China's economy has grown at an extraordinary rate of around 12 percent for the past two years, thanks to the strong winds of reform and the open policy initiated by Deng Xiaoping, China's paramount leader and chief architect of reform. Generally, a fast-growing economy provides strong uplift to a country's stock market, which reflects national economic performance. However, China's stock markets, established in Shanghai and Shenzhen in 1990, remained sluggish for much of 1994. In particular, the A-share market suffered a large setback in
mid-1994.\textsuperscript{3} This setback triggered debate over the various ways and means to revitalize stock markets in China, particularly the A-share and the B-share markets. Why, in the case of China, does not the rising water of a fast-growing economy, so to speak, lift the boat (the stock market)?

Most Chinese scholars and securities specialists agree that internationalization (\textit{guoji hua}) will help to reinvigorate China’s securities markets.\textsuperscript{4} Indeed, government officials recently announced their initial plan to make Chinese stock markets more international.\textsuperscript{5} Certain pieces of legislation are waiting to be finalized.\textsuperscript{6} Yet

\textsuperscript{3} See Joseph Kahn, \textit{Stocks Swing Wildly Again in China, Taiwan—Volatility Continues To Be Main Feature of Shanghai Market}, \textit{Asian Wall St. J.}, Aug. 4, 1994, at 1, available in WESTLAW, WSJ-ASIA Database; see also Philip Shenon, \textit{China Halts Listing of New Stock}, \textit{N.Y. Times}, Aug. 1, 1994, at D1, D4 (the Shanghai exchange is down 80\% since its peak in February 1993, and most of that plunge occurred in the last three months).

\textsuperscript{4} In recent decades, particularly from the 1980s onwards, the world has witnessed a growing process of internationalization of the world’s securities markets. Today, lines of demarcation between nations’ securities markets have begun to fade. Securities are increasingly being both traded in the markets of more than one country and offered for sale on a multinational basis. Investors throughout the world can take advantage of the electronic linkages that permit effective 24-hour-a-day trading for all world class issuers and can participate significantly in both domestic and foreign markets. Modern technology in computer data processing and telecommunications such as fibre optics and satellite transmissions have further accelerated the pace of such development. “Globalization” and “internationalization” are the usual terms to characterize the trend of development of the world capital markets. The two terms will be used interchangeably in this article. See TERRY CHUPPE ET AL., \textit{THE SECURITIES MARKETS IN THE 1980s: A GLOBAL PERSPECTIVE} (1989); see also Richard A. Debs, \textit{The Development of International Equity Markets}, 4 \textit{B.U. Int’l L.J.} 5 (1986); ALAN L. BELLER, \textit{RECENT SECURITIES LAW DEVELOPMENTS AFFECTING MARKET INTERNATIONALIZATION} (PLI Order No. B4-6846, Nov. 3, 1988); KETCHUM, \textit{INTERNATIONALIZATION OF THE SECURITIES MARKETS} (PLI Order No. B4-6802, Sept. 17, 1987).


\textsuperscript{5} See Guyuan, Liu Hongru Tichu Wuoguo Yin Jinyilbu Duiwai Kaifang Zhengquann Shichang [Liu Hongru Said that Our Country Should Further Open Up the Securities Market], MEIRI ZHENQUAN [SECURITIES DAILY], July 21, 1994, at 1 (the general direction of future development is to admit mutual fund investment and to combine A shares and B shares); see also Joseph Kahn, \textit{Chinese Markets Soar on Interest by Foreigners: Class A Share Reform Could Widen Holdings but Obstacles Remain}, \textit{Asian Wall St. J.}, Sept. 6, 1994, at 1, available in WESTLAW, WSI-ASIA Database.

\textsuperscript{6} China promulgated its first national Company Law in April 1994. Though a significant move, the Company Law is not detailed enough according to some legal scholars and practitioners. For a discussion of China’s new Company Law, see ZHONGGUO GONGSI FA LILUN YU SHIWU [THE THEORY AND PRACTICE OF THE COMPANY LAW IN CHINA] (Jiang Pin ed., 1994) [hereinafter \textit{THEORY & PRACTICE}]. The first national Securities Laws have been redrafted numerous times, yet still must be submitted for approval at the next plenary session of the Standing Committee of the National People’s Congress (NPC).
different opinions and arguments arise as to what method or strategy to adopt in order to reinvigorate the stock markets.

In light of these developments, this article first discusses the important efforts that Chinese securities authorities have made in the past two years to internationalize the securities markets, focusing on B shares and overseas listings. In addition, the article examines the problems and difficulties that these globalization efforts have encountered or may encounter. Second, the article analyzes the emerging conflict or inconsistency between some of the uniquely Chinese characteristics and international practice within the securities regulatory regime. The article concludes with the proposition that globalization of China’s securities markets should encompass not only an expansion of the B-share market and an increase of overseas listings, but also (perhaps most importantly) improvement of the securities regulatory framework and modernization of accounting and corporate systems. Furthermore, enforcement of securities law is vital to improvement of the securities regulatory regime.

I. Progress and Problems in the Globalization of China’s Stock Markets

One guiding purpose for opening up stock markets in China is to attract foreign investment in order to speed modernization. To that end, China originally devised in the early 1990s two separate stock markets, A-share and B-share markets. The government considered that such separate markets of A shares and B shares would insulate the nascent new A shares from large inflows of foreign capital, thus protecting them from international market volatility; meanwhile, the separation would allow the B-share market to attract and raise foreign funds for development. In this respect, the first issue of B shares of Shanghai Electronic Co. in early 1992 was the first step toward globalization of China’s stock markets.

