The People's Republic of China (PRC) is no longer a sleeping economic dragon. China's move toward a more open market economy has unlocked the nation's immense economic potential, spurring dizzying growth rates. For the past two years the PRC's economy has grown at the staggering rate of 13% per annum, and projections are only slightly less impressive for 1994. China's emphasis on exporting has led to dramatically increased trade and has resulted in trade surpluses with the outside world, particularly with the West.

Fueling this enormous growth has been the infusion of sorely needed capital into the Chinese economy through the PRC's fledgling capital markets. In an effort to tap the estimated $310 billion in savings held by Chinese citizens, the Chinese government opened the country's first national capital markets.

By comparison, the United States, in the midst of an economic recovery, has posted relatively modest gains of 3.5-4% Gross Domestic Product (GDP) growth in the past year. Neville Nankivell, *A Modest Growth Forecast for the Global Economy*, FIN. POST, Sept. 22, 1994, at 11. The rapid growth of China's GDP has led to inflationary pressures in recent months. For the twelve months ending in August 1994, the PRC's Consumer Price Index rose by 25.8%. Tony Walker, *Beijing's Leadership, Panicked By Inflation, Has Brought Back Price Controls*, FIN. TIMES, Sept. 22, 1994, at 5. Inflationary fears prompted the PRC to take action to slow GDP growth in 1994 to a level of 9%.

A clear example of this is China's trade surplus with the United States, which stood at $23 billion dollars at the end of 1993, and is still growing. Barnathan, *supra* note 1, at 43. China is second only to Japan in the size of its trade surplus with the United States. Currently the United States' trade deficit with Japan hovers around $60 billion. *Trade Figures Support Diversity of U.S. Exports Illustrated By Success Stories*, BUS. AM., June 1994, at 32.

The amount of money flooding these markets and thereby filling the coffers of Chinese firms has been impressive from the outset. As early as June 1992, more than 360,000 individuals had bought shares on the Shenzhen exchange alone. The trading volume on the two national equities exchanges is well over $1 billion, and it is estimated that Chinese citizens were holding debt instruments with a value of over $12 billion as of 1992. Orville Schell & Todd Lapin, *China Plays the Market: Capitalist Leap*, NATION, Dec. 14, 1992, at 734.
stock exchange in Shanghai on December 19, 1990. The opening of the Shanghai Securities Exchange was soon followed by the official recognition of the Shenzhen Stock Exchange, which opened its doors to investors on July 3, 1991. The PRC went further in its effort to attract capital in December 1991, when the government allowed the first “B shares” to be offered at the Shenzhen Exchange to foreign investors.

The markets have been quite successful in obtaining investment capital for China’s economy. However, fraud and corruption have plagued the markets, leading Chinese officials to admit candidly that the markets are among the most risky in the world. The lack of a national framework for the regulation of equities trading is largely to blame for the problems besetting the Shanghai and Shenzhen Exchanges.

The disjointed nature of the markets’ early development was caused primarily by the central government’s initial administrative policy concerning the national exchanges. In an effort to combat problems of fraud and corruption and gain some manner of centralized control over this experiment with capital markets, the PRC’s State Council enacted the Interim Regula-

---

6 Currently the PRC has two basic forms of stock. Shares of stock which are available to domestic investors are known as “A shares” and are traded on both exchanges. Foreign investors may not trade in a corporation’s “A shares” but may only invest in corporations offering governmentally approved and listed “B shares.” Issuance of “B shares” is restricted to foreign investors. Jia Zhao, *Trading Stocks in China: Regulation, Development, Issues and Prospects*, E. ASIAN EXEC. REP., June 15, 1992, available in LEXIS, News Library, Curnws File.
7 This year the Shanghai exchange plans to issue new offerings which will raise approximately $230 million in capital for local companies. Pete Engardio et al., *Bears on a Rampage in China*, BUS. WK., July 11, 1994, at 28.
9 Beginning in January 1994, both the Shenzhen and Shanghai markets have dropped significantly. As of July 1994, the Shanghai exchange was down by over 60% and volumes had fallen dramatically. The Shenzhen exchange has experienced a similar cooling effect. A major contributing factor to this decline has been the loss of investor confidence stemming from fraud and abuses on the exchanges. Engardio et al., *supra* note 7, at 28.
tions on the Issue and Trading of Shares on April 22, 1993. These interim regulations are the first major attempt by the PRC to create a national securities policy. They will likely serve as the legal skeleton upon which the finalized regulations will be based.

II. DEVELOPMENT OF EXCHANGE RULES

A. Shenzhen and Shanghai Measures

The Shenzhen and Shanghai exchanges are an outgrowth of sustained efforts to liberalize the Chinese economy first introduced by Chairman Deng Xiaopeng in 1979. The initiatives sought to create greater productivity on the part of state-owned enterprises by stimulating corporate investment. Previously, capital had been available only through central government appropriations and tightly controlled loans issued by the state-controlled People's Bank of China (PBOC). The restrictive nature of lending regulations not only made it difficult for companies to acquire adequate financing, but also allowed the government to assume a strong role in the determination of how capital could be employed once it had been issued. The lending policies of the PBOC had the most dramatic effect on smaller firms.

