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Market Structure of the Chinese Equity Markets

Chengxi Yao*

*cxyao@stu.edu.cn

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* Professor, Financial Regulation, Shantou University Business School, People’s Republic of China; Juris Doctor, Boston College Law School (1991); LLM with Distinction in Securities and Financial Regulation, Georgetown University Law Center (1997). The Author gratefully acknowledges the insightful review comments by Mr. Robert LD Colby, Chief Legal Officer of FINRA. The Author has benefitted from many conversations with Dr. Yi Liu of China Securities Regulatory Commission, and Dr. Linxiang Wu of the Shenzhen Stock Exchange. All views are Author’s own. The Author can be reached at cxyao@stu.edu.cn.

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INTRODUCTION

Founded at the end of 1990 for trading Renminbi-denominated A-shares and U.S. dollar-and Hong Kong dollar-denominated B-shares of Chinese issuers, the Shanghai Stock Exchange (“SHSE”) was ranked by the World Federation of Exchanges as No. 4, and the Shenzhen Stock Exchange (“SZSE”) No. 5, of the world’s top ten exchanges, measured by equity share trading value in 2012.¹

In 2001, China became a WTO member. A year later, China opened up its domestic A-shares market to Qualified Foreign Institutional Investors or QFIIs—in an interesting role switch with its B-shares market, which was designed exclusively for foreign investors but was reoriented to Chinese individuals. In 2005, China effected an A-shares Reform, consolidating the hitherto tradable-versus-nontradable, segmented A-shares market into a unitary, all tradable A-shares market. At the end of 2011, China officially lifted its ban on margin trading and short selling in A-shares (while the ban remains for B-shares), provided that the government be the sole securities lender to the borrowing

1. See World Federation of Exchanges, *2012 WFE Market Highlights*, 6, 9 (2013), available at http://www.world-exchanges.org/files/statistics/pdf/2012%20WFE%20Market%20Highlights_0.pdf.

securities industry and the sole securities borrower to the securities lending investors.

Beginning 2003 and 2004, respectively, in addition to their public auction market segments, the Shanghai Stock Exchange and the Shenzhen Stock Exchange each started the operation of an ATS-style block trading system on the exchange, with direct access restricted to exchange members and Chinese institutional investors. In 2006, combining the concept of the “Silicon Valley” with the concept of the “OTCBB,” China started a Zhong-Guan-Cun Brokerage System for agency trading in non-publicly issued shares of private, entrepreneurial companies from Beijing’s high-tech hub, the Zhong-Guan-Cun Park. In January 2013, the Zhong-Guan-Cun Brokerage System graduated into a new Beijing-based NEEQ, which is to function as a market making system trading securities of non-listed public companies, signifying the Chinese securities industry’s entrée onto a hitherto untraversed land. The Beijing-based NEEQ, the Shanghai Stock Exchange, and the Shenzhen Stock Exchange complete the market structure of China’s equity markets.

Initiating and guiding China’s economic reform during the 1980s-1990s, China’s economic reform architect Deng Xiaoping stated: “The fundamental difference between socialism and capitalism does not lie in more planning or more market. . . . Planning and market are both economic tools.” “Planning and market that serve socialism are socialist; planning and market that serve capitalism are capitalist.”² Reviewing the market structure of China’s equity markets, one ponders whether the secondary market in China is such an economic tool.

2. See DENG XIAOPING, 3 *SELECTED WORKS OF DENG XIAOPING*, 203, 373 (Beijing: People’s Publ’g House, 1993). Cf. LARRY HARRIS, *TRADING AND EXCHANGES—MARKET MICROSTRUCTURE FOR PRACTITIONERS*, 214 (2003) (“Many economists and political scientists study when and how governments should intervene in economies. They also consider the often unrelated issues of why governments intervene in markets.”).

I. THE LISTED EQUITIES MARKETS

A. TRANSFORMATION OF A SEGMENTED SHARES STRUCTURE

1. *The A-Shares Reform: Moving to a Unitary Structure*

Prior to the 2005 reform, the secondary market structure in China for a Renminbi-denominated A-share issuer was designed as follows:

- The State shares and State-owned legal person shares, which composed two-thirds of the total shares of a listed A-share issuer, were non-tradable pursuant to the government's self-imposed restraint;
- The employee shares were prohibited from trading;
- The public shares, which composed less than one-third of the total shares of a listed issuer, were traded on the Shanghai or Shenzhen stock exchange.³

Based on summarized statistics for all A-share issuers listed on the Shanghai and Shenzhen stock exchanges, of a listed issuer's net assets recorded on its book on June 30, 2005, 37.37% were attributable to the face-value of the shares outstanding, 38.38% were attributable to the premiums paid by the public investors for the tradable shares, and only 12.13% were attributable to the firm's non-distributed profits.⁴

In November 2003, the chairman of China Securities Regulatory Commission ("CSRC") publicly acknowledged the "compartmentalized shares structure" as an "issue" to the further development of China's stock market.⁵ On January 31, 2004, the State Council issued *Opinion on Furthering Reform and Stability of China's Capital Markets*, in which the State Council directed all political subdivisions of the central government and government agencies under the State Council to

actively but cautiously dissolve the compartmentalized shares structure, through standardizing the transfers of and providing liquidity outlet for the non-tradable shares of listed companies, with

3. See CHENGXI YAO, STOCK MARKET AND FUTURES MARKET IN THE PEOPLE'S REPUBLIC OF CHINA, 16–22 (1998).

4. See SZSE, *Speeding Up Shares Structure Reform and Restoring Functions of the Capital Markets* (Jan. 10, 2006), www.szse.cn/main/aboutus/bsyw/8112.shtml.

5. See Xinhuanet, *Historic Events Relating to China's Segmented Shares Structure Reform—November 2003: CSRC Chairman Shang Fulin's Public Statement* (Apr. 30, 2005), http://news.xinhuanet.com/stock/2005-04/30/content_2898793.htm.

a view to preventing any loss of State assets, protecting the interests of the public investors, respecting the functioning of market forces, and enhancing stability and promoting development of the stock market.⁶

On September 4, 2005, after four months of two pilot programs involving a total of 46 listed issuers,⁷ the CSRC issued *Regulation of A-Shares Structure Reform of Listed Companies* (“A-Shares Reform Regulation”), which officially commenced the policy that (1) all non-tradable A-shares of existing listed issuers shall be converted into tradable ones; (2) all A-shares to be issued by newly listed IPO issuers shall henceforward be uniformly tradable.⁸

The nontradable to tradable share conversion was to be effected, issuer by issuer, following the procedure prescribed in the A-Shares Reform Regulation. In particular, any “consideration” to be paid by the State and State-owned legal persons as holders of non-tradable shares to the public stockholders must be approved, in advance of the shareholder vote, by the State-owned Assets Supervision and Administration

6. See State Council, *SC 2004-3: Opinion on Furthering Reform and Stability of China’s Capital Markets* (Jan. 31, 2004), available at www.gov.cn/gongbao/content/2004/content_63148.htm [hereinafter, State Council, *Reform Opinion*].

7. See, e.g., CSRC, *CSRC 2005-32: Notice Concerning Pilot Program of A-Shares Structure Reform of Listed Companies* (Apr. 29, 2005), available at http://www.csrc.gov.cn/pub/newsite/scb/gqfzg/200610/t20061031_70021.htm; CSRC, *CSRC 2005-42: Notice of Second Pilot Program of A-Shares Structure Reform of Listed Companies* (May 31, 2005), available at <http://edu.westlawchina.com/maf/china-cn/app/document?&docguid=i3cf76ad30000011ef34f27cf633b9f27&hitguid=i3cf76ad30000011ef34f27cf633b9f27&srguid=ia744d04f0000014226f40d875d8c36e8&spos=1&epos=1&td=1&crumb-action=append&context=5&lang=cn&crumb-label=%E6%96%87%E4%BB%B6>; Xinhuanet, *Ten Characteristics of the 42 Issuers Participating in the Second Pilot Program* (June 20, 2005), http://news.xinhuanet.com/stock/2005-06/21/content_3112355.htm.

8. See, e.g., CSRC, *CSRC 2005-86: Regulation of A-Shares Structure Reform of Listed Companies*, Art. 2 (Sept. 4, 2005), available at http://www.csrc.gov.cn/pub/newsite/scb/gqfzg/200610/t20061031_70036.htm [hereinafter CSRC, *A-Shares Reform Regulation*]; CSRC, State-Owned Assets Supervision and Admin. Comm’n (“SASAC”), Ministry of Finance (“MOF”), People’s Bank of China (“PBOC”) & Ministry of Commerce (“MOC”), *CSRC 2005-80: Guidance Concerning Shares Structure Reform of Listed Companies*, Art. 10 (Aug. 23, 2005), available at http://www.csrc.gov.cn/pub/newsite/scb/gqfzg/200610/t20061031_70030.htm. The A-Shares Reform Regulation also provides a “gradual release formula” governing sales of the converted shares into the public market. See CSRC, *CSRC 2005-86, supra*, at Arts. 27-29.

Commission (“SASAC”).⁹ Such consideration was urged to be thought of as the “consideration paid for an amendment of contract,” in that, while in the prospectuses of the initial public offerings of the stocks the State and State-owned legal persons had undertaken not to trade their shares, now they desired to have the option to trade their shares. Thus the consideration was to “pay for the option to trade” so as to restore capital markets’ functions of price discovery and optimal allocation of resources, and not to “compensate” the public investors for the high premiums they paid or any losses they suffered “due to historical, structural reasons.” Any demand for such compensation would be deemed an inappropriate attempt to free-ride on the shares structure reform.¹⁰ By October 2006, 90% of the over 1,600 listed issuers had completed the conversion process, ahead of the schedule set by the State Council for the “basic completion of the A-shares structure reform by year end 2006.”¹¹

As epilogue to the reform, within the first three quarters in the post-reform era, i.e., during the first three quarters of 2007, the volume of sales by 5% threshold stockholders in the A-shares market was nine times that of their purchases.¹² Concerned over the “loss of State assets,” the SASAC and the CSRC jointly issued *Provisional Regulation of Share Transfers by State Shareholder* to govern price, volume, and public disclosure of sales and other transfers of shares by the State (defined to include both the State and State-owned legal persons) as a shareholder of listed companies.¹³ Such price, volume, and disclosure restrictions vary, depending on whether the State Shareholder transaction is (1) a sale via a stock exchange’s block trading system;¹⁴

9. See CSRC, *A-Shares Reform Regulation*, *supra* note 8, at Art. 15.

10. See SZSE, *Speeding Up Shares Structure Reform*, *supra* note 4, at 2.2.

11. See, e.g., RESEARCH INSTITUTE OF THE SHENZHEN STOCK EXCHANGE, SZRI-0147: REPORT ON SHARES STRUCTURE REFORM, 1, 18 (Dec. 20, 2006), available at <http://www.szse.cn/main/files/2007/04/24/987170063604.pdf>; State Council, *SC 2006-12: Year 2006 Main Programs of Work*, Art. 32 (Mar. 19, 2006), available at http://www.gov.cn/zwgk/2006-03/22/content_233622.htm.

12. See RESEARCH INSTITUTE OF THE SHENZHEN STOCK EXCHANGE, SZRI-0157: CONTROLLING STOCKHOLDER’S BEHAVIOR IN POST-REFORM PERIOD AND ITS REGULATION, 1, 15–16 (Nov. 12, 2007), available at <http://www.szse.cn/main/files/2007/12/13/303778320492.pdf>.