A. THE B-SHARE MARKET

Since the first listing of B shares of the Shanghai Vacuum Electron Device Co. on the Shanghai Stock Exchange in February 1992, and at about the same time, the first listing of the Nanbo Southern Glass B shares on the Shenzhen Stock Exchange, China’s B-share market has undergone swift, but by no means smooth, development. Between June 1992 and August 1993, after the initial offerings, the B-share market was hit quite hard: trading volume declined steadily

7. B shares, unlike A shares that are sold and traded only internally (i.e., by Chinese citizens), (1) have a face value denominated in renminbi; (2) are traded in U.S. dollars on both the Shanghai and Shenzhen markets; (3) are sold to foreign residents and foreign investment corporations both inside and outside China; and (4) enjoy the same rights as A shares. China opted for the B shares method of attracting foreign investment because issuing B shares posed fewer technical difficulties and required less experience than other methods such as mutual funds. See Qian, Riding Two Horses, supra note 2, at 89-91.
and trading prices fell below the issuing prices. The B-share market gained momentum in September 1993 when many investors turned to Hong Kong's hong chou gu (red chips issued by China's formerly state-run enterprises, also referred to as H shares). In addition, the U.S. Government lifted certain restrictions on U.S. mutual fund investment in China. By the end of 1993 the B-share market had grown by almost 50 percent. As of January 1995, twenty-nine different B-share listings were available for trade on the Shanghai Stock Exchange. Likewise, the trading volume has increased. However, in spite of this remarkable growth, China's B-share market remains quite insulated from major international stock markets and relatively small in size. Thus, the market is low in liquidity and has low issuing prices. In addition, overseas investors frequently complain that many B-share issuing companies are not truly up to international standards, especially in accounting and financial information disclosure systems. The B-share market has not pulled out of the sluggishness that haunted the market during much of 1994.

1. Same Diagnosis, Three Different Prescriptions

How to reinvigorate the B-share market is a hotly debated topic in China. Though people have the same or similar diagnoses of the sluggish market, the prescriptions for reinvigoration differ. Primarily three different proposals are offered. The first proposal urges the B-share market, historically exclusive to

9. Id. For further discussion of H shares, see infra part I.B.
10. Id.
11. The most recent B-share listing was the Shanghai China International Travel Service Co. Ltd. on September 28, 1994. See Guolu B Gu Shangshihaiwai Qianggou [B Shares of International Travel Co. Listed, Quickly Purchased at Home and Abroad], SHUI RIBAO [WORLD JOURNAL], Sept. 28, 1994, at B15. In 1992 there were nine company B-share listings (Shanghai Vacuum Electron Devices Co. Ltd., Shanghai Er'fangji Co. Ltd., Shanghai Dazhong Taxi Co. Ltd., Shanghai Wing Sung Stationary Co. Ltd., China First Pencil Co. Ltd., China Textile Machinery Stock Co. Ltd., Shanghai Rubber Belt Co. Ltd., Shanghai Chlor Alkali Chemical Co. Ltd., and Shanghai Tire & Rubber Co. Ltd.). In 1993, there were 14 company B-share listings (Shanghai Refrigerator Compressor, Shanghai Jinqiao Export Processing Zone Development Co., Shanghai Outer Gaqiao Free Trade Zone Development Co. Ltd., Shanghai Lian Hua Fibre, Shanghai Gaqiao Free Trade Zone Development Co. Ltd., Shanghai Jingjiang Tower Co. Ltd., Shanghai Forever Bicycle, Shanghai Phoenix Bicycle, Shanghai Hanxin Co. Ltd., Shanghai Yaohua Pitkinton Co. Ltd., Shanghai Dajiang (Group) Co. Ltd., Shanghai Diesel Engine Co. Ltd., Shanghai Hero Co. Ltd., and Shanghai Sanmao Textile Co. Ltd.). In 1994, there were seven company B-share listings (Shanghai Friendship & Overseas Chinese Co., Shanghai Industrial Sewing Machine Co., Shanghai Shangling Electric Appliances, Shanghai Steel Tube, Shanghai Goods & Materials Trade Center Co. Ltd., Shanghai Automation Instrumentation Co. Ltd., and the most recent, Shanghai China International Travel Service Co. Ltd.).
12. Shenon, supra note 3 (so far, 42 Chinese companies have issued class B shares worth nearly US$350 million).
foreign investors, to open up to domestic investors. By integrating the class of B shares with the class of A shares, large amounts of foreign capital would be infused into the sluggish A-share and B-share markets. The chairman of the China Securities Regulatory Commission (CSRC), China's securities regulatory agency, recently pointed out that combining A shares and B shares would promote development. The government believes that a more open stock market would: (1) attract more foreign investment; (2) provide the impetus to regulate the domestic stock markets according to international standards; and (3) promote domestic economic growth. However, the chairman cautioned people to move gradually and carefully because of the complexity involved as well as the current immature conditions. At the same time, several major international investment banks and brokerage firms are preparing to enter China's A-share market.

The second proposal urges the bolder and faster globalization of China's securities markets. Proponents of this prescription want to eliminate a separate class of B shares, thus merging B shares with H shares and N shares (or American Depositary Receipts). In this way, B shares could be reactivated by being listed and traded directly on major international stock exchanges, such as those in New York, London, Hong Kong, and Singapore.