In order to relax the strangle hold on investment capital, the PRC experimented with the issuance of corporate stock to employees of collective enterprises in the early 1980s. The State Council formally recognized this

---

12 Fairlamb, *supra* note 10, at 35. Since the early 1980s, the leadership of the PRC, under the influence of Chinese economists, has developed new theories regarding the issuance and ownership of stock, relying on Marxist notions that stock companies are a form of capital ownership by the organized working class. See Harry Zheng, *Securities Regulation in China: Development and Conflicts*, EAST ASIAN EXEC. REP., May 15, 1987, available in LEXIS, News Library, Cumws File.
13 Bersani, *supra* note 4, at 304.
15 An astounding example of this control is that of a stock company in Beijing which was forced to obtain government approval for a capital outlay of 50 yuan, which at that time equaled roughly $15. *Id.*
16 *Id.*
17 *Id.*
policy in 1983.\textsuperscript{18} The State Council also sanctioned the reorganization of state-owned enterprises into shareholding entities, which in 1986 led to the first major public issue of shares by a state-owned entity.\textsuperscript{19}

The dramatic effects of the reforms were demonstrated by the overnight emergence of regional stock exchanges in the Chinese Provinces.\textsuperscript{20} The first exchange opened in Shenyang on August 5, 1986.\textsuperscript{21} The establishment of over-the-counter markets in Shanghai, Tianjin, Chongqing, Beijing, Wuhan, and Guangzhou soon followed.\textsuperscript{22}

In an attempt to gain some manner of centralized control over the spreading wave of stock issues, the State Council released a directive in March 1987 specifically prohibiting state-owned enterprises from offering shares to the general public.\textsuperscript{23} This had little negative impact on the overall drive toward market development, as the benefits of stock companies were becoming increasingly clearer and more state-owned enterprises sought reorganization.\textsuperscript{24} Prior to the official recognition of the national markets in Shanghai and Shenzhen, innumerable curbside markets sprang up across the country, with trading occurring in both publicly issued and internal shares.\textsuperscript{25} The PBOC, established as the PRC's central bank in 1983, was

\textsuperscript{18} Id.

\textsuperscript{19} Zhao, supra note 6. The state remained the largest shareholder in these reorganized companies. The State Council hoped to stimulate effective management by reducing daily government influence in operations, and to boost employee morale and productivity through limited employee ownership, while not significantly divesting the state of its assets. The first such company to issue shares was Shenyang Jinbei Auto Industrial Shareholding Corporation. Zheng, supra note 12.

\textsuperscript{20} Id.

\textsuperscript{21} Id.

\textsuperscript{22} Id.

\textsuperscript{23} See Zheng, supra note 12 (describing Directive of the State Council on Reinforcement of Administration on Stocks and Bonds, promulgated March 28, 1987). The 1987 Directive allowed companies to continue to use stock in three instances. First, collective enterprises could use stock subject to the supervision and control of the government. Second, state-owned enterprises, which had been allowed to issue shares prior to the promulgation of the Directive, could continue to issue shares upon approval from the PBOC. Third, the Directive permitted horizontal investment between enterprises which would not result in public issue. Id.

\textsuperscript{24} Importantly, the 1987 Directive did not explicitly prohibit the issuance of stock by reorganized state-owned shareholding companies. This gave entities that had previously experimented with raising capital through issuing shares to employees a loophole to pursue eventual public issuance of shares. Zhao, supra note 6.

\textsuperscript{25} Fairlamb, supra note 10, at 35.
delegated the task of regulating these regional exchanges. The PBOC’s regulatory scheme allowed decentralized regulation of the regional exchanges by the corresponding regional branches of the bank. Naturally, this led to a wide variety of regulatory formats across the various markets. The regional nature of these emerging markets and the decentralized regulatory framework of the PBOC have destabilized the growth and maturation of the two national stock markets.

A fundamental problem posed by the PBOC’s control of the national exchanges was the potential conflict of interest created by having the markets supervised by the PRC’s largest bank and lending institution. The potential for mismanagement increased as the PBOC saw its deposits dwindle, due in part to negative real interest rates and the attractive returns offered in the marketplace.

The fact that central bank regulators simply did not work well together compounded this problem. In keeping with its policy of local bank control, the Shanghai branch of the PBOC regulated the Shanghai Exchange with little or no regard for the way the Shenzhen branch oversaw Shenzhen’s market. This lack of cooperation resulted in widely divergent regulatory schemes. Both the Measures of Shanghai Municipality for Administration

---

26 Zheng, supra note 12. The PBOC was authorized to regulate stocks, bonds, and negotiable instruments, and to administer the PRC’s financial markets under Article 5, §11, of the Interim Regulations of Banks of 1986. Id.

27 Fairlamb, supra note 10, at 38-39.

28 Id. at 39.

29 Id. at 38-39.

30 Simon Holberton, Impasse or Impetus on the Road to Reform: Riots in Southern China Pose a Dilemma for the Leadership’s Programme of Liberalisation, FIN. TIMES, Aug. 12, 1992, at 17.

31 Id. This problem still persists due to high levels of inflation. In order to curb inflation, the PRC has undertaken a policy of raising PBOC interest rates on long-term deposits to take money out of the economy. The success of this program is dubious, as the PBOC’s rates, which are 17.64% for eight-year deposits, are still less than the annual inflation rate. China Boosts Savings Subsidy Rate Amid Soaring Inflation, AGENCE FRANCE PRESSE, September 18, 1994, available in LEXIS, News Library, Curnws File [hereinafter China Boosts Savings Subsidy Rate].