13. See SASAC & CSRC, *SASAC-CSRC 2007-19: Provisional Regulation of Share Transfers by State Shareholder*, Arts. 1-2 (June 30, 2007), available at <http://www.sasac.gov.cn/gzjg/cqgl/200707060073.htm>.

14. *Id.* at Arts. 8-9, 11.

(2) a private, negotiated sale;¹⁵ (3) a no-consideration transfer to a government institution or a wholly State-owned firm;¹⁶ or (4) an indirect sale.¹⁷ It would appear that the A-shares structure reform has replaced a government self-imposed non-tradability of State shares (to prevent any erosion of the State's controlling interest in listed companies),¹⁸ with government restrictions on price, volume, and disclosure (to prevent any loss of the State assets),¹⁹ in any transfer of State shares which are now freely tradable just as the public shares—thanks to the reform, among whose proclaimed missions was to “respect the functioning of market forces.”²⁰

2. The B-Shares Market: To “B,” or Not to “B”?

The following table gives a comparative view of the performance of the B-shares market, the A-shares market, and the foreign markets listing China-based issuers in the form of H share or Red Chip.²¹

15. *Id.* at Arts. 14, 19, 24-25.

16. *Id.* at Arts. 30, 32.

17. *Id.* at Arts. 35-36.

18. See National Admin. of State Assets & State Econ. Restructuring Comm., *NASA 1994-81: Provisional Regulation of State-Owned Equity Shares Issued by Companies Limited by Shares*, Art. 3 (Nov. 3, 1994), available at <http://www.sasac.gov.cn/n1180/n1566/n258222/n259203/1733935.html>.

19. See SASAC & CSRC, *SASAC-CSRC 2007-19*, *supra* note 13, at Art. 1.

20. See State Council, *Reform Opinion*, *supra* note 6 and accompanying text.

21. See, e.g., CSRC, CHINA SECURITIES REGULATORY COMMISSION ANNUAL REPORT 2007, 69 (Aug. 2008), available at <http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/200904/P020090423500392960851.pdf>; CSRC, *Market Statistics Monthly (as of December 2012)* (Jan. 22, 2013), http://www.csrc.gov.cn/pub/zjhpublic/G00306204/zqscyby/201301/t20130122_220685.htm; SHSE, *Market Statistics Monthly (as of December 2012)* (Jan. 2013), http://www.sse.com.cn/researchpublications/publication/monthly/c/sse_stat_monthly_201212.pdf; SZSE, SHENZHEN STOCK EXCHANGE FACT BOOK 2012, 6-8, 257 (May 2013), available at <http://www.szse.cn/main/files/2013/05/28/101380619096.pdf>; see also Guo Shuqing, Chairman of CSRC, *Building a More Open and Receptive Capital Market*, Sec. 3 ¶ 2 (Jan. 14, 2013), http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201301/t20130114_220399.htm. For a discussion of H share and Red Chip issuers, see *infra* Part I.A.3.a.

Listing Data: China-Listed A-Share and B-Share Issuers and Foreign-Listed China-Based Issuers								
1990-1991	1992	1993	Year end 2000	Year end 2012	January 2013			
Début of 14 A-share issuers: --8 listed on SHSE in 1990 --6 listed on SZSE in 1991	Début of 2 B-share issuers: --1 listed on SHSE --1 listed on SZSE	Début of 6 H share issuers: --5 on HKEX --1 concurrently on HKEX and NYSE	--1,088 A-share issuers --114 B-share issuers --52 H share issuers	--2,472 A-share issuers --107 B-share issuers --179 H share issuers	--over 1,000 China-based issuers listed on foreign stock exchanges (including H share issuers and Red Chips)			
Offering Data: B-Share Issuers								
SHSE	1992-2000 B-share offerings			2001-2002 None	2003 B-share offering	2004-2012 None		
SZSE	1992-1998 B-share offerings	1999 None	2000 B-share offering	2001-2003 None	2004 B-share offering	2005-2012 None		
Trading Data: A-Share Issuers versus B-share Issuers in 2012								
	Number of Issuers		Total Market Cap (in ¥ 100 million)		Total Trading Value (in ¥ 100 million)		Total Number of Trades (in million)	
	A-shares	B-shares	A-shares	B-shares	A-shares	B-shares	A-shares	B-shares
SHSE	944	54	157,912.65	785.79	164,047.38	413.48	921.75	3.80
SZSE	1,528	53	70,862.68	796.50	149,667.76	454.65	931.53	4.04
B-Share Investor Account Data: Foreign versus Chinese Investors at Year End 2011 [See <i>infra</i> Part I.A.3.c.]								

The B-share concept, as a Renminbi-denominated but U.S. dollar (for SHSE-listed) and Hong Kong dollar (for SZSE-listed) traded equity security of a China-incorporated issuer, originated against the background when China had an extreme shortage in foreign exchange reserves. B-share was thus conveniently designed in 1992 as an instrument to attract foreign investors to invest their freely convertible currencies in the Chinese stock market.²² In 2001, to “strengthen its

22. See, e.g., CSRC, ANNUAL REPORT 2007, *supra* note 21, at 48; State Council, SC 1995-189: *Regulation of B-Share Issuers* (Dec. 25, 1995), available at http://www.csrc.gov.cn/pub/newsite/xxfw/flfg/xzfg_8248/201102/t20110214_191845.htm [hereinafter State Council, *B-Share Issuer Regulation*].

strategic position as China's international stock exchange pilot," the B-share market was opened to "Chinese individual investors" while "Chinese legal persons" remained, as they are today, prohibited from investing their foreign currencies in the B-shares market, due to China's foreign exchange control on capital account.²³

The B-shares market appears to have suffered from the outset: the primary market has stayed stagnant, and the secondary market has remained illiquid. Various theoretical and empirical studies have been made by Chinese academics and the securities industry to explain the lackluster B-shares market:

- Comparing industry sectors of the B-share issuers with those of U.S.-listed Chinese issuers, studies found that the U.S.-listed Chinese issuers tend to cluster in innovative industries representing the "new Chinese economy" developed since the last decade, whereas the domestically listed B-share issuers are concentrated in the traditional and cyclical industries.²⁴
- Comparing issuer governance and investor characteristics of B-share issuers with those of A-share issuers, studies found that many of the A-share issuers are leaders in their industries offering growth and income prospects, whereas most of the B-share issuers were "transformed" through "administrative means" from State-owned enterprises to become State-controlled B-share issuers. The B-share issuers have found themselves hamstrung by various government policy interventions and are generally eschewed by foreign investors who were, ironically, intended to be the major investor force in the original design of the B-shares market.²⁵

23. See, e.g., CSRC, *CSRC 2001-22: Permission for Chinese Individuals to Invest in B-Shares Market* (Feb. 21, 2001), available at http://www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080306_77964.htm; Xinhua (New China) News Agency, *CSRC Q&As with Press Concerning B-Shares Market Opening to Chinese Individuals* (Feb. 19, 2001), <http://www.people.com.cn/GB/jinji/35/159/20010220/399333.html>.

24. See, e.g., RESEARCH INSTITUTE OF THE SHENZHEN STOCK EXCHANGE, SZRI-0163: *PROFILES OF CHINESE COMPANIES LISTED IN THE U.S. MARKETS SINCE 2004*, 7–8, 14 (Apr. 18, 2008) (copy available from the SZSE Research Institute); Xijun Zhao & Suqin Gu, *Current Status of B-Shares and Suggestions for B-Shares' Future*, 11 CAPITAL MKTS. 72, 72 (2007); Weiping Gu, *Opportunities for an A-B Shares Merger*, 10 CAPITAL MKTS. 34, 37 (2000).

25. See, e.g., CITIC SEC., DAPENG SEC. & SHANGHAI STOCK EXCHANGE, SHJR 2001-2: *ON THE INTERNATIONALIZATION OF SECURITIES MARKETS AND RELATED REGULATORY ISSUES*, 27 (2001), available at <http://www.sse.com.cn/>

- Comparing A-share price with B-share price of the same A-plus-B issuers, an empirical study based on the closing prices on December 30, 2011 for 86 SHSE or SZSE-listed A-plus-B issuers found that, on average, the 86 issuers' B-shares traded at a 50.55% discount to their A-share counterparts; and 21 of the 86 issuers had their B-shares trading at over 60% discounts to their A-share counterparts.²⁶

On December 19, 2012, as the “first experiment” on the future of the B-shares market, China International Marine Containers (Group) Co., Ltd. (“CIMC”), whose largest shareholder is the SASAC and which had both its A-shares and B-shares listed on the Shenzhen Stock Exchange, had its “B-shares transfer-listed by way of introduction on the Main Board of the Hong Kong Exchange as H shares,” having received approvals from the CSRC and the Hong Kong Exchange (“HKEX”).²⁷ Among the rationales offered by CIMC's Prospectus for the B-shares' transfer listing was the deep discount CIMC's B-shares

researchpublications/jointresearch/c/plan20010803f.pdf; Xijun Zhao & Rong Xu, *The B-Share Market: Problems and Solutions*, 8 INT'L FIN. STUDIES 41, 43 (2000); Gu, *supra* note 24, at 37.

26. See Yanjun Tan, *On the Predicament of the B-Shares Market and Recommendations*, 1 ECON. PERSPECTIVES 74, 75 (2012). Daily information on B-share versus A-share discount for every Shanghai or Shenzhen-listed A-plus-B issuer can be found at the website of the Chinese issuer NetEase, Inc. [NASDAQ: NTES]. See Money163.com, *Daily B-Share vs. A-Share Discounts*, <http://quotes.money.163.com>.

In addition to research published in China, foreign financial literature has studies of the B-share discount puzzle. See, e.g., Kalok Chan, Albert J. Menkveld & Zhishu Yang, *Information Asymmetry and Asset Prices: Evidence from the China Foreign Share Discount*, 63 J. FIN. 159 (2008) (information asymmetry hypothesis to explain the B-share discount); G. M. Chen, Bong-Soo Lee & Oliver Rui, *Foreign Ownership Restrictions and Market Segmentation in China's Stock Markets*, 24 J. FIN. RES. 133 (2001) (illiquidity hypothesis to explain the B-share discount).

27. See, e.g., CSRC, *CSRC 2012-1548: Approval Order for CIMC's Listing on Main Board of Hong Kong Exchange* (Nov. 19, 2012), available at www.csrc.gov.cn/pub/zjhpublic/G00306214/201212/t20121227_219790.htm; Hong Kong Exchange, *HKEx-LD52-2013: Exemption/Approval Decision re Company X* (Mar. 2013), available at http://www.hkex.com.hk/chi/rulesreg/listrules/listdec/documents/ld52-2013_c.pdf; HONG KONG SEC. & FUTURES COMM'N, QUARTERLY REPORT: OCTOBER TO DECEMBER 2012, 1 (Feb. 2013), available at http://www.sfc.hk/web/TC/files/ER/PDF/Full_20130225c.pdf; CHINA INT'L MARINE CONTAINERS (GROUP) CO., LTD., PROSPECTUS FOR THE LISTING ON MAIN BOARD OF HONG KONG EXCHANGE OF H SHARES BY WAY OF INTRODUCTION, 118 (Dec. 17, 2012), available at http://www.cimc.com/ir/news/announcement/201212/t20121217_17402.shtml.

suffered on the SZSE and the deeper liquidity CIMC expected for its B-turned-H shares on the HKEX.²⁸

If one of the major reasons for the transfer-listing of CIMC's B-shares is to enhance liquidity and create value for the B-share holders, that "liquidity value" appears to be half-baked. Upon the HKEX listing, the B-turned-H shareholders were immediately classified into three groups:

- "Chinese domestic investors," who may hold or sell their CIMC B-turned-H shares but are not allowed to purchase any additional CIMC H shares on the HKEX; (one is left to wonder what would happen to the Chinese domestic shareholders if CIMC decides to issue stock dividend or conducts rights offerings);
- "foreign investors trading in China," who may buy, hold, and sell the CIMC H shares, provided that their Chinese brokers may only handle their sell orders and all their buy orders must be handled by Hong Kong brokers;
- "foreign investors trading outside China," who may freely buy and sell the CIMC H shares through Hong Kong and foreign broker-dealers.²⁹

It appears that all CIMC B-turned-H shares are not created equal.