The third proposal contends that the objectives of integrating B shares with A shares, or merging B shares with H shares and N shares, are desirable, yet not achievable in the short run mainly because of China's current regulations on

14. According to B-share regulations, only overseas legal or natural persons including residents from Hong Kong, Macao, and Taiwan could purchase and trade B shares in China. See Shanghai Shi Renminbi Tezhong Gupiao Guanli Banfa [Shanghai Regulations on the Administration of Renminbi Special Stocks (SRARSS)] of Nov. 22, 1991, § 14; see also Shenzhen Shi Renminbi Tezhong Gupiao Guanli Zhanxin Banfa [Shenzhen Provisional Regulations on the Administration of Renminbi Special Stocks (SPRARSS)] of Dec. 5, 1991 (§ 2(3) of SPRARSS is broader than § 14(3) of SRARSS because it includes “any other people approved by the authorities”). Recently, the Shenzhen provision has been favored over the more stringent Shanghai provision that may eventually open up opportunities for Chinese citizens to purchase and trade B shares.

15. See Zuofu, Zhongguo Ziben Shichang Fazhan Zhanlui de Xinsi [New Thinking of Development Strategies for China’s Capital Market—Interview with Share-holding System Expert Mr. Liu Jipeng], MEIRI ZHENQUAN [SECURITIES DAILY], July 24, 1994, at 1. Mr. Zuofu argues that, as a first step, China should combine A shares and B shares. Id. As a second step, China should separate A shares and C shares (corporation shares). Id. Third, China should integrate A shares with C shares. Id. Fourth, as conditions become ripe, A shares and H shares should be combined. Id.


17. See Kahn, supra note 3 (Merrill Lynch, Morgan Stanley, Goldman Sachs, and Baring Securities have all applied to the central government to trade A shares and B shares).

foreign currency control.19 The most urgent task facing the sluggish B-share market is to improve the system's own regulatory regime and market mechanism by promulgating national laws governing B shares, such as putting B-share regulations into the forthcoming national securities laws.20 Only in this way will B shares obtain independent and healthy development in the long run.

Currently, the third proposal, a more cautious and gradual measure, receives support from securities authorities. The Chinese Government, however, may proceed in the near future with the goal set forth in the first proposal which has been endorsed by China's top securities official. This CSRC official has indicated that China will move ahead with the internationalization of its stock markets in three steps. First, China will continue to expand B-share and H-share issues to attract foreign investment. Second, foreign mutual funds and investment banks will be permitted to participate in some of the financial businesses in China's capital markets. Third, China's entire stock markets eventually will be completely open to foreign investors.21

To start, securities authorities are contemplating permitting foreign funds to invest in China's A-share market. Yet, some specialists believe that certain conditions are currently not mature in China for foreign funds' access because: (1) laws and regulations governing mutual fund investment are not yet in place;22 (2) the relatively small volume and size of the stock markets may be subject to easy manipulation by large funds;23 (3) domestic funds must grow quickly (preferably in the forms of China-foreign joint ventures or joint cooperations) in order to compete;24 and (4) a high quality regulatory regime (including regulators) governing fund investment is urgently needed.25 In sum, faster and bolder changes to the stock markets in China, no matter how desirable, will become possible only when China further loosens many of its restrictions on foreign currency exchange and the Chinese renminbi becomes a completely convertible free currency.26

2. New Measures in 1994

In 1994, particularly during the latter half of the year, Chinese securities authorities responded to the sluggish market and increasing debate by stepping

19. In general, it is much easier for foreign currency to come into China than go out because the remittance of any foreign currency is controlled under the current foreign currency regulatory scheme in China, and the Chinese renminbi is not yet a free currency. See id.

20. Id.


23. Id.

24. Id.

25. Id.

26. Id.
up their efforts to improve the B-share market. For example, on July 1, 1994, the State Council promulgated special regulations regarding overseas listings of B shares.\textsuperscript{27} The regulations provide for detailed methods of regulating those companies that seek to raise foreign capital by issuing B shares. According to the CSRC authorities, beginning in 1994, China will focus on the following four actions to revive the B-share market: (1) expansion of B-share listings (in the past, B shares were only listed experimentally in Shanghai and Shenzhen, which host China’s only two stock exchanges;\textsuperscript{28} in the future, enterprises in the energy, telecommunications, transportation, and railway industries outside these two cities could be chosen by the Chinese Government to issue B shares);\textsuperscript{29} (2) promulgation of national laws regulating the B-share market;\textsuperscript{30} (3) improvement of the trading system and information disclosure system for B shares and solutions of problems with B shares’ issuance, trading, and clearance;\textsuperscript{31} and (4) growth of B-share issuing to US$1 billion in 1995.\textsuperscript{32}

Meanwhile, new rules have also been made regarding the conversion of C shares (corporation shares) to B shares. While still in an experimental phase, the conversion is a rather significant development in that companies may convert their C-share portfolios into B shares as long as they observe strict procedures for government approval.\textsuperscript{33}

B. H Shares and N Shares

From July 1993 until the end of 1994, the Chinese Government permitted thirty-one state-run enterprises to issue and list their shares on the Hong Kong

\textsuperscript{27} See Guowuyuan Guanyu Gufen Youxian Gongsi Jingwai Maji Gufen ji Shangshi de Tebie Guiding [The State Council Special Regulations Governing the Overseas Shares Issuing and Listing by the Limited Shareholding Companies], MEIRI ZHENQUAN [SECURITIES DAILY], Aug. 19, 1994, at 1 (these regulations were promulgated on Aug. 4, 1994).

\textsuperscript{28} See Joseph Kahn, China To Double Class B Listings on Two Markets, ASIAN WALL ST. J., May 13, 1994, at 11, available in WESTLAW, WSJ-ASIA Database; see also Shenzhen to Increase Class B Share Listings, ASIAN WALL ST. J., July 22, 1994, at 16, available in WESTLAW WSJ-ASIA Database.

\textsuperscript{29} See Dalu B Gu Jinwai Shangshi Banfa Qiyou Chutai [Regulations Governing the Mainland’s B Shares Will Come Out in July], SHIJIE RIBAO [WORLD JOURNAL], May 24, 1994, at B15.