32 See Fairlamb, supra note 10, at 38.

33 Id. at 39.

34 See generally Zhao, supra note 6.
of the Trading of Securities ("Shanghai Measures")\textsuperscript{35} and the Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares ("Shenzhen Measures")\textsuperscript{36} developed a distinctly regional flair which existed largely unreformed until the issuance of the Interim Regulations of April 22, 1993.\textsuperscript{37}

1. Stock Issuance

Working under the broad strokes of the 1987 Directive, the local PBOC branches carved out individual requirements for companies in their provinces seeking to issue stock.\textsuperscript{38} The Shenzhen Measures required that companies wishing to issue shares be granted shareholding status under the 1987 Directive, whether the company sought to engage in public or internal issuance or merely private placement.\textsuperscript{39} Shanghai developed two sets of requirements for applicants planning to issue shares. Collective enterprises desiring capital for fixed asset investment were required to file the company's articles, a prospectus, the underwriting contract, and an approval for the capital investment with the local branch of the PBOC.\textsuperscript{40} State-owned enterprises carried the additional burden of providing a certificate of approval for reorganization into a stock holding company indicating the promoters' subscription for no less than 30% of the shares and an appraisal of its assets.\textsuperscript{41}

The requirements for the application for consideration for public issuance of shares, as opposed to internal shares and private placement of shares, also developed along divergent lines in the two regions. The Shenzhen Measures required applicants to have strong financial performance and assets with a net book value of at least 10 million yuan, of which net tangible assets

\textsuperscript{35} Provisional Measures of Shanghai Municipality for Administration of the Issue and Trading of Shares, promulgated by the Shanghai Municipality, Nov. 27, 1990 (discussed in Zhao, supra note 6) [hereinafter Shanghai Measures].

\textsuperscript{36} Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares, promulgated by the City Government of Shenzhen, May 15, 1991 (discussed in Zhao, supra note 6) [hereinafter Shenzhen Measures].

\textsuperscript{37} See Zhao, supra note 6.

\textsuperscript{38} Id.

\textsuperscript{39} Shenzhen Measures, supra note 36, at arts. 5, 14-15.

\textsuperscript{40} Shanghai Measures, supra note 35, at art. 9.

\textsuperscript{41} Id. at art. 10.
PRC's Stock Market

constituted no less than 25\%.\textsuperscript{42} Furthermore, the promoters' subscription was required to comprise at least 35\% of the total share capital and be valued greater than 5 million yuan.\textsuperscript{43} The Shenzhen Measures also required at least 800 identifiable shareholders, while at least 25\% of the equity had to be held by non-identifiable holders.\textsuperscript{44}

In order to list for trading on the Shenzhen Exchange, an approved issuer was required to have engaged in profitable operations for at least three years, with a net return on capital of at least 8\% in the first two years and a net return of no less than 10\% in the third year.\textsuperscript{45} In addition, the company's shares had to be dispersed among at least 1,000 shareholders, of which over 25\% could own a stake of no more than 0.5\% of the firm's total equity.\textsuperscript{46}

While protecting the investor and lending stability to the market, these requirements made it extremely difficult for small and medium-sized companies to issue and list shares for public trading on the Shenzhen Exchange.\textsuperscript{47}

Conversely, the Shanghai Exchange developed less stringent public issuance guidelines and fewer specific requirements for an issuing company's prospectus.\textsuperscript{48} Absent the rigid guidelines of the Shenzhen exchange, approval of the right to issue shares publicly was left to the total discretion of the local PBOC authorities.\textsuperscript{49}

The Shanghai Exchange's listing requirements were more advantageous for firms seeking to list their shares. Once a company received authorization to issue shares publicly, it had only to show (1) a positive book balance for the previous two years, (2) 1,000 yuan in paid-in capital,\textsuperscript{50} (3) at least 10\% public ownership, and (4) at least 300 identifiable shareholders in order to

\textsuperscript{42} Shenzhen Measures, supra note 36, at art. 15. The net book value requirement of 10 million yuan is the equivalent of $1,162,290 at current exchange rates of 8.6037 yuan/dollar. See China Boosts Savings Subsidy Rate, supra note 31.

\textsuperscript{43} Shenzhen Measures, supra note 36, at art. 15.

\textsuperscript{44} Id.

\textsuperscript{45} Id. at art. 37.

\textsuperscript{46} Id.

\textsuperscript{47} Zhao, supra note 6.

\textsuperscript{48} Shanghai Measures, supra note 35, at arts. 9-10.

\textsuperscript{49} Zhao, supra note 6.