On January 1, 2013, the CSRC eased China-incorporated companies' foreign listings by, among others, abrogating the financial threshold requirements for such issuers—a move seen as paving the way for B-share issuers to exit the Chinese domestic exchanges and be "transfer-listed" onto the Hong Kong Exchange as H share issuers.³⁰ On

28. See CIMC, PROSPECTUS, *supra* note 27, at 285.

29. *Id.* at 287–301; see also SHENZHEN SEC. COMMC'N CO., LTD., SYSTEM GUIDE FOR CHINESE SECURITIES FIRMS IN CONNECTION WITH TRANSFER-LISTING BY WAY OF INTRODUCTION OF SZSE-LISTED B-SHARES ON THE HONG KONG EXCHANGE (Aug. 2012), available at <http://www.ssscc.com.cn/main/gywm/gsgg/2012091229780.shtml>.

For China's restrictions on domestic Chinese's direct investments in foreign stock markets, see State Council, *SC-532: Foreign Exchange Regulation of the People's Republic of China*, Ch. 3 (Aug. 5, 2008), available at http://www.safe.gov.cn/wps/wcm/connect/Safe_WEB_Store/Safe_WEB/zcfg/zhfg/jbfg/node_zcfg_jbfg_store/6a5e8d00483adb7c9ac8ba362e8d3913?digest=BiV1_hMs1-5pvxPUIixuMQ.

30. See CSRC, *CSRC 2012-45: Regulatory Guide for Overseas Stock Offering and Listing of Companies Limited by Shares* (Jan. 1, 2013), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201212/t20121220_219483.htm,

January 24, 2013, the Shenzhen Stock Exchange, which lists all the Hong Kong dollar-traded B-share issuers in China, announced: among its “Year 2013 Major Tasks” is to “actively pursue the B-shares reform, and facilitate more B-to-H switches.”³¹ The government’s “planned reform” of the B-share market, or an ending to the B-share market’s *raison d’être* dilemma through market forces, perhaps is in sight.

3. Foreign Investor and Intermediary Access to Chinese Listed Issuers

a. The China-Based Listed Issuers

Under the Company Law of the People’s Republic of China, a “company” refers to “a company established in China in accordance with the Company Law, in the form of a company limited by liability or a company limited by shares”; the former is akin to the U.S. concept of an LLC, and the latter is similar to the U.S. concept of a corporation.³² Whereas the China-listed “A-share issuers” and “B-share issuers” must be formed under the Company Law as Chinese companies,³³ a foreign-listed, China-based issuer could be a corporation organized under the Chinese Company Law or under a foreign corporate law—depending on whether the foreign listing is a “direct listing” or an “indirect listing.”³⁴ Regardless of whether it is a direct listing or an indirect listing, a

superseding CSRC, CSRC 1999-83: *Notice Concerning Enterprises’ Applications for Overseas Listings* (July 14, 1999), available at www.csrc.gov.cn/pub/zjhpublic/G00306202/200804/t20080418_14674.htm; see also Guo, *supra* note 21.

31. See SZSE, *Having Strong Faith; All Efforts Forward; Solidly Promoting the Development and Reform of a Multilevel Capital Market* (Jan. 24, 2013), <http://www.szse.cn/main/aboutus/bsyw/39749280.shtm>.

32. See NAT’L PEOPLE’S CONG., COMPANY LAW OF THE PEOPLE’S REPUBLIC OF CHINA, Arts. 2-3 (2006), available at http://www.gov.cn/ziliao/flfg/2005-10/28/content_85478.htm [hereinafter CHINESE COMPANY LAW]. Compare *id.* at Chs. 3, 5, with BLACK’S LAW DICTIONARY (9th ed. 2009) (definitions of “LLC” and “corporation”).

33. See CHINESE COMPANY LAW, *supra* note 32, at Arts. 121, 132; see also State Council, *B-Share Issuer Regulation*, *supra* note 22, at Art. 1; State Council Sec. Comm. (“SCSC”), SCSC 1996-9: *Implementation Rules of B-Share Issuer Regulation*, Ch. 1 (May 3, 1996), available at http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssbggs/200906/t20090624_108119.htm; CSRC, CSRC 2006-38: *Guide for Articles and Bylaws of Domestically Listed Companies*, Arts. 1-3 (Mar. 16, 2006), available at http://www.csrc.gov.cn/pub/newsite/flb/fgwj/gfxwj/200701/t20070108_77585.htm.

34. See CSRC, ANNUAL REPORT 2007, *supra* note 21, § 3.2.3.

Chinese enterprise's foreign listing must obtain "approval from the CSRC in accordance with relevant regulations of the State Council," as mandated by the Securities Law of the People's Republic of China.³⁵

Direct listing of a Chinese company, generally referred to as an "H share issuer," occurs where a Chinese enterprise issues its own equity securities abroad in a foreign public offering which are then listed and traded on a foreign stock exchange.³⁶ Such an H share issuer must be formed under the Company Law;³⁷ the H share issuer, its Chinese investment bankers and accountants, and China offices of foreign investment banking houses and accounting firms who participated in the issuer's foreign stock offering and listing work must comply with the Chinese secrecy laws.³⁸ Effective January 1, 2013, "to enhance regulatory efficiency," the CSRC announced that it will "relax the requirements and simplify approval procedures for foreign listings of companies established under the Company Law," a move apparently

35. See NAT'L PEOPLE'S CONG., SECURITIES LAW OF THE PEOPLE'S REPUBLIC OF CHINA, Art. 238 (2006), available at http://www.gov.cn/flfg/2005-10/28/content_85556.htm [hereinafter CHINESE SECURITIES LAW]; see also *Decree No. 5 of the President of the People's Republic of China* (June 29, 2013), available at http://www.gov.cn/flfg/2013-06/30/content_2437158.htm (announcing amendment of twelve laws, including Securities Law Article 129).

36. See CSRC, CHINA CAPITAL MARKETS DEVELOPMENT REPORT, 17 (2008), available at <http://www.csrc.gov.cn/pub/newsite/yjzx/cbwxz/ebook>; see also Yi Liu, *Direct Overseas Listing of Chinese Enterprises: A Clear Regulatory Framework and Explicit Regulatory Requirements Are Needed*, 10 STUDIES IN INT'L FIN. 46 (2010). The "H share issuer" is used as a generic term to refer to foreign directly-listed Chinese issuers. The term used to have further breakdowns into "H Shares" for the Hong Kong-listed, "N Shares" for the NYSE-listed, "L Shares" for the London-listed, and "S Shares" for the Singapore-listed Chinese issuers. See CHINA CAPITAL MARKETS DEVELOPMENT REPORT, *supra*, at 17.

37. See, e.g., State Council, *SC 1994-60: Special Regulation Governing Overseas Offerings and Listings of Companies Limited by Shares*, Art. 1 (Aug. 4, 1994), available at http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/xzfgjwj/200906/t20090623_108099.htm; SCSC & Nat'l Structural Reform Comm'n, *SCSC 1994-21: Mandatory Clauses for Articles and Bylaws of Overseas Listed Companies*, Art. 1 (Aug. 27, 1994), available at http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssgszl/200911/t20091110_167714.htm.

38. See CSRC, State Secrets Bureau & State Archives Adm., *CSRC 2009-29: Measures for Enhancing Secrecy and Archives Administration in Connection with Issuer Overseas Stock Offerings and Listing* (Oct. 20, 2009), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/200911/t20091113_168326.htm.

designed to encourage more direct listings, versus indirect listings, by Chinese enterprises.³⁹

Indirect listings of Chinese enterprises, referred to as the “Red Chip issuers,” could take place under several structures, and the foreign stock exchange-listed issuer operating the Chinese enterprise’s assets generally is not organized under the Chinese Company Law.

- Spin-off listing:

Where a Chinese domestically-listed issuer formed an offshore subsidiary for the purpose of publicly offering and listing the subsidiary’s equity securities on a foreign stock exchange, such an offshore subsidiary is subject to the foreign company law. The offshore subsidiary is commonly referred to as the “Red Chip” issuer, which is sometimes further divided into the “Grand Red Chip” for a State-controlled subsidiary, and the “Small Red Chip” or “P-Chip” for a Chinese private person-controlled subsidiary.⁴⁰

- SPV listing:

As a variation of the Small Red Chip or P-Chip issuer, where a Chinese natural person or legal person owns a Chinese enterprise’s assets in China, controls a “Special Purpose Vehicle” (“SPV”) established offshore in a jurisdiction with which the CSRC has signed a memorandum on regulatory cooperation, and causes such an offshore SPV to acquire the Chinese enterprise’s assets; subsequently, the SPV or an offshore entity controlling the SPV is listed on a foreign stock exchange—such a foreign market-listed issuer may retain its foreign locus of incorporation; provided that, among other conditions, all transactions from the setup of the offshore SPV to the SPV’s acquisition of the Chinese enterprise’s assets are approved by the Ministry of Commerce (“MOC”), and the foreign listing of the SPV or its controlling entity is approved by

39. See CSRC, *Regulatory Guide*, *supra* note 30.

40. See, e.g., State Council, *SC 1997-21: Notice Concerning Enhanced Regulation of Overseas Stock Issuances and Listings* (June 20, 1997), available at http://www.csrc.gov.cn/pub/newsite/gjb/gzdt/199706/t19970620_79369.htm; CSRC, *CSRC 2004-67: Standardizing Overseas Listings of Subsidiaries of Domestically Listed Companies* (July 21, 2004), available at http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssgszl/200911/t20091110_167728.htm; see also Yi Liu, *China’s Regulation of Domestic Companies’ Indirect Overseas Listing: A Critical Assessment After the Financial Frauds*, 5 SEC. L.J. 323 (2011).

the CSRC. Any relinquishment by the Chinese natural person of his Chinese nationality shall have no effect on the nature of his controlled enterprise as a Chinese enterprise.⁴¹

- Listing via an exchange offer:

Where a foreign corporation acquires a Chinese enterprise via a stock-for-stock exchange transaction and the surviving foreign corporation operates the Chinese enterprise's assets, such a foreign corporation may retain its foreign locus of incorporation; provided that, among other conditions, the foreign acquiror corporation is "listed in a foreign public market other than an over-the-counter market," and the acquisition is approved by the Ministry of Commerce, as well as by the CSRC if the Chinese company acquired was listed on a Chinese stock exchange.⁴²

41. See Ministry of Commerce, *MOC 2009-06: Regulation of Acquisitions by Foreign Investors of Chinese Enterprises*, § 4.3, Art. 55 (June 22, 2009), available at http://www.gov.cn/flfg/2009-07/24/content_1373405.htm. As to why many Chinese private enterprises would opt for indirect foreign listings, versus direct foreign listings or Chinese domestic listings, one research report has this explanation:

While 50% of the Chinese GDP was generated by the private sector, only 20% of China's domestically listed companies and 6.97% of foreign directly listed companies are former private enterprises. From government macro policies to micro regulatory designs, all factors work in favor of the former State-owned enterprises vis-à-vis the private enterprises, for opportunities of being "selected" by the government for the Chinese domestic markets' listings and for direct foreign listings. Further, the "pain" to be endured by a private enterprise during the process of being reorganized as a "company limited by shares" under the Company Law in order to be listed in the Chinese domestic market or for direct foreign listing is intimidating to many private enterprises. Finally, the "flexible" listing conditions in the multi-level capital markets structure in the overseas markets and the efficiency of such markets are attractive to the private enterprises.