\textsuperscript{30} Id. There have been local regulations governing B shares. See Quian, Riding Two Horses, supra note 2.

\textsuperscript{31} See, e.g., Shenzhen Cuts Class B-Share Fees in Move to Boost Trading Volume, ASIAN WALL ST. J., Aug. 26, 1994, at 13, available in WESTLAW, WSJ-ASIA Database (Shenzhen will cut 25% charges that include costs for registration, settlement fees, and minimum and maximum surcharges on stocks traded).


\textsuperscript{33} See Zuofu, Faren Gu Zuan B Gu You xin Guiding [New Rules for Converting C Shares to B Shares], MEIRI ZHENQUAN [SECURITIES DAILY], July 9, 1994, at 1; see also Joseph Kahn, Dazhong Taxi Says It Expects to Win Share-Conversion Battle, ASIAN WALL ST. J., Feb. 28, 1994, at 13, available in WESTLAW, WSJ-ASIA Database; Chinese Drug Firm to Offer Converted Class B Shares, ASIAN WALL ST. J., Sept. 29, 1994, at 24, available in WESTLAW, WSJ-ASIA Database.
Stock Exchange (HKSE). These shares are known as H shares or red chips (hong chou gu). The first issuing group of nine companies, including Shanghai Petrochemical Co. and Tsintao Beer, raised a total fund of over HK$11 billion.\(^\text{34}\) The initial public offering of Shandong Huaneng Energy International H shares (also known as American Depositary Receipts (ADRs)) in September 1994 launched the second group of twenty-two Chinese companies to issue H shares.\(^\text{35}\) In addition to Shandong Huaneng Energy International Co., four other companies in the second group, Shandong Electric, China Eastern Airlines, China Southern Airlines, and Tianjin Steel, are permitted to issue ADRs, the so-called N shares.\(^\text{36}\)

The birth and rapid growth of H shares and N shares have enabled China's stock market to become more knowledgeable about and more integrated with international capital markets. These two new classes of shares have opened a new channel of fund-raising for China's big companies. Furthermore, with overseas listing and issuing, these companies are more likely to be restructured under international standards, thus playing an exemplary role in China's overall corporate reform.\(^\text{37}\) Foreign investors eager to enter the Chinese market find H shares a more attractive vehicle than B shares.\(^\text{38}\)

H shares have also had positive effects on the HKSE. First, the total market value of the HKSE has increased 100 percent, so that Hong Kong now ranks sixth in the world's stock markets. Second, the issuance of H shares by China's big industrial companies greatly altered the mix of HKSE shares that used to concentrate in the service industry, including the real estate development, hotel, and finance industries.\(^\text{39}\) Third, investors in Hong Kong now can make direct

\(^{34}\) See Dalu Shoupi H Gu Zai Gang Shou Zuipeng [The First Group of Mainland H Shares Are Favored in Hong Kong], SHUIE RIBAO [WORLD JOURNAL], June 18, 1994, at B14; cf. WuDunn, supra note 13.


\(^{36}\) See Lin Hui, Shandong Huaneng zai Hua'erjie Guapai: Lakai le Wuoguo Di'er pi Guoqi dao Haiwai Shanghang Xumu [Shandong Huaneng Is Listed in Wall Street: Prelude to the Second Group of State-run Enterprises' Overseas Listing], SHANGHAI ZHENQUAN BAO [SHANGHAI SECURITIES NEWS], Aug. 17, 1994, at 1; see also Mei Jinrong Jie Renshi Jinyan Zhongguo Qiye Faxin Yutuo Zhenquan She "Rumei" Youxiao Tujin [U.S. Bankers Say Issuing ADRs Is an Effective Way to Enter the U.S. for China's Enterprises], SHANGHAI ZHENQUAN BAO [SHANGHAI SECURITIES NEWS], Aug. 12, 1994, at 1. The N share is named after New York, the place of listing, issuance, and trading of the ADRs; the H share is named after Hong Kong, the place of listing, issuance, and trading of hong chou gu.

\(^{37}\) See Henny Sender, China: Innovate, or Else, FAR E. ECON. REV., May 12, 1994, at 76, available in WESTLAW, FEER Database; see also Chen Ji, Hu Gu Xiang Shijie Dakai de Yi Shan Chuangkou [H Shares: Opening Another Window to the World], SHANGHAI ZHENQUAN BAO [SHANGHAI SECURITIES NEWS], Aug. 18, 1994, at 1.

\(^{38}\) See WuDunn, supra note 13 (analysts agree that H shares are much safer bets than B shares listed on the exchanges in Shanghai and Shenzhen, where accounting and regulatory standards fall short of international standards and there is less liquidity).

\(^{39}\) Id.
investments in mainland China. In addition, exchanges in the securities industry between the mainland and the rest of the world, especially Hong Kong and the United States, have increased. Since August 8, 1994, the HKSE has been publishing the Heng Seng China Enterprise Index. This publication allows international investors to see more clearly the performance of those H shares listed on the HKSE.

Nevertheless, new problems go hand-in-hand with the progress made. One of the major problems facing the H shares and N shares is the transformation of those H-share and N-share issuing companies (which were earlier restructured from state-owned to shareholding forms) into companies that truly comply with international standards, including those of accounting, investor protection, and information disclosure. In particular, according to the CSRC, the H-share issuing companies should focus on reforming their systems and promoting business. First, H-share and N-share issuing companies should use the funds raised in the stock offering in accordance with the prospectus. Second, H-share companies should set up a basic corporate structure and governing procedure. These procedures should include defining rights for shareholders, convening regular meetings for shareholders, establishing a board of directors and a supervisory committee, devising a long-term corporate development strategy, and establishing systems to manage the company’s human resources and finances. Third, H-share companies should improve their productivity and maximize their profits in order to benefit the shareholders and to establish a good reputation in the secondary market.