\textsuperscript{50} Paid-in capital is the element of shareholders' equity that normally results from cash or other assets invested in the firm. One thousand yuan is the equivalent of approximately $125. ROGER H. HERMANSON & JAMES DON EDWARDS, FINANCIAL ACCOUNTING 622 (5th ed. 1992).
list on the Shanghai Exchange.\textsuperscript{51} Compared to the much more rigorous Shenzhen Measures, these regulations were a boon to small and mid-sized corporations seeking to have their shares traded.\textsuperscript{52}

2. Disclosure Requirements

One of the major concerns arising from the creation of the national exchanges was the protection of investors from faulty financial disclosure by companies listing for trading on the exchanges.\textsuperscript{53} Issuing companies on both exchanges were bound to disclose all material facts necessary for investors to make informed decisions.\textsuperscript{54} The exchanges created penalties for issuers who misrepresented or omitted relevant financial data in their company's prospectus.\textsuperscript{55}

In Shenzhen, a violation of disclosure obligations was treated as a technical violation. Offending issuers were subject to the publication of a notice of criticism in the local newspaper, a fine of up to 10,000 yuan, or roughly $1,250, and a temporary stay of quoted trading in the company's stock.\textsuperscript{56} In the most egregious cases, the violating issuer could be arraigned for criminal proceedings.\textsuperscript{57}

The penalties for omitting or falsifying information on the prospectus in Shanghai were more severe than those established in Shenzhen. Under the Shanghai Measures, improper disclosure could result in fines as high as 200,000 yuan, or approximately $25,000.\textsuperscript{58} Issuers were also accountable for any damages incurred by any person who "acquired such securities in good faith."\textsuperscript{59} The Shanghai Measures, therefore, allowed individual shareholders to sue for restitution if they were misled by the financial disclosures of a corporation. The Shanghai Measures extended potential

\textsuperscript{52} Zhao, supra note 6.
\textsuperscript{53} Id. The disclosure requirements of the two exchanges covered most of the basic elements found in U.S. regulation S-K and Form 10-k. Id.
\textsuperscript{54} Id.
\textsuperscript{55} Id.
\textsuperscript{56} Shenzhen Measures, supra note 36, at art. 87.
\textsuperscript{57} Id.
\textsuperscript{58} Shanghai Measures, supra note 35, at art. 75(3).
\textsuperscript{59} Id. at art. 20.
personal liability to all managerial personnel, underwriters, and other professionals involved in the publication of the prospectus. Liability, however, was based upon actual knowledge by the individuals of the wrongdoing rather than mere negligence.

3. Insider Trading

Both markets established limited fiduciary duties for brokers under which they could only act with the explicit authorization of their clients. The role of the broker as advisor to an investor was greatly limited under the regulations of both exchanges, and blanket authorization for brokers to trade or establish margin accounts on behalf of a client was strictly forbidden.

The exchanges addressed the issue of insider trading by drafting limitations on who could purchase issued securities. The Shanghai Measures prohibited several classes of individuals from trading stock. These classes included personnel of the local PBOC authority, managerial personnel of the exchange, employees of a broker directly involved in the issuance or trading of shares, and employees of governmental agencies regulating stock issuers.

Shenzhen extended these restrictions to include "all cadres of the Party and the government instrumentalities and military servicemen on active duty." Shenzhen also prohibited trading in certain securities for set time periods. Shares issued to employees directly without underwriting could not be traded by their holders for one year. Further, the Shenzhen Measures prohibited members of the issuing corporation's board of directors from trading their shares during their tenure, and employee holders were restricted from trading their employer's shares in the month prior to the release of semiannual or annual financial statements. Individual holdings

---

60 Id.
61 Zhao, supra note 6.
62 Id.
64 Zhao, supra note 6.
65 Shenzhen Measures, supra note 36, at art. 29.
66 Id. at art. 16.
67 Id.
68 Id. at art. 41; Shenzhen Security Exchange Rules, supra note 51, at art. 205.
of securities were limited in Shenzhen to 50,000 yuan, or approximately $6,200.\(^6^9\)

**B. Interim Regulations**

The Shenzhen and Shanghai Measures, while moderately effective, were hampered by their lack of scope and cohesion. The decentralized regulation of the PBOC led to large scale abuses that threatened the legitimacy of the markets in the eyes of potential investors. One shocking example of the widespread fraud in the regional markets occurred in Shenzhen on August 10, 1992, when citizens rioted after a botched issue of share application forms.\(^7^0\) The riots prompted the State Council to take more control of the markets, leading to the removal of the PBOC from its regulatory function in October, 1992.\(^7^1\) The PBOC was replaced by the newly created State Council Securities Committee (SCSC) and the China Securities Regulatory Commission (CSRC).\(^7^2\) These bodies were responsible for the formation of a nationwide regulatory policy for the national markets in Shanghai and Shenzhen and the other informal exchanges which had emerged in cities across the PRC.\(^7^3\)

The SCSC responded on April 22, 1993, with the promulgation of the Interim Regulations on the Issue and Trading of Shares ("Regulations").\(^7^4\) The document legitimizes the SCSC and the CSRC as the central regulatory

---

\(^6^9\) Shenzhen Measures, supra note 36, at art. 29.

\(^7^0\) The riots proved to be the largest outbreak of civil unrest since the disastrous events in Tiananmen Square in 1989. The riots were sparked after Shenzhen officials allegedly rigged a share application offering by allowing insiders to acquire the opportunity to buy shares in the public issue unfairly. The original five million application forms were distributed by a number of official organizations, including the local police and Shenzhen city authorities. *China Seeks to Appease Investors After Shares Riot*, Reuters, Aug. 11, 1992, available in LEXIS, News Library, Reuters File.