ZEJIANG UNIV., JINTONG SEC. & SHANGHAI STOCK EXCHANGE, SHJR 2004-11: HURDLES TO DOMESTIC LISTINGS OF PRIVATE ENTERPRISES (2004), available at <http://www.sse.com.cn/researchpublications/jointresearch/c/plan20040716d.pdf>.

42. See Ministry of Commerce, *MOC 2009-06*, *supra* note 41, at Arts. 2, 6, 27-29, 32. The restriction of foreign acquiror being a listed issuer effectively precludes Chinese enterprises from accessing the U.S. OTCBB market, whether through a reverse merger or through an acquisition by an operating company quoted on the OTCBB.

- Foreign shell:
“A Chinese enterprise is prohibited from effecting a foreign listing through acquiring a controlling stock in any foreign listed issuer that is a shell company,” the State Council decreed.⁴³

Based on listing venue and incorporation jurisdiction, there are thus three types of “listed Chinese issuers”: (1) the domestically listed issuers (issuing A-shares, B-shares, or A plus B shares) that are China-incorporated companies; (2) the foreign market directly listed H share issuers that are China-incorporated companies; and (3) the foreign market indirectly listed Red Chip issuers (including Grand Red Chips and Small Red Chips) that are generally foreign-incorporated

In 2011, the NYSE, NASDAQ, and NYSE Amex adopted rule changes to their respective listed company manuals, to impose more stringent listing requirements for “Reverse Merger companies” or companies formed by means of a “Reverse Merger” (including a reverse merger, an exchange offer, or otherwise) with an Exchange Act reporting shell company. The additional listing requirements include (i) one-year issuer seasoning, (ii) minimum stock price for a sustained period of time both prior to listing application and prior to actual listing, and (iii) requisite SEC filings. A Reverse Merger company is exempt from the additional listing requirements if its listing is in connection with a substantial size firm commitment underwritten public offering, or if it has filed four annual reports with the SEC since the Reverse Merger. *See, e.g.*, SROs; NYSE LLC; Notice and Order Granting Accelerated Approval to Proposed Rule Change, . . . Adopting Additional Listing Requirements for Companies Applying to List After Consummation of a “Reverse Merger” with a Shell Company, 76 Fed. Reg. 70,795 (Nov. 15, 2011); SROs; NYSE Amex LLC; Notice and Order Granting Accelerated Approval to Proposed Rule Change, . . . to Adopt Additional Listing Requirements for Companies Applying to List After Consummation of a “Reverse Merger” with a Shell Company, 76 Fed. Reg. 70,790 (Nov. 15, 2011); SROs; The NASDAQ Stock Market LLC; Notice and Order Granting Accelerated Approval to Proposed Rule Change, . . . Adopting Additional Listing Requirements for Companies Applying to List After Consummation of a “Reverse Merger” with a Shell Company, 76 Fed. Reg. 70,799 (Nov. 15, 2011). It does not appear that the Chinese enterprises would be able to access the U.S. exchange markets via the Reverse Merger company route as they are prohibited from merging with an OTCBB-quoted issuer in the first place under MOC 2009-06. *But see* NASDAQ, 76 Fed. Reg. 70,799, *supra*, at 70,800 n.10 (transactions not treated as “Reverse Merger,” such as a “back-door listing”).

43. *See* State Council, *SC 1997-21, supra* note 40, at Art. 4. The term “shell company” is not defined by the State Council, the CSRC, or the Ministry of Commerce. *Cf.* 17 C.F.R. § 240.12b-2 (SEC definition of “shell company”); SROs; NYSE; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Amending its Listing Standard for Reverse Merger Companies . . . to Harmonize with Nasdaq Stock Market Rules . . . , 78 Fed. Reg. 59,992, 59,993 n.4 (Sept. 30, 2013) (factors to be considered when determining whether a company is a “shell company”).

companies—all embody the Chinese domestic enterprises in their various listing forms in the Chinese and international capital markets. As such, they are all “China-based” listed issuers.⁴⁴

b. Foreign Investor Access to China’s Domestic Equities Market

While the U.S. and Hong Kong dollar traded B-shares market was designed in 1992 for foreign retail and institutional investors and was expanded in 2001 to accept Chinese individual investors,⁴⁵ the Renminbi traded A-shares market was restricted to the Chinese retail and institutional investors from its inception in 1990 to November 2002.⁴⁶ A

44. The term “China-based issuer” is undefined under either the U.S. securities law or the Chinese securities law, although the term is widely used in both the United States and China. *Cf.* The term “foreign private issuer” is defined by the SEC to mean

any foreign issuer other than a foreign government except an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter:

- (i) More than 50 percent of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States; and
- (ii) Any of the following:
 - (A) The majority of the executive officers or directors are United States citizens or residents;
 - (B) More than 50 percent of the assets of the issuer are located in the United States; or
 - (C) The business of the issuer is administered principally in the United States.

17 C.F.R. § 230.405 (2013).

The Chinese enterprise operated by a “China-based listed issuer” must remain a Chinese company subject to the Chinese Company Law. *See* Ministry of Commerce, *MOC 2012-8: Provisional Regulation of Capital Contributions to Foreign-Invested Firms by Way of Equity Interests in Chinese Enterprises*, Art. 2 (Oct. 22, 2012), available at <http://www.mofcom.gov.cn/aarticle/b/c/201210/20121008398882.html>. In addition, although Red Chip issuers are generally non-Chinese companies, Red Chip issuers’ Chinese stockholders and investment bankers and accountants who participated in the issuer’s foreign stock offering and listing work must nevertheless comply with the Chinese secrecy laws in ways similar to the H share issuer treatment. *See* CSRC et al., *CSRC 2009-29*, *supra* note 38, at Art. 11.

45. *See* State Council, *B-Share Issuer Regulation*, *supra* note 22, Art. 4.

46. *See* China Sec. Depository and Clearing Corp. (“SD&C”), *Securities Accounts Regulation*, Art. 3.3 (May 1, 2002), available at <http://www.sse.com.cn/lawandrules/>

year after China's WTO accession in 2001, the A-shares market was opened up to "Qualified Foreign Institutional Investors" or "QFIIs," initially defined to refer to a narrow set of institutions such as foreign commercial banks with asset levels ranking among the world's top 100.⁴⁷

Beginning July 2012, the QFII qualification thresholds have been substantially lowered, and QFIIs now refer to five types of investor meeting the following criteria:

- an assets manager with two years of assets management experience and having US\$500 million worth of securities under management;
- an insurance company having been in business for two years and owning US\$500 million worth of securities;
- a securities firm having been in business for five years, with US\$500 million worth of net assets and US\$5 billion worth of securities under management;
- a commercial bank having been in business for ten years, with US\$300 million Level I capital and US\$5 billion securities under management; and
- any other similar type of institutional investors such as a retirement fund, a charitable foundation, a trust company, or a sovereign fund, which has been in existence for two years and owns or manages US\$500 million worth of securities.⁴⁸

While any one QFII's A-share holding in a listed issuer is still capped at 10% as in 2002, the cap for all QFIIs' A-share holdings in one issuer collectively has been raised from 20% in 2002 to 30% in 2012.⁴⁹ Instead of the "one broker" policy of 2002, a QFII may now use three Chinese securities firms on each of the Shanghai and Shenzhen stock

regulations/tradclear/a/p0006.pdf [hereinafter SD&C, *Securities Accounts Regulation (2002)*].

47. See CSRC & PBOC, *CSRC-PBOC 2002-12: Provisional Regulation of QFIIs' Securities Investment Activities in China* (Dec. 1, 2002), available at http://www.csrc.gov.cn/pub/zjhpublic/zjh/200804/t20080418_14491.htm [hereinafter *QFII Regulation (2002)*].

48. See CSRC, *CSRC 2012-17: Implementation Rules of QFII Regulation*, Art. 1 (July 27, 2012), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201207/t20120727_213211.htm [hereinafter *QFII Regulation (2012)*].

49. Compare *QFII Regulation (2012)*, *supra* note 48, at Art. 9, with *QFII Regulation (2002)*, *supra* note 47, at Art. 20.

exchanges.⁵⁰ Short sale and margin trading by QFIIs remain, however, prohibited as they have been historically, so as to prevent QFIIs from bypassing their investment limits through leveraged transactions.⁵¹

A derivative form of the QFII concept, the “Renminbi QFII” or “RQFII,” appeared in early 2012, when the CSRC, People’s Bank of China (“PBOC”), and State Administration of Foreign Exchange (“SAFE”) jointly commenced a pilot program to allow the Hong Kong subsidiaries of mainland China’s fund management companies to have their Renminbi assets raised in Hong Kong invested in mainland China’s stock market.⁵² In March 2013, the RQFII operation was expanded to subsidiaries of other types of parent financial institutions in China, and to all foreign financial institutions having Hong Kong as both their jurisdiction of incorporation and their principal place of business, with the permissible investment scope for RQFIIs being similar to that of QFIIs.⁵³

50. Compare *QFII Regulation (2012)*, *supra* note 48, at Art. 13, with *QFII Regulation (2002)*, *supra* note 47, at Art. 19. In a study prepared by the CSRC, the CSRC noted the “significant, positive roles” played by QFIIs in helping local brokers develop their international client skills and the firms’ research capability. See CSRC, *A Comparative Study of QFII Regulatory Regimes in Various Jurisdictions* (Dec. 28, 2006), available at http://www.csrc.gov.cn/pub/newsite/flb/lfzl/jnlfsyzy/yjyd/200701/t20070108_77313.htm.

51. See, e.g., CSRC, *CSRC 2003-3: Notice Concerning Clearing and Settlement of QFIIs’ Trading in China* (July 4, 2003), available at http://www.csrc.gov.cn/pub/newsite/flb/fgwj/bmgz/200803/t20080303_78030.htm; CSRC, *QFII Regulation (2012)*, *supra* note 48, at Arts. 8-9; SD&C, *Rules Governing Clearing and Settlement of QFIIs’ Securities Trading in China*, Arts. 24-27 (Feb. 20, 2013), available at <http://www.chinaclear.cn/main/03/0301/030101/1361350203499.pdf>.

52. See, e.g., CSRC, PBOC & State Admin. of Foreign Exchange (“SAFE”), *CSRC-PBOC-SAFE 2011-76: Pilot Program for Fund Management Firm or Securities Firm-Controlled RQFII Investment Activities in Mainland China* (Dec. 16, 2011), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201112/t20111216_203868.htm; CSRC, *CSRC 2011-37: Implementation Rules Governing Fund Management Firm and Securities Firm RQFII Pilot Program* (Dec. 16, 2011), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201112/t20111216_203867.htm.

