are financial institutions that mainly do securities business. The first securities company was created in 1987 in Shenyang. Since then securities companies have developed quickly. Fifty-nine securities companies and more than 300 securities management institutions had sprung up in large and medium-sized cities by the end of 1991. In addition, another 1000 securities management agencies conduct business on the national level.

Almost each big city has securities companies or has securities management agencies for securities activities.

The establishment of a securities company must be approved by the People's Bank of China. The necessary requirements for approval include the following: no less than RMB 10 million yuan capital; professional employees familiar with securities business; and a fixed trading place and qualified trading equipment. To establish a securities company, the following documents are submitted to the People's Bank of China: an application form; articles of association; and a list of names and resumes of the leading personnel.[44]

The scope of activities of securities companies engaged in the securities business include the following: to undertake or promote the sale of securities; to buy and sell securities for their own account or act as an agent for the buying and selling of securities; to engage in securities investment and trust; to provide services for maintaining, accounting and assigning securities; and to provide consulting services for the issuance and investment of securities and other services.[45]

---

[44]. Administrative Measures of Shanghai Municipality on the Trading of Securities (thereafter Shanghai Securities Regulations), promulgated by the Shanghai Municipal Government on November 27, 1990, Art 46.

[45]. Shanghai Securities Regulations, supra note 44, Art 42.

C. Regulations on Securities Activities

The securities activities include two parts: issuance of securities and trading of securities.

1. Issuance of Securities

Because stocks play an important role in the securities market now and the procedure for issuing bonds is to a large extent similar to that for stocks, the following summary on requirements will concentrate on stock issuance.

The issuance of stocks can be separated into three phases: prior to registration; registration; after registration.

a. Prior to Registration

According to current regulations, during such period, the issuer of stocks should finish the following steps:

The meeting of sponsors: The issuer should hold a meeting with its sponsors for making issuance decisions.[46]

The approval letter: After the decision of issuance, the issuer should apply to the competent department of

---

[46]. Promoters of shareholders of an enterprise are such legal and nature persons who have shares in the enterprise, in another word, promoters of shareholders of an enterprise are owners of the enterprise, for example, the State is big owner of any larger and middle size enterprises. To joint-ventures using foreign investment, foreign investors are promoters of shareholders.

government for approval.[47] If the issuer is a foreign invested enterprise as joint ventures, the approval of government is unnecessary.

The legal documents: The issuer should prepare legal documents such as prospectus and underwriting agreement to be submitted to the securities commission after receiving a general approval from government to go public.[48] The form and content of the prospectus is similar to those in the U.S.

On the cover is the following sentence: "The issuer guarantees the truth, accuracy and completion of the contents of the prospectus. Any decision made by government and securities regulatory authority does not mean guaranty or judgment as to the value of the stock or investment benefits".[49]

The following basic information on the issuer should be contained in the prospectus:

The sponsor and the issuer's brief background;

---

[47]. All enterprises in China come under an executive controlling department of government. The relationship between an enterprise and the controlling department of government is consentrated in the executive area. For example, it should obtain approval to change its general manager from the controlling department of government. Such relationship is unique in China and one can not find its equivalent in the U.S.

[48].As stated in footnote 47, each enterprise is under an executive department of government and the relationship between the enterprise and its controlling department of government is concentrated in the executive area, the approval letter from the controlling department of government is an executive document and is a prerequisite for issuing stocks. This procedure is unique to China's securities regulations.

[49]. <u>The Provisional Regulations</u>, supra note 33, Art 16.

The goal of issuing stock;

The total share capital of the company;

The class of stocks and total amount of stocks to be issued;

The net capital value of per share before issuing.

Underwriting: According to Shanghai securities regulations, the public offerings of securities should be distributed through an underwriter. Large offerings of RMB 30 million yuan and above must be conducted through an underwriting group led by a securities company. The underwriting group is composed of more than two underwriters with one lead underwriter which should sign an agreement with other underwriters. The lead underwriter is chosen by the issuer according to a policy of fair competition.[50]

The underwriters are generally of two types in terms of liability: guaranteed underwriter and agent underwriter. Guaranteed underwriters can purchase the entire securities issue or part of the total shares to be resold to the public. The other option for a guaranteed underwriter is to purchase any unsold securities after the close of the public offer. An agent underwriter, on the other hand, can return any unsold securities to either the issuer or to a guaranteed underwriter. The liability for the two kinds of underwriters is different. Guaranteed underwriters take full responsibility for selling all securities bought by them

---

[50]. Shanghai Securities Regulations, supra note 44, Art 17.

from the issuer to the public during the period of underwriting. Thus the underwriter takes the risk of completing the distribution. The agent underwriter is just liable to the issuer as deputies.[51]

The underwriter should check the truth, accuracy and completeness of prospectus and other documents.