Another problem facing H shares and N shares comes from constant market changes. The issuance of H shares and N shares has been influenced to a large extent by the overall market performance of the world’s major capital markets. For example, the Hong Kong market remained rather volatile in late 1993 after a major U.S. investment bank announced that it would reduce its investment in

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40. See Jin Chuan, Hengseng Guoqi Zhishu Benyue Bari qi Fabu [Hengseng China Enterprise Index Will Be Published on the Eighth of this Month], ZHONGGUO ZHENQUAN BAO [CHINA SECURITIES News], Aug. 2, 1994, at 1.
42. See Erik Guyot, Neoh to Press H-Share Firms for Better Data, ASIAN WALL ST. J., Oct. 3, 1994, at 13, available in WESTLAW, WSJ-ASIA Database (pointing out that some of the H-share issuing companies have released financial documents that have not been verified by independent auditors); cf. Wu Jie, Xianggang Lianjiaosuo Zuxi Li Yieguang dai zai Xianggang Shangshi Guoqi Biaoshi Manyi, Cheng Gang Gu Biaoxian Bujia Ji Waivei Xinxiang [Chairman of the HKSE Li Jinye Was Satisfied with H Shares Issuing Companies and Said that Poor Performance in Hong Kong Was Due to External Effects], ZHONGGUO ZHENQUAN BAO [CHINA SECURITIES News], Aug. 2, 1994, at 1.
43. See Wu Jie, Zhongguo Zhengjianhui Zhuxi Liu Hongru Zhichu, Haiwai Shangshi Gongsri Xinxiang Guanxi Houxu Qiye Couzi Xiyni [CSRC Chairman Liu Hongru Pointed Out that the Image of the Overseas Listed Companies Concerns the Attraction of Fund Raising for Subsequent Companies], ZHONGGUO ZHENQUAN BAO [CHINA SECURITIES News], Aug. 2, 1994, at 1.
China. This market volatility has also affected, to some extent, the H-share listing. Therefore, in order to avoid many Chinese enterprises’ H-share listings at a time when the HKSE remains sluggish and demand low, the CSRC has cautioned that some of the twenty-two companies previously approved to be listed on the HKSE in 1994 may not be listed, subject to market conditions.

In addition, public relations regarding the image of China’s enterprises also matters a great deal in major international markets. After media coverage of several large Chinese companies’ alleged refusal to pay Western financial institutions because of derivatives trading losses, Chinese companies suffered a blow to their reputation. The creditworthiness of the Chinese companies and the sovereign debt that China issued have come under close scrutiny in world financial centers. Inevitably, spill-over effects damage those Chinese companies seeking to issue ADRs and to be listed in New York.

Apart from the plan to expand the B-share market and to increase H-share and N-share issuing, the Chinese Government is also considering permitting direct investment by foreign mutual funds in A shares. If this new measure is soon adopted, the Chinese A-share market, which has been kept exclusively internal, could be brought closer to the international financial markets. Indeed, in the past two years, several major international brokerage firms have opened offices in either Beijing or Shanghai, or in both cities, and have acquired membership seats on the Shanghai Stock Exchange; some of these firms are now ready to apply for permission from China’s securities authorities to participate

44. See Hong Kong Shares Fall on Broker’s Move—Morgan Stanley Lowers Exposure to Colony, Cites Stocks’ Rapid Rise, ASIAN WALL ST. J., Nov. 19, 1993, at 13, available in WESTLAW, WSJ-ASIA Database.

45. See Craig S. Smith, Chinese Offering Is Latest Victim of Low Demand, ASIAN WALL ST. J., May 18, 1994, at 1, available in WESTLAW, WSJ-ASIA Database; see also, e.g., Eric Guyot, Luoyang Trims IPO, Suggesting Possible Trend, ASIAN WALL ST. J., June 20, 1994, at 13, available in WESTLAW, WSJ-ASIA Database; Eric Guyot, Turning Cautious: This Year, H-Share Investors Need To Examine Fundamentals, ASIAN WALL ST. J., Mar. 21, 1994, at 1, available in WESTLAW, WSJ-ASIA Database.


48. See Dong Shaopeng, Touzi Jijin Guanli Jiang Youfa Kexin [Regulations Governing Administration of Mutual Fund Will be Promulgated], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Aug. 18, 1994, at 1 (the drafts for Regulations Governing Mutual Funds Administration and Regulations Governing Sino-Foreign Mutual Funds Administration have been completed and await amendment and future promulgation); see also Joseph Kahn, Chinese Markets Soar on Interest by Foreigners—Class-A Share Reform Could Widen Holdings But Obstacles Remain, ASIAN WALL ST. J., Sept. 6, 1994, at 1, available in WESTLAW, WSJ-ASIA Database.

in stock trading in China. Furthermore, initial negotiations recently have been conducted regarding the possibility of foreign companies being listed on the Chinese stock markets and issuing China Depositary Receipts (CDRs) on the Shanghai Stock Exchange. If the CDR program could be launched shortly, Shanghai would be better positioned to become one of the major international capital markets in the next decade.

II. Securities Regulatory Regime: Chinese Characteristics Versus International Practice

In establishing its securities regulatory system, China borrowed from Western models. Many of the provisions in China's securities laws and regulations are drawn from U.S. securities laws. The regulations include provisions governing stock registration, disclosure, trading, insider information, broker-dealers, and administration of the stock exchanges. China's system has also benefited from review of Hong Kong's system, inasmuch as China's CSRC is modeled after Hong Kong's Securities and Futures Commission, which was set up under a centralized system of "one agency, one market."