53. See, e.g., CSRC, PBOC & SAFE, *CSRC 2013-90: Pilot Program for RQFII Investment Activities in Mainland China* (Mar. 1, 2013), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201303/t20130308_222029.htm; CSRC, *CSRC 2013-14: Implementation Rules Governing RQFII Pilot Program* (Mar. 1, 2013), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201303/t20130308_222028.htm.

In addition to QFIIs and RQFIIs, since 2006 “Foreign Strategic Investors” or “FSIs” were allowed into the A-shares market as well, in order to “bring foreign advanced management skills, technology and funds to, and improve the corporate governance of, listed companies in China.”⁵⁴ The FSIs refer to those foreign investors who, having obtained the necessary approvals from the Ministry of Commerce and the CSRC, make “substantial and long-term equity investment in listed companies” in China, and who shall acquire their A-shares only in private offerings (whether primary offerings by the issuer or secondary offerings by the selling stockholders).⁵⁵

The A-shares market remains closed to foreign individual investors, and to foreign institutional investors not qualified as QFII, RQFII, or FSI.⁵⁶

c. Foreign Broker-Dealer Access to China’s Secondary Equities Market

On November 10, 2001, China accepted the *Protocol on the Accession of the People’s Republic of China* (to the WTO Agreement) and became a WTO member on December 11, 2001.⁵⁷ At the time of its WTO accession, China pledged the following, as related to foreign broker-dealers’ access to China’s domestic equities market:

54. See MOC, CSRC, State Admin. of Taxation (“SAT”), State Admin. for Indus. & Commerce (“SAIC”) & SAFE, *MOC 2005-28: Regulation of Strategic Investments by Foreign Investors in Listed Issuers*, Art. 1 (Dec. 31, 2005), available at http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssbgcz/200906/t20090624_108133.htm.

55. *Id.* at Arts. 2-3, 5(1), 7-9.

56. See SD&C, *Securities Accounts Regulation (2002)*, *supra* note 46. Beginning April 1, 2013, the A-shares market was opened up to “those individual investors from Hong Kong, Macao, and Taiwan who are residing and working in mainland China.” See, e.g., SD&C, *Notice of Amendment to Securities Accounts Regulation* (Mar. 9, 2013), available at http://www.chinaclear.cn/old_files/1362793569287.pdf; SD&C, *Securities Accounts Regulation*, Arts. 1.5-1.6, 3.3 (2013), available at http://www.chinaclear.cn/old_files/1364200301861.pdf [hereinafter SD&C, *Securities Accounts Regulation (2013)*].

This Article does not discuss Chinese investors’ access to international capital markets, as outside the scope of this Article.

57. See WORLD TRADE ORGANIZATION, WT/L/432, PROTOCOL ON THE ACCESSION OF THE PEOPLE’S REPUBLIC OF CHINA (Nov. 10, 2001), available at http://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm. Under the WTO procedure, the Protocol entered into force on the 30th day following the day of its acceptance. See *id.* at Part III.

- foreign broker-dealers may participate, directly and without the intermediation of any Chinese securities firms, in B-shares trading;
- foreign broker-dealers may, beginning three years from China's WTO accession, form joint ventures with Chinese securities firms subject to the cap of one-third of equity interest in any one Chinese securities firm; such a Sino-foreign joint venture securities firm may, without the intermediation of any other Chinese securities firm, engage in (1) underwriting—but not trading—of A-shares, (2) underwriting and trading of B-shares, H shares, and Government and corporate bonds, and (3) sponsorship of investment funds;
- foreign broker-dealers' China representative offices may become "Special Members" in any and all securities exchanges in China;
- foreign securities service providers may form joint ventures with Chinese firms, subject to the cap of 33% during the first three years from 2001 and the cap of 49% beginning in 2004 of equity interest in any one Chinese firm, for the purpose of engaging in securities investment fund management business.⁵⁸

On May 4, 2012, during the Fourth Round of U.S.-China Strategic and Economic Dialogue, China pledged, as related to foreign broker-dealer access to China's securities markets, to (1) allow foreign equity interest in any Sino-foreign joint venture securities firm to increase from China's WTO commitment of one-third to 49%; and (2) allow Sino-foreign joint venture securities firms to apply to expand their business scope after a two-year operation, "assuming other conditions are met."⁵⁹

With respect to secondary market for A-shares—the heart of China's domestic stock market—both prior to and after China's WTO accession, it was and remains closed to foreign broker-dealers, whether by direct participation, via Chinese securities firms' intermediation, or through joint venture with Chinese securities firms.⁶⁰ With respect to secondary market trading in B-shares on both Shanghai and Shenzhen

58. See CSRC, *WTO Undertakings*, available at http://www.csrc.gov.cn/pub/newsite/gjb/sczr/zgzqywtoen/200610/t20061011_79435.htm.

59. See Xinhua (New China) News Agency, *Joint Fruits of the Fourth Round of Sino-U.S. Strategic and Economic Dialogue*, § 4 (May 4, 2012), http://www.gov.cn/jrzq/2012-05/05/content_2130383.htm.

60. See CHINESE SECURITIES LAW, *supra* note 35, at Ch. 6 Arts. 122-123. Compare SD&C, *Securities Accounts Regulation (2013)*, *supra* note 56, at Art. 3.3, with SD&C, *Securities Accounts Regulation (2002)*, *supra* note 46, at Art. 3.3.

stock exchanges, both prior to and after China's WTO accession, it was and remains open to foreign broker-dealers.⁶¹

To be eligible for B-shares trading, a foreign broker-dealer shall apply to the CSRC for a "B-share Business License." The foreign broker-dealer's B-share business is subject to the CSRC's regulatory oversight and compliance examinations. Any non-compliance or non-cooperation with the CSRC's requests or requirements may subject the foreign broker-dealer to fines and penalties.⁶²

Each foreign B-share broker shall purchase a "Special B-share Seat" from the exchange, but shall not be eligible as a "member" of or to purchase any "standard seat" from any exchange.⁶³ The fees for a Special B-share Seat at the Shanghai Stock Exchange are a non-refundable lump sum "Seat Fee" of US\$75,000 plus an annual "Seat Management Fee" of US\$2,415; the fees charged by the Shenzhen Stock Exchange are a non-refundable lump sum HK\$600,000 plus an annual payment of HK\$30,000. The Special B-share Seat, once purchased, may not be sold back to the exchange although it may be "transferred"

61. See CHINESE SECURITIES LAW, *supra* note 35, at Art. 239. Compare SD&C, *Securities Accounts Regulation (2013)*, *supra* note 56, at Art. 3.4, with SD&C, *Securities Accounts Regulation (2002)*, *supra* note 46, at Art. 3.4.

This Article does not address any underwriting or assets management businesses in the Chinese capital markets accessible to foreign broker-dealers or foreign investment advisers, as beyond the scope of this Article. Neither does this Article discuss H share or Red Chip underwriting or trading in the capital markets outside China, also as beyond the scope of this Article.

62. See, e.g., CSRC, CSRC 1996-5: *Qualification Regulation of Chinese Securities Firms and Foreign Broker-Dealers Participating in B-Share Business (Interim)*, Arts. 2, 18-19 (Oct. 23, 1996), available at www.csrc.gov.cn/pub/newsite/flb/fgwj/bmgz/200803/t20080304_77884.htm.

63. See, e.g., SHSE, SHSE 2002-99: *Provisional Measures Governing B-Share Seat Applications by Foreign Securities Firms*, Art. 2 (July 17, 2002), available at http://www.sse.com.cn/lawandrules/sserules/member/c/c_20120918_49767.shtml [hereinafter SHSE, *B-Share Seat Measures*]; SHSE, SHSE 2007-9: *Membership Regulation of the Shanghai Stock Exchange*, Ch. 1 Art. 1.2, Ch. 2 Art. 2.1, Ch. 3 Art. 3.2 (May 1, 2007), available at http://www.sse.com.cn/lawandrules/sserules/member/c/c_20120918_49754.shtml; SZSE, SZSE 2002-76: *Measures Governing B-Share Seats of Foreign Securities Firms*, Art. 2 (June 19, 2002), available at <http://www.szse.cn/main/rule/bsywgz/hyl/39744235.shtml> [hereinafter SZSE, *B-Share Seat Measures*]; SZSE, *Membership Regulation of the Shenzhen Stock Exchange*, Ch. 1 Art. 1.2, Ch. 2 Art. 2.1, Ch. 3 Art. 3.2 (May 7, 2007), available at <http://www.szse.cn/main/rule/bsywgz/hyl/39744258.shtml>.

to a third party if acceptable to the exchange.⁶⁴ Foreign broker-dealers are allowed to trade B-shares on both agency and proprietary basis, whereas Chinese securities firms are prohibited from “dealing” in B-shares and are permitted to engage in “agency trading” only.⁶⁵ Chinese securities firms may trade B-shares for both Chinese and foreign investors, whereas foreign broker-dealers’ agency trading in B-shares is restricted to foreign investors only.⁶⁶ Each foreign B-share broker-dealer shall submit, in addition to its initial application for the Special B-share Seat, an Annual Business Report and Current Reports to the exchange, disclosing specified material information such as its corporate ownership structure, its financial condition, its B-share business in China, and its trading statistics in all other countries. All disclosures shall have a Chinese language version, which shall be “the” official version; and all trading records shall be kept for a minimum of 20 years.⁶⁷ As with the QFIIs, all margin trading and short selling are prohibited to foreign B-share broker-dealers.⁶⁸ Each foreign B-share broker-dealer shall make an advance payment to the “Clearing Risk

64. See, e.g., SHSE, *B-Share Seat Measures*, *supra* note 63, at Arts. 8-9; SZSE, *B-Share Seat Measures*, *supra* note 63, at Arts. 8, 14. The Shanghai and Shenzhen stock exchanges replaced the fixed “Annual Seat Management Fee” with a floating “Annual Seat Usage Fee” in 2004. See, e.g., SHSE, *Notice Concerning New Structure of Annual Seat Fees* (Dec. 13, 2004), available at <http://www.sse.com.cn/marketservices/tradingservice/charge/announ20041213.htm>; SZSE, *SZSE 2004-191: Notice Concerning New Structure of Annual Seat Fees* (Dec. 13, 2004), available at <http://www.szse.cn/main/rule/bsywgz/hyl/39744248.shtm>.

65. See, e.g., CSRC, *Qualification Regulation*, *supra* note 62, at Arts. 5-6; CSRC & SAFE, *CSRC 2001-26: Supplementary Requirements for Securities Firms Engaging in B-Share Business*, Art. 4 (Feb. 23, 2001), available at www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080304_77966.htm.

66. See CSRC, *CSRC 2001-22*, *supra* note 23, at Art. 4; see also RESEARCH INSTITUTE OF THE SHENZHEN STOCK EXCHANGE, ON THE LEGAL REGULATION OF STOCK EXCHANGE MEMBERS, 78 (2004), available at www.szse.cn/upfiles/attach/1903/2005/04/28/1404367500.doc (foreign B-share brokers’ agency trading limited to foreign investors).

67. See, e.g., SHSE, *B-Share Seat Measures*, *supra* note 63, at Arts. 2, 7, 11; SZSE, *B-Share Seat Measures*, *supra* note 63, at Arts. 5, 10-12.