If the underwriter wishes to make an offer or sell the stocks to the public after the deadline of underwriting period, it must be approved by the state or local securities commission.

The negotiation between the issuer and the underwriter can be effectuated before registration and the issuer can sign an underwriting agreement with the underwriter before it makes an application for issuing securities to the state or local securities commission.

The underwriter's fee for such issues is controlled by the policies decided by the state or local securities commission.[52]

The underwriter will discuss with the issuer the issue of pricing the stocks. If the underwriting is guaranteed, the price should be determined by the underwriter with the agreement of the issuer. However, if the underwriter is an agent, the price is decided by the issuer through an agreement with the underwriter. The state

---

[51]. Shanghai Securities Regulations, supra note 44, Art.21-23.

[52]. Id.

or local securities commission has the ultimate authority on the price of stocks.

The underwriting agreement is signed by the issuer and the underwriter before an application is submitted to the relevant government department.

The underwriting agreement should include the following articles:

The names and address of the underwriter;

The name, quantity, value and issue price of stocks;

The date of issuance;

The method and date of payment for underwriting;

The calculation of charges;

The way of returning the balance of unsold stocks.[53]

b. Registration

After finishing all necessary preparations, the issuer can make an application to the securities commission for issuing the stocks. This is the registration period and it involves the issuer's submission of the following documents:

Application form;

Decision of issuance approved by the meeting of sponsors or shareholders;

Approval letter from the relevant department of government;

Business license;

---

[53]. The Provisional Regulations, supra note 33, Art 20.

Articles of association of the company;

Prospectus;

Feasibility report on capital use;

Comptroller's report and legal opinion report;

Asset evaluation report;

Underwriting agreement.

The securities commissions will make a decision on whether or not to allow the issuer to register within twenty days after receiving the above documents.

c. After Registration

After receiving the approval of the securities commission, the underwriter can offer stocks to the public by issuing purchase application forms. One application form entitles one to buy from 500 shares to 1000 shares. Usually one application form is used for one stock issue. One application form may also be used for several stock issues if they are issued at the same time.

Without a special approval from the securities commission, the distribution period may not exceed ninety days and be less than ten days, which is defined as the time between the date the offering begins and the date the distribution concludes. The underwriter must also submit a written report on the distribution of stocks to the state or local securities commission within fourteen days after the closing of the period.[54]

---

[54]. Id.

If the state or local securities commission approves, the underwriter can make an offer or sell the stocks to the public after the end of distribution period.

2. Trading of Securities

For securities trading, the issuer should make another application to the securities commission and the securities exchange. An application for trading stocks can be made within thirty days after or prior to their issuance.

A full application should include the following documents:

An application form;

The registration documents of the company;

The approval document for issuing stocks to the public;

A financial report;

Recommendation letters from members of the securities exchange and the latest prospectus.

The issuer should also submit the following documents to the securities exchanges:

An application form;

A report on the securities to be listed for dealing;

A financial report;

The certificate indicating an agreement to support the dealing issued by at least one institution engaged in securities business.

The securities exchange should provide a letter of examination within ten days after receipt of the application form and forward the application form and report its opinion to the state or local securities commission, which will decide whether approval should be granted and notify the securities exchange of its decision. A final decision will be made within twenty days.[55]

After receiving the approval, the company should publish the trading report and all the documents stated above. The trading report should include all contents in the prospectus and the following:

The date of commencement of trading and the approval documents;

The structure of ownership of stocks, the names of the ten largest shareholders, the number of shares the largest shareholders hold respectively, and the kind of shares the largest shareholders hold;

The resumes of the directors, supervisors and its senior management, and the number of shares they hold;

Profit report and forecasts.[56]

According to the time of clearance, one of these styles of trading can be used: trading at the same day, meaning the sellers and buyers clear on the same day as

---

[55]. Id.

[56]. The Provisional Regulations, supra note 33, Art 32.

trading; ordinary trading, meaning the clearance will be made in the fourth business day after the transaction; or fixed-date trading, meaning the clearance will be made in the fifth day after the transaction.

The issuing stocks is a legal job so how to issue stocks must follows the steps stated on the securities regulations and other relative regulations.