Nevertheless, differences abound between Chinese and Western securities laws and practice. First, U.S. securities laws follow common-law tradition, and according to one legal scholar, are like a huge web—a plethora of federal laws and state laws. To the contrary, China still does not have a national securities law. The drafting of the national securities law began almost simultaneously with the establishment of the securities exchanges in Shanghai and Shenzhen some four years ago. In 1994 the draft of the national securities law was submitted for discussion, but fell short of approval by the Standing Committee of the National People's Congress (NPC), China's national legislature. Although approval of the securities law, together with some fifteen other pieces of commercial law

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50. He Zhufeng, Miandui Zhongguo Shichang, Wo Geren Bi Zhongguo Touzizhe Leguan [I Am Personally More Optimistic than the Chinese Investors for China's Securities Market—Interview With Former Chairman of the U.S. Securities and Exchange Commission], ZHONGGUO ZHENQUAN BAO [CHINA SECURITIES LAW], Aug. 26, 1994, at 1 (Coopers & Lybrand is helping the German Benz Company to explore the possibility of issuing China Depositary Receipts on the Shanghai Stock Exchange).

51. See Shanghai Gufen Youxian Gongsi Zanxin Guiding [Shanghai Provisional Regulations on Shareholding Limited Company], of May 18, 1992; Shanghai Zhenquan Jiaoyi Guanli Banfa [Regulations on Administration of Shanghai Securities Trading], of Nov. 27, 1990; Charter of the Shanghai Stock Exchange; see also Shenzhen Zhenquan Jigou Guanli Zhanxin Guiding [Shenzhen Provisional Regulations on Securities Agencies]; Shenzhen Zhenquan Jiaoyisuo Zhangchen [Charter of the Shenzhen Stock Exchange]; Shenzhen Shi Guipiao Faxin yu Jiaoyi Guanli Zhanxin Banfa [Shenzhen Provisional Regulations on Administration of Stock Issuing and Trading], (texts available in ZHONGGUO GUPIAO ZONGLAN [OVERVIEW OF CHINA'S STOCK MARKETS] (Guan Jinshen et al. eds., 1992)).

legislation, is on the NPC’s 1995 agenda, the national securities law was not even submitted for discussion at the most recently convened NPC hearings in March 1995. Nevertheless, the lack of a national securities law impedes the fast development of China’s securities industry, which urgently requires a sound and effective regulatory regime. Currently, Chinese securities law at the national level consists of mostly rules and regulations, sketchy in form and general in substance, issued by government agencies. The more specific and detailed local rules have only limited jurisdiction and sometimes conflict with each other. The legislative history of China’s national securities law clearly illustrates the governing principles in China’s legislation: national laws will only be promulgated when experiments have been conducted on a small scale and when successful results have been achieved. However, in many cases, laws and regulations precede and guarantee the successful development of a new industry. This is especially true in the securities industry, which has significant participation of foreign players in an increasingly global market. Major international investors would be more hesitant to knock on the door of a market with inadequate market rules and regulations, even if the market presents investors with big potential or major opportunity.

Second, stemming from the unique features of the shareholding companies in China, Chinese stocks are structurally different from U.S. stocks. Chinese stocks are divided into three categories depending on the corporate ownership, that is state shares (guojia gu), legal person shares (gongshi gu), and individual shares (geren gu). Generally, to date only individual shares are traded on domestic stock markets in large volumes. In addition, the shares are classified depending on the nature of listing and issuing: A shares (internal shares), B shares (external shares sold and traded on domestic markets), C shares (corporate shares largely nontradable), H shares (shares issued and traded in Hong Kong) and N shares (shares in the form of ADRs traded in New York). To classify shares according to the above types of enterprise ownership and methods of listing and issuing, rather than according to the criteria of stockholders’ rights and obligations, may not be helpful in creating a consistent and clear securities regulatory framework.

Third, in order to maintain fairness and objectivity, a sound securities regula-

53. Tian Jiyun Tan Jinji Lifa [Tian Jiyun On Legislation of Economic Laws], RENMIN RIBAO [PEOPLE’S DAILY] (overseas ed.), Jan. 18, 1995, at 4 (the 15 pieces of commercial legislation include securities law, law of the people’s bank, law of commercial banks, insurance law, state assets law, contract law, bankruptcy law, etc.). In the next three years, over 30 pieces of economic legislation will be made by the Eighth NPC. Id.

54. Though undergoing several drafts, the first national Securities Law was not submitted for approval during the Eighth NPC, which convened in March 1993. Instead, the State Council and the China Securities Regulatory Commission (CSRC) promulgated two regulations governing stock issuance and trading, i.e., the Gupiao Faxing Yu Jiaoyi Guanli Zanxing Guiding [Provisional Regulations Concerning the Administration of Stock Issuing and Trading] of Apr. 22, 1993 (promulgated by the State Council) and the Gongkai Faxing Gupiao Gongsi Xinxi Pilu Shishi Xize [Detailed Rules of Implementation Regarding Information Disclosure for Companies Issuing Shares to the Public] of June 10, 1993 (promulgated by the CSRC).
tory regime should be founded on provisions that provide adequate shareholder protection (especially for minority shareholders), full and timely disclosure of information, and forceful law enforcement. While China has made much progress, it still has a long road ahead to build a fair and efficient regulatory system. As the Chinese sayings go, "youfa biyi" (laws must be enforced) and "zhifa biyan" (law enforcement must be tough).