68. See, e.g., SD&C Shanghai, *Interim Regulation Governing B-Share Clearing and Settlement*, Ch. 7 Arts. 75-78 (May 1993), available at <http://www.chinaclear.cn/main/10/1008/100804/1189580250134.pdf>; SD&C Shenzhen, *SD&C-SZ 95-20: Regulation Governing B-Share Clearing and Settlement*, Ch. 8 Arts. 8.5-8.8 (Oct. 12, 1995), available at <http://www.chinaclear.cn/main/10/1009/100906/1163818915004.pdf>.

Common Trust Fund” maintained by China Securities Depository and Clearing Corporation (“SD&C”): US\$50,000 at the SD&C-Shanghai Branch, and HK\$500,000 at the SD&C-Shenzhen Branch.⁶⁹

Based on the SHSE and SZSE’s lists as of October 2013, there are 38 foreign B-share broker-dealers on the Shanghai Stock Exchange, and 18 foreign B-share broker-dealers on the Shenzhen Stock Exchange.⁷⁰ The nationality-based distribution of B-share investor accounts at the end of 2011 is summarized in the table below, based on the SD&C data.⁷¹

B-Share Investor Accounts Distribution at Year End 2011 Shanghai Stock Exchange (SH) and Shenzhen Stock Exchange (SZ); Unit: Account	
Domestic Chinese Individual Investors: 1,462,922 (SH); 877,494 (SZ) Sub-total: 2,340,416	U.S. Investors: 12,360 (SH); 7,716 (SZ) Sub-total: 20,076
Hong Kong, Macao, and Taiwan Investors: Hong Kong: 97,849; Taiwan: 14,589; Macao: 4,727 Sub-total: 117,165	Other Foreign Countries and Unspecified: Japan: 5,583; UK: 3,313; Singapore: 2,895; South Korea: 2,804; Malaysia: 1,194; Indonesia: 225; Other countries: 25,996; Unspecified: 1,912 Sub-total: 43,922
SH Ratio = Foreign Investor B-share Accounts / Total B-share Accounts = 4.09% SZ Ratio = Foreign Investor B-share Accounts / Total B-share Accounts = 11.75% SH + SZ Weighted Average Ratio = Foreign Investor B-share Accounts / Total B-share Accounts = 7.11%	

With respect to stock exchange membership, prior to China’s WTO accession, foreign broker-dealers were allowed to set up their China

69. See, e.g., SD&C Shanghai, *supra* note 68, at Ch. 2 Arts. 6-7; SD&C Shenzhen, *supra* note 68, at Ch. 2 Arts. 2.2, 2.4.

70. See, e.g., SHSE, *Overseas B-Share Brokers List*, <http://english.sse.com.cn/tradmembership/trading/brokers/overseas/> (listing 38 foreign B-share brokers); SZSE, *B-Share Seat Rankings by Trading Value (as of October 2013)*, <http://www.szse.cn/main/files/2013/11/04/473440310634.html> (listing 18 foreign B-share brokers).

71. See CSRC, CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK 2012, §§ 6.5, 6.7 (Apr. 2013), available at <http://www.csrc.gov.cn/pub/newsite/xxfw/cbwxz/tjnj/zqqtjnj/> (investor nationality-based account counting). Cf. SD&C, CHINA SECURITIES REGISTRATION AND SETTLEMENT STATISTICAL YEARBOOK 2011, §§ 2.5, 2.13 (Aug. 2012), available at <http://www.chinaclear.cn/main/03/0305/1344586217950.pdf> (account locale-based account counting).

Representative Offices, of a non-commercial character.⁷² After China's WTO accession, such China Representative Offices may apply to become "Special Members" of China's stock exchanges and the Securities Association of China, of an honorary character.⁷³ Under the "Ordinary Membership" versus "Special Membership" dichotomy in the post-WTO era:

"Ordinary Members," i.e., Chinese securities firms, shall continue to enjoy the right to participate in an exchange's governance (such as being *ex officio* members of the Membership Assembly, voting for and being elected to the Board of Governors), the right to purchase one or more exchange seats or trading booths, and the right to exercise functions and to receive services related to or provided by the exchange.⁷⁴

72. See CSRC, *CSRC 1999-26: Regulation of China Representative Offices of Foreign Securities-Type Firms*, Art. 2 (Apr. 21, 1999), available at http://www.csrc.gov.cn/pub/newsite/flb/fgwj/bmgz/200803/t20080303_77914.htm; see also SCSC, *Regulation of Stock Exchanges*, Ch. 6 Art. 41 (Dec. 10, 1997), available at <http://edu.westlawchina.com/maf/china-cn/app/document?&docguid=i0adf589b0000011e6d832948d238aa0a&hitguid=i0adf589b0000011e6d832948d238aa0a&srguid=ia744dc1e00000141e920d1cf9a867111&spos=2&epos=2&td=4&crumb-action=append&context=30&lang=cn&crumb-label=%E6%96%87%E4%BB%B6> [hereinafter SCSC, *Regulation of Stock Exchanges (1997)*].

73. See, e.g., CSRC, *CSRC 2001-4: Regulation of Stock Exchanges*, Ch. 6 Art. 41 (Dec. 12, 2001), available at www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080305_77998.htm [hereinafter CSRC, *Regulation of Stock Exchanges (2001)*]; SHSE, *SHSE 2002-4: Provisional Regulation of Foreign Special Members of the Shanghai Stock Exchange*, Art. 2 (July 24, 2002), available at http://www.sse.com.cn/lawandrules/sserules/member/c/c_20120918_49766.shtml [hereinafter SHSE, *Foreign Special Membership Regulation*]; SZSE, *SZSE 2002-80: Regulation of Foreign Special Members of the Shenzhen Stock Exchange*, Art. 2 (July 24, 2002), available at <http://www.szse.cn/main/rule/bsywgz/39744246.shtml> [hereinafter SZSE, *Foreign Special Membership Regulation*]; SAC, *Regulation of China Representative Offices of Foreign Securities-Type Firms as SAC Special Members*, Art. 2 (Jan. 15, 2013), available at http://www.sac.net.cn/flgz/zlgz/201303/t20130305_61735.html [hereinafter SAC, *Foreign Special Membership Regulation*].

74. See, e.g., SHSE, *SHSE 1999-7: By-Laws of the Shanghai Stock Exchange*, Art. 9 (Aug. 12, 1999), available at www.sse.com.cn/lawandrules/sserules/organization/c/c_20120803_4865.shtml; SHSE, *Membership Regulation*, *supra* note 63, at Arts. 1.2, 8.1; SZSE, *By-Laws of the Shenzhen Stock Exchange*, Art. 8 (May 20, 1993), available at <http://edu.westlawchina.com/maf/china-cn/app/document?&docguid=i3cf76ad3000001206488bafb58bf81d6&hitguid=i3cf76ad3000001206488bafb58bf81d6&srguid=ia744dc1e00000141e9231364011455db&spos=1&epos=1&td=2&crumb->

“Special Members,” i.e., China Representative Offices of foreign broker-dealers, shall have the obligation to (1) comply with the Chinese laws and stock exchange bylaws and rules, (2) submit to the exchange Annual Working Reports and Current Reports on material events, (3) accept annual, *ad hoc*, and unannounced inspections by the exchange, (4) act as the foreign broker-dealer’s liaison with the Chinese stock exchange on matters of mutual interest, and (5) pay the “Special Membership dues and related fees” to the exchange. In exchange for fulfilling such obligations, the “Special Members” shall have the right to (1) attend the exchange’s Membership Assembly as observer, (2) make suggestions and recommendations to the exchange, and (3) receive any technical training as may be provided by the exchange to them—“provided that Special Members shall claim no right whatsoever as members of an exchange.”⁷⁵

Following suit, the Securities Association of China (“SAC”) or the Financial Industry Regulatory Authority (“FINRA”)’s Chinese counterpart classifies the Chinese securities firms as its “Statutory Members,” and accepts the foreign broker-dealers’ China Representative Offices as SAC’s “Special Members.”⁷⁶ Both Statutory Members and Special Members enjoy the right to “make suggestions and recommendations,” and bear the obligation to “pay dues,” to the SAC. However, only Statutory Members shall have the right to vote for and be elected to the governing bodies, and to sit on the various technical and advisory committees of the SAC. Special Members shall have no such right but shall have the obligation to make timely disclosures to the SAC of specified material events concerning their own organizations.⁷⁷

Both pre-and-post China’s WTO accession, China Representative Offices of foreign broker-dealers and their personnel were and are prohibited from “entering into any income producing commercial

action=append&context=42&lang=cn&crumb-label=%E6%96%87%E4%BB%B6;
SZSE, *Membership Regulation*, *supra* note 63, at Arts. 1.2, 8.1.

75. See, e.g., SHSE, *Foreign Special Membership Regulation*, *supra* note 73, at Ch. 3; SZSE, *Foreign Special Membership Regulation*, *supra* note 73, at Ch. 3.

76. See, e.g., SAC, *By-Laws of the Securities Association of China*, Ch. 3 Arts. 12, 14(4) (Oct. 24, 2011), available at http://www.sac.net.cn/ljxh/xhzc/201203/t20120327_363.html; SAC, *SAC Membership Regulation*, Ch. 2 Arts. 5, 7.4 (July 18, 2012), available at http://www.sac.net.cn/flgz/zlgz/201207/t20120718_43970.html; SAC, *Foreign Special Membership Regulation*, *supra* note 73, at Art. 2.

77. See, e.g., SAC, *By-Laws*, *supra* note 76, § 3.2, Ch. 4 Arts. 24(7), 30(7), 45(9); SAC, *Foreign Special Membership Regulation*, *supra* note 73, at Arts. 9-11.

contracts with any legal or natural persons in China, or otherwise engaging in any business activities.”⁷⁸ Any exchange seat renting or contracting, whether for the full seat interest or for any partial interest, between any private parties was, and still is, strictly prohibited.⁷⁹ Foreign broker-dealer’s Chief Representative to China may not concurrently assume any business management position at the foreign broker-dealer, nor may he assume any concurrent position with any Chinese institution. These regulations apply equally to the China Representative Offices of Sino-foreign joint venture securities firms as they apply to those of foreign broker-dealers.⁸⁰

To complement its regulation of China Representative Offices of foreign broker-dealers, in 2007 the CSRC adopted *Regulation of China Representative Offices of Foreign Stock Exchanges*.⁸¹ From thereon, a foreign stock exchange’s China Representative Office shall strictly limit its activities to liaising, awareness, research and similar activities of a “non-commercial” nature. It is prohibited from engaging in “any income-producing” activity, conducting any advertisement or publicity of any form or shape, or pursuing personal solicitations of any kind.⁸² If the Chief Representative Office desires to approach any Chinese enterprise to promote awareness about the foreign stock exchange, it shall submit its activity plan and related materials to the CSRC for a no-objection clearance; and it is cautioned against “making any false claims, engaging in any type of unfair competition, or serving the interest of any organization.”⁸³ The foreign stock exchange’s Chief Representative to China may not concurrently assume any business management position at the exchange, or take on any position with any Chinese business firm.⁸⁴

78. CSRC, *Regulation of China Representative Offices of Foreign Securities-Type Firms*, *supra* note 72, at Art. 14.

79. Compare SCSC, *Regulation of Stock Exchanges (1997)*, *supra* note 72, at Arts. 43-44, with CSRC, *Regulation of Stock Exchanges (2001)*, *supra* note 73, at Arts. 43-44.

80. See CSRC, *Regulation of China Representative Offices of Foreign Securities-Type Firms*, *supra* note 72, at Arts. 15, 29.