D. Regulations for B Shares

1. Characteristics of B Shares

B shares are foreign currency-denominated stocks available exclusively to foreign institutions and individuals.[57] The subscription of B shares, and the subsequent trading, dividend and cash bonus distributions are all in foreign currencies based on the applicable market exchange rates. Under current regulations, B shares have the same rights and obligations as ordinary Reminbi-denominated shares.

2. Issuance of B Shares

A company wishing to issue B shares in Shanghai must comply with the following requirements:

---

[57]. Guangdong Securities Regulations, supra note 37, Art 2 and Shanghai Securities Regulations, supra note 42, Art 14.

It must be an approved joint-stock company which has been registered with the Administration for Industry and Commerce or whose establishment has been approved and has met all the issuing requirements set forth by the securities exchange.

The proceeds from the issuance of B Stocks must be used in accordance with state policies on the Administration of Foreign Investment.

It must have a stable, adequate source of foreign exchange revenue, i.e. such revenue in any one year being sufficient to pay out the B shares dividends for that year.[58]

Shenzhen has similar requirements for the issuing B shares.

The issuance of B shares in Shanghai may be through a public offering or a private placement. A public offering must be conducted on behalf of the issuer by an approved securities company. The issuance of B shares through a underwriting group must be managed by a domestic securities company. The prospectus for an issue of B shares must be published in an approved newspaper or other publication on dates designated by the securities commission.[59]

In Shenzhen, the issuance of B shares through an underwriting group undertaking sales on behalf of the issuer must be managed by authorized domestic securities

---

[58]. Shanghai Securities Regulation, supra note 44, Art 9.

[59]. Id., Art 12.

institutions or approved foreign securities institutions. The issue price of B shares may not be lower than the issue price of A shares by the same company. An issuer may require private placement of its B shares with legal persons outside China with which it has close business connections, provided that such legal persons are approved by the securities commission and that the number of shares privately placed does not exceed 15% of the total number of B shares in such issue.[60]

3. Trading of B Shares

Because distributing B stocks is carried out through approved securities institutions, this trading must also be carried out on behalf of buyers and sellers by approved securities institutions. Trading must be processed through a domestic securities company which is in the business of dealing in B stocks and it may not engage in B stocks business for its own account.[61]

All transactions must be effectuated through the securities exchange. No off-market transactions are allowed. The Shanghai and Shenzhen Securities Exchanges are highly automated with trading and settlement performed electronically. Clearing and settlement of B share transactions are effected on the third day after the

---

[60]. Guangdong Securities Regulations, supra note 37, Art 9.

[61]. Guangdong Securities Regulations, supra note 37, Art 4.

relevant trade day. Clearing, settlement and depository services are handled by approved banks, like Citibank, NA and the Hong Kong and Shanghai Banking Corporation.

Clearing and settlement of B share transactions are effected in a scripless manner. In such a manner, if an investor sell his B shares, a credit will enter his accounts; if investors buy B stocks, a debit will enter their account. No stock certificates are issued to investors.

CHAPTER 3

COMPARED TO THE SECURITIES REGULATIONS OF THE UNITED STATES: A LONG ROAD AHEAD FOR CHINA

Because Chinese securities markets are emerging markets undergoing rapid growth and change, the current securities regulations in China are not yet mature. The unique characteristics of this situation can clearly be seen in comparisons with American securities regulations.

A. Regulatory Authorities

The Securities and Exchange Commission (SEC) is the primary regulatory authority of the securities business in the US. Compared to the Securities Commission in China, the former is much stronger in the structure. It consists of five commissioners and acting as a group, they are the final arbiter of its overall policy.

The SEC's Division of Enforcement is responsible for the investigation of all suspected securities laws violations. Once it has been ascertained that a violation has been committed, the result may be in the form of Securities and Exchange judicial enforcement actions, reference to the Justice Department for criminal prosecution, or administrative sanctions imposed after a hearing. These actions may be taken against registered issuers, their officers and employees, registered broker/dealers, and members of exchanges or self-regulatory associations.

The Division of Corporation Finance has primary responsibility for examining all registration documents for compliance with the securities laws' disclosure requirements.

The Division of Market Regulations is devoted to regulatory practices and policies relating to the exchanges, the over-the-counter markets, and broker/dealers.

The Division of Investment Management is charged with handling the Securities and Exchange Commission's responsibilities under the Public Utility Holding Company Act of 1935.

There are also various important policy making offices below the five divisions. The office of the General Counsel is charged with the responsibility of advising both the Securities and Exchange Commission and all of its divisions on questions of law. It also represents the Securities and Exchange Commission in litigation, both at the trial and appellate court levels, and is instrumental in preparing commission sponsored legislation. The Chief Economist and Directorate of Economic and Policy Analysis are in charge of generating various economic studies used by the Securities and Exchange Commission and its divisions. The office of Policy Planning formerly had the task of coordinating the Securities and Exchange Commission's long term goals.