Because China's securities laws and regulations are increasing in volume and the securities transactions are becoming more sophisticated, China needs not only well-trained securities lawyers who can advise companies on securities transactions, but also large numbers of judges and government regulators who have expertise in securities laws and regulations. According to one American lawyer, the risk for foreign investors investing in China is not so much a specific regulatory risk, nor a specific contractual risk, but rather an "enforcement risk." Indeed, enforcement activity in China is so far not significant, particularly in cases involving overseas investment. Any true efforts to internationalize China's stock markets should focus on improvement of the securities regulatory framework generally, and the enforcement mechanism in particular.

Most Chinese officials and scholars agree that securities laws and regulations must have strong Chinese characteristics. Such notions inevitably will lead to conflicts with international practice because Chinese companies that meet the domestic requirements for listing, stock issuance and information disclosure may not necessarily comply with the international standards required for listing and stock issuance on major international stock markets (such as the markets for H shares in Hong Kong and N shares in New York). On one hand, securities regulatory agencies in China, Hong Kong, and the United States are working together to reconcile, if not eliminate, the existing differences between their regulatory systems. On the other hand, if China wishes to continue to expand

55. The Justice Department and Chinese securities authorities require Chinese lawyers practicing in the securities area to obtain a special permit in order to be eligible for such specialty practice.

56. See Dealing with China, supra note 41.


58. The U.S. Securities and Exchange Commission (SEC) and China's CSRC signed a memorandum of cooperation and reconciliation in the securities regulatory regime in early 1994.

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its direct foreign fund-raising channel to major international financial markets, it should make every effort to upgrade its securities regulatory framework to be compatible, if not completely parallel, with international standards. Therefore, some of China's securities system's unique characteristics, such as the scheme of issuing three categories of shares for one company, with state shares and corporation shares essentially nontradable (which is ironically so important to preserve the Chinese characteristics of public ownership), may have to be either changed or modified.

III. China's Barings

In late February 1995, Shanghai International Securities Company (SISCO)—China's version of Merrill Lynch—lost heavily in the speculative trading of bond futures.59 Traders at SISCO allegedly tried to manipulate the market by orchestrating a mass of sell orders ten minutes before closing.60 The trading loss put SISCO on the brink of bankruptcy as it scrambled to raise cash from state banks to cover its trading position and to prepare for a rash of redemptions from clients.61 Instead of letting the market forces determine the fate of SISCO as happened in the recent collapse of Barings, the venerable British investment house,62 the Chinese securities authorities managed to sustain the survival of SISCO to avoid a major crisis in China's financial markets. As a modus vivendi, the CSRC asked the Shanghai exchanges to cease trading for some time. Furthermore, the CSRC has imposed new restrictions on bond futures trading, including daily price-movement ceilings, tighter enforcement of limits on individual positions, and less generous margin requirements.63 The SISCO scandal may have caused the early retirement of China's top financial regulator at CSRC.64

To a great extent, the recent SISCO incident, though scarcely revealed to the public in China, is no less significant than the much publicized Barings' collapse. It illustrates the paucity of laws and regulations governing China's bond market,

59. The loss was estimated at between $80 million to $150 million, while SISCO has registered capital of only $120 million. See Seth Faison, Scandal Besets Chinese Markets, N.Y. TIMES, Mar. 6, 1995, at D1, D5.

60. Id.

61. See Joseph Kahn, Beijing Takes Control of Shanghai Markets, Imposes Restrictions After Bond Scandal, ASIAN WALL ST. J. Mar. 6, 1995, at 20; see also Faison, supra note 59.

62. See Richard W. Stevenson, Young Trader's $29 Billion Bet Brings Down a Venerable Firm, N.Y. TIMES, Feb. 28, 1995, at A1, D9 (28-year-old trader Nicholas W. Leeson put $29 billion of the firm's money in Japanese stock futures contracts and Japanese interest futures contracts and lost more than a billion of it; the loss forced the firm to collapse); see also Richard W. Stevenson, New Barings Owner Retains the Firm's Top Executive, N.Y. TIMES, Mar. 7, 1995 (ING Group, the Dutch company, would acquire the British investment house after necessary court and regulatory approval).

63. The margin requirement was up from the original range of 1%-2.5% to 10%. See Faison, supra note 59, at D5; see also Kahn, supra note 61, at 20.

64. See Joseph Kahn, China to Change Regulators in Wake of Market Turmoil, WALL ST. J., Mar. 8, 1995, at A17 (Liu Hongru will be succeeded by Zhou Daojing, vice chairman of the State Development Bank, as chairman of China's Securities Regulatory Commission).
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which has become one of the fastest growing securities markets in China today. The SISCO incident appears to be a replay of a familiar pattern in China’s financial markets: after a new avenue is created for raising capital, a lack of adequate market regulations plus initial indifference to any existing regulations lead to a frenzy of active trading and speculation. Finally, when scandals occur, the authorities have to intervene with strong administrative (rather than market-oriented) measures to stop excesses as well as any active trading.

Indeed, China’s first national securities law, after years of drafting and debating, was still short of the final submission for approval at the most recently convened National People’s Congress in March 1995. Thus, China still has a long way to go to meet international standards in establishing a sound and effective securities regulatory framework. In order to make Shanghai one of the major international and Asia-Pacific financial centers in the twenty-first century to fuel the engine of China’s economic growth, the Chinese securities authorities must learn their lessons from the SISCO incident, in the same way as regulators in other major securities markets are reflecting upon the Barings’ crisis.