\(^7^3\) The SCSC was created to shape policies for new securities regulations which were to be executed by the CSRC. *Id.*

agencies in charge of all issues and trading of shares in the PRC.\textsuperscript{75}

1. \textit{Stock Issuance}

A central component of the Regulations is the establishment of uniform controls over the public issuance of shares.\textsuperscript{76} In keeping with the guidelines established under the 1987 Directive, the Regulations stipulate that only limited-liability companies\textsuperscript{77} and state-owned companies authorized to reorganize as limited-liability companies may issue shares.\textsuperscript{78}

Under the Regulations, new enterprises established as limited-liability corporations must meet less stringent issuance requirements than formerly state-owned companies reorganized as limited-liability entities.\textsuperscript{79} Limited liability companies must meet the following conditions before being authorized to issue shares: the entity's operations must conform to the government's industrial policy; the promoter must buy at least 35\% of the shares issued; the value of the stock the promoter must purchase must be at least 30 million yuan, or roughly $3.7 million; and no less than 25\% of the stock must be sold to the public, while no more than 10\% of the issue can be sold to employees or managers of the corporation.\textsuperscript{80}

Reorganized state-owned enterprises must meet the above criteria as well the requirement that the company's net assets account for no less than 30\% of its total assets, with intangible assets accounting for no more than 20\% of net assets.\textsuperscript{81} These enterprises also must show net profits for three years, with the apportionment of shares between the public and the government determined on an ad hoc basis by the State Council of the PRC.\textsuperscript{82} These heightened requirements for reorganized state-owned companies are designed to preserve the value of state assets in the shift toward privatization, and to allow the state to retain a high degree of ownership and control.\textsuperscript{83}

\begin{flushleft}
\textsuperscript{75} \textit{Id.} at ch. 1, art. 5.  \\
\textsuperscript{76} \textit{Id.} at ch. 1, art. 2.  \\
\textsuperscript{77} Limited-liability companies are responsible to their creditors only to the extent of their assets. The shareholders are liable only to the extent of the shareholdings. \textit{See} Bersani, \textit{supra} note 4, at 309.  \\
\textsuperscript{78} \textit{Id.} at ch. 1, art. 7.  \\
\textsuperscript{79} \textit{See} \textit{Interim Regulations}, \textit{supra} note 74, at ch. 1, arts. 8, 9.  \\
\textsuperscript{80} \textit{Id.} at ch. 1, art. 8.  \\
\textsuperscript{81} \textit{Id.} at ch. 1, art. 9(1).  \\
\textsuperscript{82} \textit{Id.} at ch. 1, art. 9(2).  \\
\textsuperscript{83} Bersani, \textit{supra} note 4, at 305-06.
\end{flushleft}
The application for stock issuance can be submitted for approval only after the applicant has had its assets, credit, and financial position examined and evaluated by such "specialized organizations as accounting firms, asset evaluation organs and lawyer offices." Local limited-liability firms must then seek approval from their local governments, while reorganized state-owned companies must gain approval from the central government. All applications are subject to re-examination by the CSRC before final approval to make public stock offerings is awarded.

The Regulations further require that companies desiring to list shares on an exchange must have issued their shares publicly, resulting in no less than 50 million yuan ($6.25 million) in paid-in capital. This requirement significantly limits the ability of small firms to list on the national exchanges and results from the CSRC's displeasure with the much more lenient listing provisions previously found in the Shanghai Measures.

After the share issue, a minimum of 1,000 individuals must hold stock with a par value of no less than 1,000 yuan ($125), and the aggregate par value of all stock held by individuals must not be less than 10 million yuan ($1.25 million). Companies must also show a profit for each of the three years prior to application for listing. Again, in the interest of protecting individuals trading on the exchanges, the Regulations have opted for corporate performance requirements and shareholder diversity policies which more closely resemble those promoted under the Shenzhen Measures.

2. Disclosure Requirements

The Interim Regulations place a great deal of emphasis on the disclosure of financial information by listed corporations. All listed companies must submit semi-annual interim financial reports to the CSRC. Annual reports

---

84 Interim Regulations, supra note 74, at ch. 3, art. 12(1).
85 Id. at ch. 3, art. 12(2).
86 Id. at ch. 3, art. 12(3).
87 Id. at ch. 3, art. 30.
88 See Shanghai Securities Exchange Rules, supra note 63, at art. 34.
89 Id.
90 Id. at ch. 3, art. 30.
91 See Interim Measures, supra note 74, at ch. 6, arts. 57-67.
92 Id. at ch. 6, art. 57(1). The interim report must include the company's financial report, an analysis of the company's financial position, significant litigation to which the company is a party, and changes in the status of outstanding shares. Id. at ch. 6, art. 58.
must be submitted within 120 days of the end of the company's accounting period. The Regulations specify that both reports must be in accordance with the accounting standards of China. The CSRC will then make all reports submitted by listed companies publicly available. The company is also required to disclose publicly any significant event reasonably expected to affect the market price of the company's shares in a material way.

The Regulations limit the amount of stock a Chinese citizen may hold in a single listed company to 0.5% of the company's outstanding shares. If a citizen purchases more than 0.5% of the outstanding shares, the offering company must buy back the excess portion of the shares at the lower of the original purchase price or the market price.