The next level of commission hierarchy contains the offices that handle the day-to-day operation of the Securities and Exchange Commission's activities: administrative services, controller, data processing, personnel, public information, records, and registrations and reports.

Under the direct supervision of the Executive Director, who is the Chairman of Securities and Exchange Commission, are the nine regional offices. Along with the branches that exist in some of the business regions, they carry out the work of the Securities and Exchange Commission on a regional level and working closely with attorneys, prepare disclosure documents to be filed within the U.S., the Securities Commission in China has not the Securities and Exchange Commission.[62]

Compared to the Securities and Exchange Commission established a mature hierarchy. As stated in Charter II, the State Council Securities Commission can be regarded as a national executive agent in charge of securities business in China, but the inside structure of the agents very weak.

---

[62]. Thomas Lee Hazen, *The Law of Securities Regulations*, second edition (West Publishing, Oct. 1994)

The securities regulations have not clarified as to how many divisions and offices there are under the Securities Commission and what are the major responsibilities of different divisions and officers. At present, only Shanghai and Shenzhen have established local securities commissions, but the relationship between local securities commissions and the State Council Securities Commission is still ill-defined. Because the structure of the Securities Commission is still a gray area in current securities regulations in China, the Securities Commission in China cannot play a role as important as its counterpart does in the U.S.[63]

For example, the US Securities Commission has important authority, not only in organizing the issuance and trading of securities, but also the registration of securities companies. In contrast, the State Council Securities Commission controls only the issuance and trading of securities. The matter of how to establish a securities company is presently determined by the People's Bank of China. In other words, although the People's Bank of China has transferred its authority with respect to securities business to the State Council Securities Commission, it still plays an important role in securities business.

---

[63]. The State Council Securities Commission is a department of the State Council. It is therefore one of the executive agencies. Its difference from other departments of the State Council is that its authority concentrates on the nation's securities business.

The differences between the regulatory authorities of China and the U.S. result in part from the different financial systems that the two countries have.

The economic system in America is free-market economy. Under the economic system, large or small firms raise funds for productive activities and services in the money market and capital markets. Banks, the state and local government, non-bank financial institutions, firms and individuals may act as both borrowers or lenders in the market.[64] To protect the interests of participants and promote healthy operations of markets, extensive regulations and laws were promulgated and the regulatory authority was created for enforcing these regulations and administering securities market.[65]

China maintained a strict centralized planning economic system before 1978. Under the system, an enterprise could only open accounts with and borrow from a single bank. The function of the bank was to allocate money to enterprises according to the state budgetary appropriation plan.[66] Since economic reforms began, however, significant progress has been made in the development of the banking and financial system. The important changes are the establishment of securities markets and transformation of

---

[64]. Kanfuman, *The U.S. Financial Institutions, Markets and Economic Activity* (1982).

[65]. 15. U.S.C. Sec. 78d (1981).

[66]. Liu Hongru, supra note 6.

banks from bookkeepers to independent financial institutions.[67] At present, banks still bear the task to extend credit to their customers under the state plan, although to a lesser extent. Because of the history and current role, the bank maintains a special position in securities markets.

B. Securities Market

It is clear that there are some fundamental differences between the Chinese securities market and American securities market with respect to each of the elements constituting the market.

1. Securities Exchanges

Besides the two major stock exchanges--the New York Stock Exchange and the American Stock Exchange, there are also eight regional exchanges which at one time only traded secondary stocks and provided regional trading for New York and American Exchange listed securities.[68] The eight regional exchanges are: the Boston Stock Exchange, Chicago Board Options Exchange, Cincinnati Stock Exchange, Intermountain Stock Exchange, Midwest Stock Exchange, Pacific Stock

---

[67]. Id.

[68]. J. Walter, *The Role of the Regional Securities Exchanges* (1958).

Exchange, Spokane Stock Exchange, and Philadelphia Stock Exchange.

In China there are at present only two exchanges--the Shanghai Stock Exchange and Shenzhen Stock Exchange. Because China is a very large country, the imperative to establish new exchanges becomes stronger and stronger. To meet such demands, China has established a national market system with automated quotations and a single tape reflecting all transactions and volume, whether or not the transactions are made in Shanghai and Shenzhen. Whether or not to establish new stock exchanges in China depends on the development of the securities business.

2. Securities

As in the U.S.A., there are stocks, bonds and options in China's securities markets. The difference is that there are only two classes stocks in China at present: A stocks and B stocks.