81. See CSRC, *CSRC 2007-44: Regulation of China Representative Offices of Foreign Stock Exchanges* (May 20, 2007), available at http://www.csrc.gov.cn/pub/newsite/flb/fgwj/bmgz/200803/t20080303_78236.htm.

82. *Id.* at Ch. 1 Art. 2, Ch. 4 Arts. 22-23.

83. *Id.* at Arts. 24-25.

84. *Id.* at Art. 21.

Post-China's WTO accession, a "foreign-invested Chinese securities firm" ("F-CN BD") may be formed in one of two ways: (1) establishment of an F-CN BD through joint equity contributions by a Chinese securities firm and a foreign broker-dealer (or "JV model"); and (2) a foreign broker-dealer's acquisition of an equity interest in a Chinese securities firm (or "acquisition model"). Under either model, the foreign equity interest shall not exceed 49%, while the Chinese equity interest shall not be less than 49%; the foreign party shall pay for its equity interest using freely convertible currencies, and the Chinese party may pay for its equity interest using the Chinese currency or in kind.⁸⁵

An F-CN BD must be formed as a Chinese company governed by the Company Law, and must obtain a "Securities Business License" from the CSRC.⁸⁶ An F-CN BD is prohibited from holding any equity interest in its controlling stockholder, or in any Chinese securities firms under common control with the F-CN BD.⁸⁷ Appointments to the positions of the board of directors of the F-CN BD shall proportionally reflect stock holdings of the nominating stockholders,⁸⁸ provided that members of an F-CN BD's board of directors, board of supervision, and senior management shall meet the qualification criteria set by the CSRC, and any appointment to any such position shall be invalid without the CSRC approval.⁸⁹ An F-CN BD is allowed to have foreign personnel occupying a maximum of 50% of its "managerial staff positions."⁹⁰

An F-CN BD is allowed to engage in the following lines of securities business:

- Underwriting and sponsoring in A-shares, B-shares, H shares, Chinese government bonds, and Chinese corporate bonds;

85. See CSRC, *CSRC 2012-86: Regulation of Foreign-Invested Chinese Securities Firms*, Arts. 2, 8-10 (Oct. 11, 2012), available at www.csrc.gov.cn/pub/zjhpublic/G00306201/201210/t20121016_215866.htm.

86. *Id.* at Arts. 4, 17.

87. See CSRC, *CSRC 2012-27: Provisional Regulation of Subsidiary Formation by Securities Firms*, Art. 10 (Oct. 11, 2012), available at www.csrc.gov.cn/pub/zjhpublic/G00306201/201210/t20121016_215856.htm.

88. *Id.* at Art. 9.

89. See CSRC, *CSRC 2012-88: Qualification Regulation of Members of Board of Directors, Board of Supervision, and Senior Management of Securities Firms*, Arts. 2-3 (Oct. 19, 2012), available at www.csrc.gov.cn/pub/zjhpublic/G00306201/201210/t20121019_216037.htm.

90. *Id.* at Art. 36.

- Agency trading in B-shares in China, and in H shares in foreign markets;
- Agency trading and dealing in Chinese government bonds and corporate bonds.⁹¹

Conspicuously, an F-CN BD, just as any foreign broker-dealer, is prohibited from trading, whether agency or proprietary, in A-shares; and a Chinese securities firm-turned-F-CN BD must “clean up and remove any businesses prohibited to an F-CN BD.”⁹²

Based on the CSRC’s statistics as of Q3 2013, of China’s total of 111 securities firms, 13 are F-CN BDs, one of whom is listed on the Shanghai Stock Exchange; 12 Chinese securities firms are listed on either the Shanghai or the Shenzhen stock exchange.⁹³ The SHSE-listed F-CN BD is Everbright Securities Co., Ltd. The “foreign stockholder” of Everbright Securities is the Hong Kong-registered, HKEX-listed China Everbright Limited, a diversified financial services enterprise operating in Hong Kong and mainland China. China Everbright Limited in turn is controlled by China Everbright Group, a Chinese State-owned, “Central Government-managed” conglomerate.⁹⁴ The 13 F-CN BDs and their foreign JV partners are listed below.⁹⁵

List of F-CN BDs as of September 30, 2013		
No.	F-CN BDs	Foreign JV Partners
1	China International Capital Corporation Limited	<ul style="list-style-type: none"> ✓ The Government of Singapore Investment Corporation Pte. Ltd. ✓ TPG Asia V. Delaware, L.P. ✓ KKR Institutions Investments L.P.

91. See CSRC, *CSRC 2012-86*, *supra* note 85, at Art. 5.

92. *Id.* at Art. 19(9).

93. See, e.g., CSRC, *Roster of Chinese Securities Firms (as of April 30, 2012)*, www.csrc.gov.cn/pub/zjhpublic/G00306205/201206/t20120614_211428.htm; CSRC, *Complete List and Categories of Listed Issuers as of Q3 2013—Category J-67: Capital Markets Services* (Oct. 2013), <http://www.csrc.gov.cn/pub/newsite/scb/ssgshyfljg/201310/W020131012576275202852.pdf>; CSRC, *List of JV Securities Firms (as of September 2013)*, http://www.csrc.gov.cn/pub/cscc_en/OpeningUp/RelatedLists/Securities/201311/P020131112534728902524.xls.

94. See, e.g., Everbright Securities Co., Ltd., *Corporate Profile*, <http://www.ebscn.com/companyInstruction.html?resourceId=001007>; China Everbright Limited, *Corporate Profile*, <http://www.everbright165.com/AboutUs/CorporateProfile>; China Everbright Group, *Corporate Profile*, <http://www.ebchina.com/ebchina/about.shtml>.

95. See CSRC, *List of JV Securities Firms (as of September 2013)*, *supra* note 93.

		<ul style="list-style-type: none"> ✓ Great Eastern Life Assurance ✓ Mingly Corporation
2	BOC International (China) Limited	BOC International Holdings
3	Everbright Securities Co., Ltd. (SHSE-listed)	China Everbright Limited (HKEX-listed)
4	Fortune CLSA Securities Limited	CLSA ECM Ltd.
5	Daiwa SMBC-SSC Securities Co., Ltd.	Daiwa Securities
6	Goldman Sachs Gao Hua Securities Company Limited	Goldman Sachs Asia Limited
7	UBS Securities Co., Ltd.	<ul style="list-style-type: none"> ✓ UBS AG ✓ IFC
8	Credit Suisse Founder Securities Co., Ltd.	Credit Suisse
9	Zhongde Securities Co., Ltd.	Deutsche Bank
10	Hua Ying Securities Co., Ltd.	The Royal Bank of Scotland Group Plc
11	Morgan Stanley Huaxin Securities Company Limited	Morgan Stanley Asia Limited
12	J.P. Morgan First Capital Securities Co., Ltd.	J.P. Morgan Broking (Hong Kong) Limited
13	Citi Orient Securities Co., Ltd.	Citigroup Global Markets Asia Ltd.

B. TRADING IN SHSE-LISTED STOCKS

Pursuant to the Securities Law, all stocks issued through public offerings shall be listed and traded “on stock exchanges only,” unless the State Council has approved their trading on “other securities trading platforms.”⁹⁶ Under the current market structure of China’s equity markets, all Shanghai Stock Exchange-listed stocks shall be exclusively traded on the SHSE, and all Shenzhen Stock Exchange-listed stocks shall be exclusively traded on the SZSE. There is no such concept as “unlisted trading privileges”; neither is there any such concept as “OTC transactions in listed stocks”—by law, or in practice.⁹⁷

96. See CHINESE SECURITIES LAW, *supra* note 35, at Art. 39.

97. See, e.g. SHSE, *SHSE 2012-202: Trading Rules of the Shanghai Stock Exchange*, Art. 1.2 (Jan. 1, 2013), available at http://www.sse.com.cn/lawandrules/sserules/trading/universal/c/c_20121217_3669124.shtml; SZSE, *SZSE 2013-66: Trading Rules of the Shenzhen Stock Exchange*, Art. 1.2 (Aug. 5, 2013), available at <http://www.szse.cn/main/rule/bsywgz/jyl/>

1. Listing Board of the Shanghai Stock Exchange

At present the SHSE runs a Blue Chip Board, featuring large State-controlled enterprises; and the SHSE is in the process of “constructing” an International Board.⁹⁸ For an A-share IPO issuer to be listed on the SHSE Blue Chip Board, its financials shall meet the thresholds prescribed by the CSRC, and its public float shall meet the requirements of the SHSE; specifically:

- The issuer has been in business for at least three years; had a net profit in each of the most recent three years, and a cumulative net profit for the most recent three years exceeding CN ¥ 30 million;
- The issuer’s cumulative net cash flow generated from its business operations in the most recent three years exceeded CN ¥ 50 million; alternatively, the issuer’s total revenues for the most recent three years exceeded CN ¥ 300 million;
- As of the most recent year, the issuer did not have any outstanding net operating loss;
- In the most recent year, the ratio of the issuer’s intangible assets value to the issuer’s total net assets value did not exceed 20%;
- Pre-IPO, the issuer had an equity of at least CN ¥ 30 million;
- Upon IPO and listing, the issuer’s total equity will be at least CN ¥ 50 million, with a public float of at least 25%; alternatively, the issuer’s total equity will be at least CN ¥ 400 million, with a public float of at least 10%.⁹⁹

The offering and listing of a B-share issuer are governed by regulations of the State Council, the former State Council Securities

ybgd_front/39750224.shtml. Cf. Securities Exchange Act of 1934 § 12(f), 15 U.S.C. § 78l(f) (2012) (“unlisted trading privileges”); Governing Off-Board Trading by Members of National Securities Exchanges, 17 C.F.R. § 240.19c-3 (2013).

98. See, e.g., SHSE, *Shanghai Stock Exchange Secures Footing on Main Board Blue Chip Market* (Dec. 14, 2006), <http://english.sse.com.cn/aboutsse/news/c/28172.shtml>; SHSE, *Strategic Plan of the Shanghai Stock Exchange (2011-2020)*, Part 3 No. 4 (Dec. 13, 2010), available at <http://222.73.229.9/sseportal/ps/zhs/home.shtml>.

99. See, e.g., CSRC, *CSRC 2006-32: Regulation of Initial Public Offering and Listing*, Arts. 2, 9, 33 (May 17, 2006), available at http://www.csrc.gov.cn/pub/zjhpublic/zjh/200804/t20080418_14502.htm; SHSE, *SHSE 2012-34: Shanghai Stock Exchange Stock Listing Rules*, Art. 5.1.1 (July 2012), available at http://www.sse.com.cn/lawandrules/sserules/listing/stock/c/c_20120918_49621.shtml.

Committee (“SCSC,” the supervisory agency over the CSRC),¹⁰⁰ and the CSRC, and not by the stock exchange rules. A B-share issuer is generally transformed from a former State-owned enterprise, whose B-share issuance and listing are “recommended” by a local government or a central government department having jurisdiction over the issuer. Such recommending government division shall submit to the SCSC, among other documents, its own written recommendation, the issuer’s balance sheet and income statement for the most recent year which shall have been “reviewed” by a registered Chinese accountant, and the issuer’s projections as to its after-tax profits for the current year.¹⁰¹ The SCSC will then “select” the B-share issuer candidates and notify the recommending government divisions accordingly. Thereafter, the B-share issuer candidate shall submit, again through the recommending government division, to the CSRC specified documents, including its audited financial statements for the most recent three years and an auditor’s report. Once “verified” by the CSRC as “meeting the requirements,” the issuer will be approved by the SCSC for B-share offering and listing, or by the State Council if the offering proceeds exceed US\$30 million.¹⁰² Use of B-share offering proceeds shall be in line with China’s national industrial policies, the national policies governing fixed assets investments, and the national policies governing foreign investments.¹⁰³

The SHSE’s ongoing ambitious construction of an International Board started in 2009, when in April that year the State Council issued *Opinion on Speeding Up the Development of a Modern Services Industry and an Advanced Manufacturing Industry in Shanghai to Build Shanghai into an International Financial Center and International*

100. The State Council Securities Committee (“SCSC”) was established in October 1992 as the supervisory agency over the CSRC. In April 1998, the SCSC was dissolved; its functions were transferred over to, and it was consolidated with, the CSRC. See CSRC, CHINA CAPITAL MARKETS DEVELOPMENT REPORT, *supra* note 36, at 11.