The Regulations also establish policies limiting the market activities of corporate management, individuals involved in the securities industry, and professionals engaged in the process of producing financial documents for issuing corporations. Members of a corporation's management holding a 5% stake in their company are prohibited from selling shares within six months of their purchase, and from buying shares for six months after a sale. All professional personnel in the securities industry are prohibited from trading in shares directly or indirectly, with the exception of an approved investment fund. Individuals who violate these regulations may be censured, compelled to sell their shares, forced to return any illegal profits, or fined.

---

93 Id. at ch. 6, art. 57(2). The annual report must include, *inter alia*, a brief description of the company, its products and services, and its major assets; information regarding the company outstanding shares; and a summary of the financial position of the company for the previous three years if applicable. *Id.* at ch. 6, art. 59.

94 Id. at ch. 6, art 57. The failure of the Chinese to adopt Generally Accepted Accounting Principles and continued reliance on Chinese standards has caused alarm on the part of some potential foreign investors in China. Fairlamb, supra note 10, at 34. However, the differences in methodology should not decrease the effectiveness of disclosure efforts aimed at mainland investors. See *Zhao*, supra note 6.

95 Interim Regulations, *supra* note 74, at ch. 3, art. 64.

96 Id. at ch. 3, art. 60.

97 Id. at ch. 3, art. 46.

98 Id.

99 Id. at ch. 3, art. 38.

100 Id. at ch. 3, art. 39. This provision applies to any person employed in a securities regulatory agency or a securities industry self-regulatory organization, as well as individuals employed in institutions engaged in the issue and trade of securities. See also *id.* at ch. 3, art. 81(17)(18) (defining "managerial personnel of the securities industry" and "workers of the securities industry").
between 50,000 yuan and 500,000 yuan, or up to $62,000.\textsuperscript{101}

Legal persons (corporations) which acquire over 5\% of a company's outstanding shares must report to the company, the CSRC, and the securities exchange within three days of the acquisition, and must similarly report any subsequent change in position of 2\% or more.\textsuperscript{102} Once such a report is made, the legal person is barred from purchasing or selling any additional shares in the company for a two day trading period.\textsuperscript{103}

Upon amassing a stake of 30\%, a legal person is required to make a tender offer to the remaining shareholders of the company within 45 days of the acquisition, at either the highest price the offeror paid for the shares within the previous 12 months, or the average market price of the shares for the 30 days prior to the tender.\textsuperscript{104} The tender offer is valid for thirty days after its initiation and cannot be withdrawn until the end of the thirty day period.\textsuperscript{105}

At the termination of this period, if the legal person holds less than 50\% of the outstanding shares in the target company, the tender offer will be considered a failure and the number of the company's shares the offeror may purchase each year after the failed takeover is limited to 5\%.\textsuperscript{106} If, however, the offeror is able to amass 75\% or more of the outstanding shares of the target company, the company will be de-listed from its securities exchange.\textsuperscript{107} If the offeror acquires 90\% of the outstanding shares, the remaining shareholders are entitled to force the offeror to make a compulsory purchase of their shares under the same terms of the tender offer.\textsuperscript{108}

In order to curb the growing mistrust of the integrity of the markets among shareholders, the Regulations go to great lengths to specify actions which are subject to state sanction. Under the Regulations, companies issuing stock without approval may be censured, forced to forfeit profits, or fined.\textsuperscript{109} Furthermore, fraudulently obtaining approval to list or issue shares or failure to issue shares in the proper manner, amount, or time frame

\textsuperscript{101} Id. at ch. 7, art. 72.
\textsuperscript{102} Id. at ch. 5, art. 47.
\textsuperscript{103} Id.
\textsuperscript{104} Id. at ch. 5, art. 48.
\textsuperscript{105} Id. at ch. 5, art. 49.
\textsuperscript{106} Id. at ch. 5, art. 51.
\textsuperscript{107} Id.
\textsuperscript{108} Id.
\textsuperscript{109} Id. at ch. 3, art. 70.
will result in the imposition of fines. Repurchasing outstanding stock without state approval is similarly punishable. Liability for these actions may also be imposed upon individual directors, supervisors, or managers who are directly responsible for the infraction.

The standard of conduct for the securities industry is also laid out in the Regulations. Brokers and dealers are subject to censure or fines ranging from 30,000 yuan to 300,000 yuan (up to $37,000) for engaging in illicit activities ranging from faulty underwriting to lending clients' shares as collateral, charging unreasonable fees, profit sharing, or providing funds or shares to clients on a credit basis. In the case of gross violations of these policies, the institution or individual involved may have its business curtailed, its operation suspended, or its license revoked entirely.

3. Insider Trading

Insider trading is dealt with severely under the Interim Regulations, because the use of inside information in trading had seriously weakened the viability of the markets under the system developed by the PBOC. Violations of the prohibitions against insider trading are punishable with fines up to 500,000 yuan ($62,000), while individuals profiting from inside information must forfeit all profits gained from their dealings and forfeit their share ownership.