The difference between the two stocks is related to the types of investors they respectively cater to: A stocks can only be held by Chinese investors whereas B stocks can only be held by foreigners or overseas Chinese.

Compare to A stocks, B stocks are not openly welcomed in the market. A shares are usually trading at a much high P/E ratio than their B counterparts. For example, on March 19, 1993, on the Shanghai securities market, the price of B shares is 72% of the price of their A counterparts.[69]

There are also some special problems related to B stocks with respect to securities regulations in China which have no US counterparts.

a. Exchange control over currency conversion

The official Chinese currency, Reminbi is not freely convertible. The exchange rate of Reminbi against foreign currencies is regulated and published daily by the State Administration of Exchange Control (SAEC). Because the companies that issue B stocks are required to have adequate foreign exchange earnings, dividends and distributions made by the issuers of B stocks will generally be made in foreign exchange out of the issuers' foreign exchange earnings. It is possible, however, that there may be times when the companies' foreign exchange income will not be sufficient for paying B share dividends and for distributions. Under such circumstances, the companies will have to supplement their foreign exchange income by converting RMB income into foreign currency at the Foreign Exchange Adjustment Centers, commonly known as 'swap markets'. These adjustment centers provide an official market where foreign invested enterprises may, under the supervision and control of SAEC and its branch offices, engage in mutual adjustment of their foreign exchange surpluses and shortfalls. More recently,

---

[69]. Standard & Chartered Securities Research Limited, <u>Read Stars over China</u>, p.27.

regulations have been made to allow Chinese state enterprises and individuals to participate in foreign exchange swap transactions. Trading of RMB and foreign currencies at the swap centers is conducted at rates determined by supply and demand and not at an official exchange rate. The turnover at the various swap centers reached U.S.dollars 20.4 billion in 1991, an increase of 65 per cent over that of 1990.[70]

b. Repatriation of capital and remittance of profits

Dividends from B shares and proceeds from sale of B shares may be freely remitted outside China, subject to payment of tax and completion of the requisite formalities. There is no legal requirement of a lock-in period for investment in B shares.

c. Tax treatment

Under the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, dividends received by a foreign enterprise with no operations in China or by a foreign individual will be subject to tax at a rate of 20 per cent. This tax on dividends is exempt if the payer is an enterprise with foreign investment. Pursuant to the relevant regulations issued by the Chinese Government, dividends received by foreign investors from companies qualifying as enterprises

---

[70]. *China Economic News*, No 32, 1992, p13.

with foreign investment such as Sino-foreign joint ventures will be exempted from income tax. Dividends received by foreign investors from their investment in companies not qualifying as such but which are located in Shanghai and Shenzhen as well as other eligible cities and regions will be subject to a 10 per cent tax. Currently, almost all Chinese companies issuing B stocks are based in Shanghai and Shenzhen, and most, if not all companies, that issue B stocks, will qualify as foreign invested enterprises.[71]

Although current Chinese tax law does not explicitly provide for taxation of capital gains, any capital gains realized from the sale of B shares by foreign investors with no established presence in the China will likely be treated as Chinese source income and will generally be subject to a 20 per cent tax. However, since B shares in a Chinese company are a new form of investment made available to foreign investors, there is no precedence on the taxation of gains realized by foreign investors in B stocks. Given the Chinese government's policy of seeking to attract foreign investment, it is possible that the Chinese tax authorities may decide to grant further tax reductions or exemptions to B stocks investors.

---

[71]. The Income Tax Law of the PRC on Enterprises with Foreign Investment and Foreign Enterprises, Art 19.

3. Broker/dealers

The regulations on broker/dealers--the market makers--is an important part of the securities law of the United States.[72] Chinese securities regulations do not use such terms as "broker" or "dealer", because there are no brokers or dealers as defined in the American securities regulations in China at present. Since securities companies play a role as broker or dealer in Chinese securities markets, so the regulations related to securities companies can be regarded as the regulations on brokers or dealers.

The definition of a broker/dealer in America's securities law is stated as follows: A broker is "any person engaged in the business of effecting transactions in securities for the account of others";[73] a dealer is "any person engaged in the business of buying and selling securities for his own account through a broker or otherwise".[74] The distinction between brokers and dealers is that brokers do not buy and sell assets for their own account. There is no definition of securities companies in China's securities regulations, but the scope of securities business includes buying and selling of securities on one's own, acting as an agent for buying and selling of securities, engaging in other business related to

---

[72]. 15 U.S.C.E. Sec. 78o, 78k, 78s (1981).