IV. Will the Water Continue to Rise? A Concluding Note

The process and outcome of internationalizing China’s securities market are closely related to a whole spectrum of micro as well as macro factors. First, at the micro level, building a new securities industry is part of China’s ambition to modernize its overall outdated and ineffective banking and financial systems that have been in operation for several decades under the centrally planned economy. In 1994, under the new stewardship of Zhu Rongji, vice premier and president of the People’s Bank of China, China’s new central bank, some important steps have been taken to reform the banking and financial systems. These measures include: (1) restructuring the banking system by establishing a central bank and several commercial banks, including a national import and export bank and a national development bank; (2) reforming the foreign currency control

65. The bond market, which existed in China even before the stock market, has become one of the three largest financial markets in China, together with the stock market and the commodity market. The bond market in Shanghai came alive in October 1994 when the government added a premium to interest rates on bonds to make them attractive. The premium was linked to inflation, currently about 24%. Speculation over the size of the premium thus fueled futures trading. Daily volume in bond trading surged from $1 billion a year ago to $6 billion in January 1995. On February 23, 1995, when a newspaper reported that a new premium would be higher than expected, trading exploded to $102 billion, more than four times the previous high. Faison, supra note 59, at D6.

66. Id. at D1, D5.


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system by eliminating the dual exchange rate of renminbi to foreign currency; and (3) allowing more business participation of foreign banks in China, including permitting them to handle, on a limited basis, the local Chinese currency. Most importantly, the internationalization of China's securities industry is directly linked to how soon China's renminbi becomes a fully convertible free currency (projected by some Chinese officials to occur no later than 2000). Until renminbi becomes a truly free currency, which would be a major breakthrough in reforming China's banking and financial system, any effort to internationalize the Chinese securities market will be only of limited success.

Second, internationalization will also be closely related to enterprise reform in China. Currently, nearly one-third of China's large or medium-sized enterprises are losing money, and survive only with government subsidies. These subsidies seriously drain the central government's financial resources and impede further economic growth. Beijing has set enterprise reform as its priority for economic reform in 1995. Accordingly, the Company Law (the first of its kind in China) came into effect in July 1994. Many financially troubled state enterprises are expected to restructure under the Company Law, and they could go bankrupt. Thus, enterprise reform, however necessary and urgent, is not without risks and difficulties. Enterprise reform will need, at a minimum, a new bankruptcy law and a new social security and pension system in China, in order to minimize or eliminate the social ingredients of instability. Successful enterprise reform could offer ample opportunities for equity and, perhaps, debt offerings, since


many of those state-run enterprises would be restructured to become public shareholding companies in compliance with China's Company Law.\footnote{The Company Law (which was approved by the fifth session of the Standing Committee of the Eighth NPC on December 29, 1993, and went into effect on July 1, 1994) governs two forms of companies, the limited liability company (youxian zeren gongsi) and the limited shareholding company (gufen youxian gongsi). The Company Law also provides for the stock issuing and transferring for limited shareholding companies. But more detailed securities laws must be contained in the Securities Law, which is pending the NPC's approval. For a detailed explanation of the Company Law, see Theory & Practice, supra note 6.}

At the macro level, the political climate after the Deng Xiaoping era will determine the general direction of development. As Deng's health declines, some people wonder whether the rising water will continue to rise in China or whether it will begin to fall after the passing of China's paramount leader. So far, certain arrangements appear to be underway to assure a smooth transition of the political power to a third-generation collective leadership, led by Jiang Zeming, that will continue to embrace and implement the whole package of economic reform,\footnote{See Kathy Chen, As Deng's Health Appears to Worsen, Leaders in China Jockey in the Wings to Succeed Him, WALL ST. J., Jan. 23, 1995, at A15.} including internationalizing China's securities markets. At the same time, while forecasting China's political climate in the post-Deng era is always tempting, it is a frustrating (if not futile) exercise, and beyond the scope of this article. Nevertheless, since China's leaders view political and socioeconomic stability in an otherwise possibly tumultuous period as top priorities, they want to make sure that any economic reform will not undermine such stability. Thus, China will continue to modernize its securities industry and securities regime experimentally, or in the recent words by Zhu Rongji, the overseer of China's economy, "in both a positive (jiji) as well as safe (wentuo) manner."\footnote{See Zhu Rongji Wei "Zhongguo Zhenquan Shichang Nianjian" Zhouru Zhichu: Zhenquan Shichang Yao Jiji Wentuo di Shiyan [Zhu Rongji Pointed Out in his Preface for "China's Yearbook of the Securities Market" that Experiments in the Securities Market Shall Be Positive and Incremental], RNMIN RIBAO [PEOPLE'S DAILY] (overseas ed.), Jan. 21, 1995, at 1.}

In summary, in response to the sluggish stock markets in China, Chinese securities authorities are planning for gradual, yet significant, steps toward building a more global stock market, primarily for the purpose of reinvigorating the domestic markets. If realized, this globalization could provide ample opportunities to foreign investors to access one of the fastest growing markets in the world, as well as assist China in tapping world financial markets. Yet, a truly more globalized stock market not only means increasing numbers of overseas listings and stock issues for H shares and N shares and expansion of the B-share market, but also improvement of the overall system, including the securities regulatory system, accounting system, and law enforcement mechanisms. To a large extent, the latter must precede the former. Until China possesses a mature and efficient regulatory system compatible with major international market standards, it will
not be able to accomplish its goals of attracting and sustaining a large inflow of
foreign capital to fuel economic development and modernization, and of building
China’s stock market into one of the major international financial centers in the
near future. Globalization (guoji hua) is a fundamental way to upgrade the Chinese
stock markets. In the Chinese proverb, “the rising water lifts the boat.” When
(and if) the rising water continues to lift the boat, the boat will sail for its destina-
tion, although perhaps not as swiftly as one may hope.