The Regulations significantly limit the trading activities of certain individuals. Professional personnel of the securities industry are generally prohibited from trading securities on their own account. Professional personnel involved in the production of audits, appraisals, or other required disclosures of listed companies are prohibited from owning shares in these

---

110 Id.
111 Id.
112 Individuals found guilty will be censured or subject to fines of no less than 30,000 yuan ($3,700) and no greater than 300,000 yuan ($37,000). Id.
113 Id. at ch. 3, art. 71.
114 Id.
115 Id. at ch. 3, art. 72. The Regulations define an “insider” as a “natural person having access to insider information due to the individual’s holding of the issuer’s shares, being a director, supervisor, or manager of the issuer or closely related to such a person, or serving in a regulatory or professional role.” Id. at ch. 3, art. 81(14).
116 Id. at ch. 3, art. 39. These individuals are allowed to invest in certain governmentally approved investment funds. Id.
companies prior to the release of their reports. Furthermore, directors, senior managers, or any individual shareholders owning 5% or more of a company's stock are not permitted to sell their shares within six months of their purchase.

III. ANALYSIS

The Interim Regulations on the Issue and Trading of Shares are extremely important to the continued growth and development of China's experiment with equity markets. Prior to their promulgation, the two national exchanges in Shanghai and Shenzhen, as well as the numerous other unofficial regional exchanges across the People's Republic of China, were locally regulated entities fraught with corruption. For this reason alone, the Regulations have immense value because they demonstrate the PRC's dedication to the concept of individual equity ownership, equity-based financing, and a viable national securities system. From a limited standpoint, therefore, the Interim Regulations have been quite successful at installing a uniform system of regulation where none had existed previously. This should certainly lead to more stable markets and increased capital investment as less speculative investors are attracted to the more centrally controlled markets.

A. Stock Issuance

The Interim Regulations clearly define the process of application and approval for public issuance of shares. They fail, however, to regulate internal shares issued by corporations to their employees. The PRC has authorized over 5,000 companies to issue internal shares as a way to raise capital without publicly issuing stock. Scores of unauthorized companies, mostly small companies in rural areas, have undertaken internal share offerings to their employees as a means to raise needed capital. The Regulations establish severe penalties for unauthorized share issues and for the trading of shares outside officially sanctioned securities establishments, but have failed to reduce the burgeoning black market trading of unautho-

---

117 Id. at ch. 3, art. 40.
118 Id. at ch. 3, art. 38. Any profits realized from the early sale of these shares are forfeited to the company.
120 Id.
The Regulations suffer from the fact that they are all punishment and no reward with regard to internal shares. By establishing public issuing measures which require the initiator of the issue to purchase at least 30 million yuan ($3.75 million) of the proposed issue, the Interim Regulations effectively alienate small and medium-sized companies from the hope of public offerings.\textsuperscript{122} Thus smaller companies are forced to rely on internal issues for capital accumulation. The Regulations provide severe penalties for illegally issuing and trading in internal shares, but give no viable alternative for small, undercapitalized companies to raise funds.\textsuperscript{123} In this regard, the Regulations are little better than the preceding regional schemes.\textsuperscript{124}

The high standards for the public issuance of shares benefit large companies by allowing them to raise capital at a reduced risk to investors. Given the reality of illicit internal shares trading, however, the PRC would have been better served, and investors better protected, by lowering the requirements for issuing public shares.\textsuperscript{125} Allowing smaller firms to issue shares publicly would have enabled the PRC to impose disclosure policies and extend greater control over these firms, reducing the need for black market trading and providing greater protection to citizens involved in internal shares trading.

The Regulations also leave in place the distinction among three types of publicly issued shares: state-held shares, legal person shares, and individually-held shares. Of the three, only individually-held shares are freely

\textsuperscript{121} Id.

\textsuperscript{122} See Interim Regulations, supra note 74, at ch. 1, art. 8.

\textsuperscript{123} See id. at ch. 7, art. 70. Violations of the Interim Regulations with regard to issuing shares without state approval can result in fines of up to 300,000 yuan, or roughly $37,000. Id.

\textsuperscript{124} The PRC has subsequently allowed China's officially recognized bourses in Shanghai and Shenzhen to establish "regional brokers" in order to give investors outside these areas the opportunity to trade in the officially sanctioned shares listed on the exchanges. Celine Tng, \textit{China Bearing Down on Its Many Underground Stock Markets}, THE STRAITS TIMES, Nov. 1, 1993, at 27. The PRC has also forced local authorities to crack down on the numerous roadside stalls where illegal shares were openly traded. Id. These actions have reduced the volume of illegal trading, but have done nothing to alleviate the capital shortage being faced by many small businesses. See \textit{Underground Stock Market Thrives in China}, supra note 119, at D3.

\textsuperscript{125} See Interim Regulations, supra note 74, at ch. 1, arts. 8-10.
The legal person shares are restricted in trading, and the state-held shares are strictly non-tradable.2 These restrictions keep large quantities of stock out of the market and create spiraling demand for the remaining individual shares, increasing the price of freely traded shares.2 Although lifting restrictions on trading state-held and legal person shares would flood the market and cause an initial drop in the price of shares held in the private sector, the long range effect would be to create a rational pricing structure in which prices more accurately reflect the actual value of listed companies.2

B. Disclosure Requirements

A significant advancement under the Regulations is the stringent disclosure requirements imposed on companies issuing shares publicly and listing their shares on the national exchanges.3 These requirements create a greater degree of corporate accountability and inform and shield China’s inexperienced mainland investors.4 The Regulations further hold management and professionals personally liable for any material omissions or falsehoods in the financial information in semi-annual and annual reports.5 However, the regulations do not specify the standard by which individual liability will be determined. Under the now-defunct Shanghai Measures, liability was based on actual knowledge.6 The Regulations fail to state whether individual liability will be based on actual knowledge or the more rigorous standard of due diligence. Given the relative inexperience and general shortage of professional personnel, the PRC should retain the lower standard