[73]. 15 U.S.C. Sec. 78c (1981).

[74]. Id.

securities. The lines of business are similar to the business of the broker/dealers.

According to America's securities law, all broker/dealers must register with the Securities and Exchange Commission,[75] and must also register with the state securities commission in the states in which they operate.[76]

Securities companies in China must apply to a regulatory authority for the right to operate and can engage in the securities business after approval according to Chinese securities regulations.[77]

Both China's and America's securities regulations contain provisions that establish net capital requirements for broker/dealers. The broker/dealer engaged in a general securities business must have a minimum net capital for each security in which they make a market.[78] Securities companies in China must have the required capital in the form of actual currency on account or working capital in a separate account that can be used in the concurrent operation of securities business.[79]

According to American securities regulations broker/dealers are subject to the fraud provisions and

---

[75]. 15 U.S.C. Sec. 78o(a)(1) (1981).

[76]. 15 U.S.C. Sec. 15 (b)(4) (1981).

[77]. Shanghai Securities Regulations, supra note 42, Art 41.

[78]. 17 C.F.R. Sec. 15c3-1 (9) (1991).

[79]. Shanghai Securities Regulations, supra note 44, Art 51-54.

inside trading provisions applicable to the purchase and sale of securities. Broker/dealers have special responsibilities to maintain and enforce procedures to prevent unlawful trading based on inside information by their employees.[80] According to Chinese Securities regulations, securities companies have the same obligations as broker/dealers do in the U.S..[81]

4. Securities Activities

Securities activities include issuance and trading of securities. Because the major goal of securities regulations is to protect the investors, the disclosure system is an important part in the regulations related to the securities activities.

American securities regulations implement a disclosure system through three forms: Forms-1, Forms-2, and Forms-3.

Forms-1 requires complete disclosure in the prospectus and permits no incorporation by reference. Forms-1 is to be used by registrants in the Exchange Act reporting system for less than three years and also may be used by any registrants who choose to do so or for whom no other form is available.

---

[80]. 40 S.E.C. Sec. 907 (1961).

[81]. Shanghai Securities Regulations, supra note 44, Art 51-54.

Forms-2 combines reliance on incorporating Exchange Act reports by reference with delivery to investors of streamlined information. Forms-2 allows the issuers to choose between the following options: to deliver a copy of their annual report to security holders along with the prospectus describing the offering or to present registrant-oriented information comparable to that of the annual report in the prospectus along with the description of the offering.

Forms-3, in reliance on an efficient market theory, allows maximum use of incorporation by reference of Exchange Act reports and requires the last disclosure to be presented in the prospectus and delivered to investors. Generally, the Forms-3 prospectus will present the same transaction-specific information as will be presented in a Forms-1 or Forms-2 prospectus. Information concerning the registrant will be incorporated by reference from Exchange Act reports. The prospectus will not be required to present any information concerning the registrant unless there has been a material change in the registrant's affairs which has not been reported in an Exchange Act filing or the Exchange Act report incorporated by reference do not reflect certain restated financial statements or other financial information incorporated by reference do not reflect certain restated financial statements or other financial information.

At present, there are no standard forms for disclosing necessary information by the issuers to the investors in Chinese securities regulations, but three documents play the same roles as forms in the U.S.[82]

a. Prospectus

As stated above, the prospectus must include all basic information about the issuer so that the investor can have a general idea about the issuer and decide whether to buy the stocks or not.

The basic information about the issuer must be true and any wrong information will not be accepted.

b. Financial report

After the issuer is registered with the Securities Commission and his stocks are listed in Securities Exchange, the issuer should submit mid-term and term-end financial reports for disclosing streamlined information to the investors. The financial reports include the following information: the financial situation of the issuer; the major businesses of the issuer; the background of directors, supervisors and senior management; the number of shareholders and the name of big shareholders.[83]

Financial reports should be submitted to the state or local securities commission and securities exchanges. All of the information should be published in the newspaper designated by the state or local securities commission.

---

[82]. Loss, *Fundamentals of Securities Regulation*, (Little, 1983) pp.151-153.

[83]. Id.

c. Events reports

Events reports should be submitted to the state or local securities commission and securities exchange within 15 days after one or more the following events have occurred:

A contract or an agreement which greatly affects the assets, liabilities, the rights and interests of the shareholders;

An important change;

A policy on important or longer term investment;

Serious liabilities or losses;

Heavy losses in the enterprise's assets;

Great change in the production and operation environment;

A change of personnel on the board of directors or on the senior administrative personnel;

Changes to shareholders who own over 5% of the total amount of shares or to the members of the board of directors or to senior administrative personnel who are holding shares of the company;

The company takes part in a major legal action;

An important decision on mergers or acquisition;

The company has started to be liquidated or to undergo a rectification due to bankruptcy.[84]

---

[84]. Id.