---

127 Id.
128 The Shanghai Exchange’s price-to-earnings ratio, determined by dividing a stock’s price by the company’s earnings per share, hovers at roughly 58, while that of the Shenzhen Exchange is about 31. Christine Chan, Allowing the Listing of State-Held and Legal Person Shares Is Urgently Required, SOUTH CHINA MORNING POST, Dec. 21, 1993, at 4.
129 Id. at 5.
130 Interim Regulations, supra note 74, at ch. 6, arts. 57-65.
131 Zhao, supra note 6.
132 These individuals may be subject to censure and fines of up to 300,000 yuan. Interim Regulations, supra note 74, at ch. 3, arts. 70, 73.
133 See Shanghai Measures, supra note 35, at art. 20.
of actual knowledge in the short run. However, as the markets develop, it will be imperative to increase this standard to one of due diligence in order to promote higher professional standards in the securities industry and add legitimacy to the equities markets.

C. Corporate Takeovers

The Interim Regulations carefully outline the PRC's policy regarding corporate takeovers. Interestingly, these policies have been among the first to be tested by China's growing ranks of aggressive capitalist managers. In October, 1993, the PRC witnessed its first attempted hostile raid. The incident proved the CSRC's willingness to monitor such actions carefully and quickly punish disclosure violations by potential raiders. It also illustrated one of the weaknesses of the Interim Regulations. Under the existing scheme, the management of the company under attack has little or no ability to fend off hostile bids. One primary defensive measure is effectively denied management due to the restriction placed on the repurchase of outstanding shares. Currently this action can only be lawfully undertaken if approval has been obtained from the CSRC.

Potential problems also arise in this area from the standpoint of the individual shareholder. First, a raider's tender offer will not present shareholders with a fair valuation of their corporation. In addition, the proposed takeover can lead to a great deal of market manipulation by the raider at the average shareholder's expense. Under the Interim Regula-

---

134 Zhao, supra note 6.
135 Id.
136 Interim Regulations, supra note 74, at ch. 3, arts. 47-52.
137 The hostile bid ended with Bao An Enterprises of Shenzhen failing to take over Shanghai Yanzhong Industrial. Bao An, after driving up the share prices of its intended target by unleashing a wave of speculative buying, aborted its efforts and realized a tidy profit of nearly 500,000 yuan ($86,000) upon liquidation of its holdings. The CSRC later found Bao An guilty of failing to disclose its position in Yanzhong after it had acquired over 5% of Yanzhong's stock, and fined the company one million yuan after seizing the profits gained from Bao An's subsequent sale of its position in Yanzhong. Jeffrey Parker, China Watchdog Snarls Over First Hostile Takeover, REUTER ASIA-PACIFIC BUS. REP., Oct. 22, 1993, available in LEXIS, News Library, Curnws File.
138 See Interim Regulations, supra note 74, at ch. 5, arts. 46-52.
139 Id. at ch. 7, art. 70.
140 Id.
141 Parker, supra note 137.
tions, upon amassing 30% of a company's outstanding shares, the hostile party must tender its offer to the shareholders.\textsuperscript{142} The offer is restricted to the higher of either the highest price the offeror paid for the target company's shares within the twelve months preceding the purchase order, or the average market price of the stock for the thirty-day period after the tender offer has been made.\textsuperscript{143} While this formula would potentially work in an efficient market scenario, the present situation in China does not lend itself to corrective market pricing due to a general lack of readily available information.

A reflection of the reluctance of the State Council to prod the markets too quickly to maturity can be found in the Regulations' strict prohibitions against short-selling and borrowing of individuals shares by other investors without their knowledge for the purpose of selling short.\textsuperscript{144}

Although the Regulations protect market stability by decreasing speculative behavior on the part of investors, they create a fundamentally flawed marketplace in which savvy investors are unable to take advantage of overvalued companies. This creates a surreal trading environment in which profits can only be obtained when companies' share prices increase. Given the shortage of shares available for trading, this system has not caused any severe problems to this date. However, as the markets grow in size and volume, the need for short-selling to foster realistic market forces will become evident.

\textbf{IV. CONCLUSION}

The Interim Regulations are a critical step in the right direction for the continued growth and rational development of China's fledgling equities markets. The Regulations establish a strong cornerstone around which the PRC can base its finalized securities law. As a stop-gap measure, the Regulations have performed quite well. However, as the national equities markets in China continue to expand, the regulatory framework designed to promote orderly development must also mature. Presently, the Interim Regulations are capable of regulating China's markets; but in the future, their lack of sophistication in several areas will become apparent. Hopefully the

\textsuperscript{142} Interim Regulations, \textit{supra} note 74, at ch. 5, art. 48.
\textsuperscript{143} \textit{Id.}
\textsuperscript{144} \textit{Id.} at ch. 3, arts. 71, 74.
State Council will recognize this fact in drafting the finalized securities law. Regulations are static, but markets very seldom are.

*Benjamin R. Tarbutton*