According to Chinese securities regulations, the following information can be exempted from disclosure:

Business secrets protected by laws or regulations;

Non-open information received by the state or local securities commission during investigations.[85]

5. Violations and Remedies

Activities that violate the securities regulations, subject to a wide variety of liabilities and remedies in both China and America.

Like US securities regulations, Chinese securities regulations list four kinds violations: misstatement, fraud, inside trading and control market.

a. Misstatement

Similar to·section 11(a) of the US Securities Act of 1933, Chinese securities regulations create an express right of action for securities purchasers when the documents related to the securities contain untrue statements of material fact or omission of material fact. The documents which may embody such a misstatement include: prospectus, financial reports, comptroller's reports, evaluating reports and legal opinions.

The persons and entities which may be liable for misstatement include the following: the issuers, securities companies, accounting firms, law firms, assets evaluating

---

[85]. The Provisional Regulations, supra note 33, Art 64.

agencies, and other self-regulatory organizations which made or signed the documents.[86]

The provisions on misstatement in securities regulations play the same role as in the U.S.--to protect investors. they also make it clear how the investors may take an action against the issuer according to the provision and whether the issuer can raise some defenses. This corresponds to section 12(2) of the Securities Act of 1933, which provides the buyer must show that he did not know about the statement of untruth or omission, and gives the seller a defense, if he can sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of such untruth or omission.

With respect to the misstatement, the Securities Commission has authority to investigate the kind of activities and give executive punishment. Although the Securities Commission has not authority to give criminal punishment, the Securities Commission thinks criminal punishment is necessary, it can make such suggestions to the respective government department or to a Court.

b. Inside trading

According to Chinese securities regulations, two kinds of activities are regarded as inside trading:

---

[86]. Interim Regulations for Forbidden Cheating in Securities Activities (hereafter Forbidden Cheating), promulgated by the SCSC on Sep. 2, 1993, Art 12.

Inside persons who buy or sell or suggest that others buy or sell according to inside information;

Non-inside persons get inside information via illegal ways and buy or sell or suggest that others buy or sell securities according to the information.

To inside persons, Chinese securities regulations adopt the "special fact" doctrine in American securities regulations and make it clear that inside persons mean the persons who can contact or get inside information through holding shares, taking positions as directors, supervisors, high managers, or working as professional persons, or working as an employee. It does not matter whether the insider actually received the information, or utilized it. His mere status makes him liable.[87]

Inside information means important information which has been known by inside persons, which cannot be published and may influence the price on the securities market. This information includes the following:

Information relating to the government's activities;

Information relating to the authorities of the issuer;

Information relating to the liability of the issuer;

Information relating to the business activities of the issuer;

---

[87]. Id., Art 4.

Information relating to the shares.[88]

The liability for inside trading is the same as that of misstatement.

c. Fraud

The principal tool against fraud in American securities is rule 10b-5. The Rule bars, "in connection with the purchase or sale of any securities", any use of an instrumentality of interstate commerce: a. to employ any device, scheme or artifice to defraud; b. to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or not to engage in any act, practice or course of business which operate or would operate as a fraud or deceit upon any person.[89]

According to this rule, fraud includes two basic elements: connection with purchase or sale securities and material misstatement.

Because it is little different how to explain and understand fraud in China comparing to the U.S.A. Chinese securities regulations on fraud have two differences from the rule 10b-5:

---

[88]. Forbidden Cheating, supra note 86, Art 5.

[89]. Cox, Hillman, *Langevoort Securities Regulation,* (Little, Brown and Company, 1991), p.717.

Only the issuers and securities companies can be defendants;[90]

The fraud activities include not only misstatement but also any other activities against the will of client, and they bring damage to the client.

Securities regulations list several fraud activities: if a securities company which works as a broker buys or sells securities against the will of trustor or does not offer the certificate of buying or selling to the trustor within the fixed period, the securities company is engaged in trading fraud; if the securities company buys or sells securities by itself and at the same time works as a broker, it must separate its business from the broker's business, otherwise the company will be regarded as having "mixed agency business with operating its business" which is a serious fraud activity; and if the issuer sells the securities to the buy without offering a prospectus or other documents, the issuer is acting fraudulent.[91]

As to the fraud, the Securities Commission can investigate and punish the fraudulent activities by using executive authority, if it thinks the other punishments are necessary, it can suggest that the Court or other Government Department criminally punish the issuer or securities company executives.

---

[90]. Forbidden Cheating, supra note 86, Art 10.

[91]. Id., Art 12.

d. Market control

Activities of market control include:

To control the price of a security on the securities market by reaching an agreement or other contract;

To influence the issuance or trading of securities by spreading rumor;

To buy or sell securities without changing the ownership in order to establish a false price;

To sell or offer to sell the securities which are not in fact held by the seller;

To trade continuously one security in order to increase or decrease the price of such a security;

To increase or decrease the price of securities by taking advantage of the position.

Market control will result in warning, confiscation, fine and suspension or stopping of the securities business.[92]

e. Suspending and de-listing securities

According to the Shanghai Securities Exchange, the state or local securities commissions may, upon the occurrence of any of the events set out below, require that trading in the securities of a listed issuer be suspended:

Any material reorganization or any material change in the listed issuer so that the listed issuer no longer meets listing requirement;

Any failure by the listed issuer to comply with disclosure requirements imposed by law or/and inaccuracy in

[92]. Id., Art 7-8.

any financial report or other documents submitted to the state or local securities commissions;

Any damage to the public interest arising as a result of any act of any member of the board of directors or the supervisory committee or any management member of the listed issuer, or as a result of any act of any shareholder whose shareholding is more than 5% of the total registered capital of the listed issuer;

The average monthly trading volume in the shares of the listed issuer in the immediate preceding year is less than 100 shares or there is no trading of the shares of the listed issuer in the immediately preceding three months;

Continuous loss in the immediately preceding two years;

Liquidation of the listed issuer;

Suspension of business with banks as a result of problems in connection with the financial creditability of the listed issuer;

Non-payment of listing fee in any quarter period and any other reason for trading to be suspended.

The state or local securities commissions may, upon the occurrence of any of the events set out below with the approval of the supervisory authority, de-list the securities of a listed issuer:

The occurrence of any of the events giving the state or local securities commissions to suspend the trading of the securities of the listed issuer, and serious consequence have arisen as a result of such event;

The listed issuer fails to take remedial action after the occurrence of an event giving the state or local securities commissions the right to suspend the trading;

Dissolution or liquidation of the listed issuer or any other reason for de-listing.

CHAPTER 4

CONCLUSION

The United States is one of the most developed countries and has assumed a principal role in the leadership of the free world and the primary responsibility for rebuilding the world economy since the end of World War II.[93] Although the United States is facing grave economic problems, it is still playing an important role in the world economy. The financial markets and institutions are critical elements of the American economy. They contribute almost 15% of the total market value of new goods and services produced each year.[94]

Securities regulations in America began around the turn of the century. During drafting of the Securities Act, the United States used in great part as a model for generations of state regulations and several centuries of legislation found in England. With the expansion of securities industry, the United States amended its securities regulations in light of developments in

---

[93]. Sick, *The United States and the World Economy*, (Foreign Affairs, 1987).

[94]. Haufman, *The U.S Financial System* (1983).

securities activities. Although securities regulations in America are not necessarily universally applicable, many of the provisions can be used as a guide in different in countries seeking to regulate securities activities, because the general problems in the securities industry are identical to a large extent.[95]

The fact that China's securities regulations share many features with America's regulations shows that although the securities regulations have only been in existence for several years, China has done her best to learn from the developed legal securities system of other countries and to make her securities industry conform with the general practices in the world.

In conclusion, the reemergence of the securities market and industry is the logical outcome of China's economic reform and ideological liberation that have been going on since 1978. After overcoming initial difficulties in the first two stages of development, the securities markets, industry and associated regulations are moving toward comprehensivness and maturity. From the opening of the first securities market in Shenyang in 1986 to the successful issuance of B shares in Shanghai in 1992, the pace of development of securities in China has been fast.

There are, however, good reasons to pursue this development more cautiously at the present time since hasty

---

[95]. Id.

efforts to expand are likely to be detrimental to its healthy growth in the long run. After all, the scope and pace of the future development of securities markets will depend on reforms in China. For example, without the necessary price reform, it is almost impossible to assess accurately the performance of an enterprise. Thus its shares will not reflect their real market values. In the absence of further financial reforms, the regulatory mechanism for the securities market and industry will not be effective, and the market will be plagued by distortions. Under these circumstances, the regulatory regimes currently in place or to be introduced in the near future will not be able to overcome their tentative, provisional characteristics, reflecting the current status of China--a large developing country with a socialist ideology undergoing a period of profound reform and transformation.