101. See, e.g., CSRC, CSRC 1999-52: *Announcement Concerning Eligible B-Share Issuers* (May 19, 1999), available at www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080306_77917.htm; SCSC, SCSC 1996-9, *supra* note 33, at Art. 4.

102. See, e.g., State Council, SC 1995-189, *supra* note 22, at Arts. 2, 10-12; SCSC, SCSC 1996-9, *supra* note 33, at Arts. 5-6.

103. See State Council, SC 1995-189, *supra* note 22, at Art. 8. The last year the SHSE saw a B-share offering and listing was 2003, and 2004 for SZSE. See *supra* note 21 and accompanying text.

Shipping Center.¹⁰⁴ A month later, the Shanghai Municipal Government issued its *Implementation Opinion*, expressly setting forth the task of “building an International Board at the Shanghai Stock Exchange, to list foreign issuers and to have the Red Chip issuers back in China to issue and list their A-shares on the Shanghai Stock Exchange.”¹⁰⁵ According to the SHSE, among the preparatory efforts it has made since then are:

Reaching out to and maintaining close contacts with target foreign issuers and Chinese H share and Red Chip issuers, including marketing activities conducted in the U.S. and Canada in 2012; exploring differential listing frameworks for foreign issuers and Red Chip issuers; making every effort conducive to the creation of an International Board.¹⁰⁶

104. See State Council, *SC 2009-19: Opinion on Speeding Up the Development of a Modern Services Industry and an Advanced Manufacturing Industry in Shanghai to Build Shanghai into an International Financial Center and International Shipping Center*, ¶ 4(7) (Apr. 14, 2009), available at www.gov.cn/zwgc/2009-04/29/content_1299428.htm.

105. See Shanghai Mun. Gov't, *SHG 2009-25: Opinion on Implementing the State Council Shanghai Financial Center Construction Opinion*, ¶ 2.4.1 (May 8, 2009), available at <http://www.shanghai.gov.cn/shanghai/node2314/node2319/node12344/userobject26ai18342.html>.

106. See, e.g., SHSE, SHANGHAI STOCK EXCHANGE FACT BOOK 2009, 6 (2009), available at <http://www.sse.com.cn/researchpublications/publication/factbook/c/factbook2008.pdf>; SHSE, SHANGHAI STOCK EXCHANGE FACT BOOK 2010, 7 (2010), available at <http://www.sse.com.cn/researchpublications/publication/factbook/c/factbook2009.pdf>; SHSE, SHANGHAI STOCK EXCHANGE FACT BOOK 2011, 7 (2011), available at <http://www.sse.com.cn/researchpublications/publication/factbook/c/factbook2010.pdf>; SHSE, SHANGHAI STOCK EXCHANGE FACT BOOK 2012, 9 (2012), available at <http://www.sse.com.cn/researchpublications/publication/factbook/c/factbook2011.pdf>; SHSE, SHANGHAI STOCK EXCHANGE FACT BOOK 2013, 8 (2013), available at http://www.sse.com.cn/researchpublications/publication/factbook/c/_20130411_3699256.pdf.

There have been academic discussions in China as to whether foreign stocks as well as Red Chips and H shares to be listed and traded on the International Board should be in ordinary share form or in China Depository Receipt (“CDR”) form. See, e.g., Shiliang Wu, *On the Feasibility of CDR Trading in China*, 5 J. OF CAPITAL U. OF ECON. & BUS. 5 (2007) (addressing pro-and-con of CDRs: Chinese investors may benefit from gaining access to foreign blue chip issuers, whereas Chinese domestic stock market may suffer due to arbitrageurs buying low-PE ordinary shares in foreign markets and selling high-PE CDRs in the Chinese market); Ansheng Dong, *Certain Issues Related to the Construction of an International Financial Center and an International Board*, 1 SEC. L. J. 196 (2009) (endorsing the CDR approach and

On May 24, 2012, the State Council transmitted to all provincial and municipal governments and all departments and agencies under the State Council, for implementation, *Guidance on Making Effective Use of International Cooperation and New Competitive Advantage*, submitted by eight ministries under the State Council: the National Development and Reform Commission, the Ministry of Commerce, the Foreign Ministry, the Ministry of Science and Technology, the Ministry of Industry and Information Technology, the Ministry of Finance, the People's Bank of China, and the General Administration of Customs.¹⁰⁷ The Guidance directs the various government departments to “formulate rules and regulations governing overseas enterprises’ offerings of Renminbi-denominated stocks in mainland China; be fully prepared technologically; and launch off such an overseas enterprises’ mainland offerings pilot at the right timing.”¹⁰⁸ As of the time of this Article, the contemplated International Board has yet to be launched.¹⁰⁹

2. Auction-Style Retail Trading on the Exchange Floor

Retail trading on the SHSE is effected in an auction market environment via the exchange's Central Order Book. There is no specialist or market maker for any stock, and the main role of an exchange member on the floor appears to be an order information delivery intermediary between the customer and the exchange system.¹¹⁰ Except for foreign investors' B-share trading, all customer orders must be “designated orders” whereby each customer must send all its orders

contemplating entry by foreign broker-dealers into the Chinese secondary market); Xiaolong Li & Lixue Shi, *Building China's International Board: A Legal Perspective*, 4 TIANJIN LEGAL SCI. 51 (2011) (discussing legal hurdles facing foreign issuers and Red Chips as International Board issuers, including difficulties posed by China's restrictions on foreign exchange); Wanquan Liang, *A Comparison of Two Forms of Trading on the International Board*, 2 CAPITAL OBSERVER 70 (2011) (recommending both ordinary share and CDR forms, to be elected by issuers).

107. See Office of the State Council, *OSC 2012-32: Transmittal of “Guidance on Making Effective Use of International Cooperation and New Competitive Advantage” Submitted by Eight Agencies* (May 24, 2012), available at www.gov.cn/zwggk/2012-06/01/content_2151106.htm.

108. *Id.* ¶ 3(15).

109. Information based on Author's conversation with the Shanghai Stock Exchange staff on SHSE's Public Communication Line on October 10, 2013.

110. See SHSE, *Trading Rules*, *supra* note 97, §§ 2.1, 3.1

exclusively to one member firm for handling.¹¹¹ The exchange uses two auction mechanisms: “call auction” for the opening cross, and “continuous auction” for the day’s two trading sessions.¹¹²

Opening cross runs from 9:15 a.m. to 9:25 a.m., during which time orders may be entered; beginning 9:20 a.m., orders may not be cancelled; at 9:25 a.m., orders are matched and executed at the single equilibrium price resulting in the maximum volume of executions. From time to time between 9:15 a.m. and 9:25 a.m., the exchange will display to member firms real time market data with respect to each stock, showing the “indicative opening price, indicative execution volume, and indicative unexecuted volume.”¹¹³ There is no closing cross session; instead, the weighted average of the prices of all trades executed during the last one minute of market close is treated as the closing price of the day. If there are no such trades on the trading day, then the closing price of the previous trading day is treated as the closing price of the trading day.¹¹⁴

Continuous auction sessions run from 9:30 a.m. to 11:30 a.m., and then from 1:00 p.m. to 3:00 p.m. During a continuous auction session, the exchange will release to member firms real time market data with respect to each stock, displaying:

- the five highest-priced standing buy orders, the five lowest-priced standing sell orders, and the last sale price;
- the highest and the lowest prices of the day; the cumulative trading volume and cumulative trading value of the day; and
- the closing price of the previous trading day (which shall be the public offering price in the case of an IPO).¹¹⁵

The continuous auction adopts a price-time priority rule, such that (1) where the highest priced buy order and the lowest priced sell order have the same price, the two orders are matched and a trade is executed at that price; (2) where an incoming buy order is priced higher than the lowest-priced standing sell order, the two orders are matched and a trade is executed at the price of the lowest-priced standing sell order; (3) where an incoming sell order is priced lower than the highest-priced standing buy order, the two orders are matched and a trade is executed at

111. *Id.* § 3.2.

112. *Id.* §§ 2.4, 3.5.

113. *Id.* §§ 2.4, 3.5-3.6, 5.2, 11.4.

114. *Id.* § 4.1.

115. *Id.* §§ 2.4, 5.2.

the price of the highest-priced standing buy order,¹¹⁶—a pricing rule that appears to reward the liquidity taker and penalize the liquidity supplier.¹¹⁷

The exchange permits two types of order: limit orders, which must be used for IPO stocks' first day trading and for all stocks' opening cross; and market orders, which, as well as limit orders, may be used for non-IPO stocks' continuous auction sessions.¹¹⁸ There are two subtypes of market order. A market order may be specified to be executed successively against the five, best priced standing contra orders in the Central Order Book, with any remaining unexecuted portion of the market order:

- either canceled;

116. *Id.* at Art. 3.6.3.

117. The concepts of “liquidity” provided by, and “free option” implicit in, a limit order have been addressed by financial economists. “Liquidity” is described as the price of immediacy which traders wishing to trade now pay relative to waiting to trade next period. In contrast to the liquidity taker, a limit order trader enhances the liquidity of the market by pre-committing to buying or selling at a particular price and thus furnishing the rest of the market with a “free option” at the specified strike price that can move in or out of the money as market prices change, exposing the writer to the risk of the option being exercised at his expense or imposing monitoring costs on the limit order trader. *See, e.g.*, MAUREEN O'HARA, MARKET MICROSTRUCTURE THEORY, 197, 221 (1995); Hans Stoll, *Principles of Trading Market Structure*, 6 J. FIN. SERVS. RES. 75, 77, 84 (1992).

Thus it would seem fair to reward the liquidity supplier and penalize the liquidity taker. It would be interesting empirical questions whether the limit order trader qua liquidity supplier in the Chinese equity market has incorporated this fair compensation notion into its posted limit order price, and whether the liquidity taker strategically uses aggressively priced limit order instead of market order to both obtain immediacy and protect against instantaneous adverse market move.

The Chinese stock exchanges appear not the only exchanges to adopt such a pricing rule. In describing the “Limit Order Market,” Professor Joel Hasbrouck gave this example: when an order to “sell 300 shares at \$30” is hit by a subsequent order to “buy 100 shares at \$32,” “an execution will take place for 100 shares at \$30.” JOEL HASBROUCK, EMPIRICAL MARKET MICROSTRUCTURE: THE INSTITUTIONS, ECONOMICS, AND ECONOMETRICS OF SECURITIES TRADING, 10 (2007). Professor Larry Harris opines that the “discriminatory pricing rule” used by the “continuous trading auction markets” “favors large liquidity demanding traders over small liquidity suppliers.” HARRIS, *supra* note 2, at 126–27, 137.

118. *See* SHSE, *Trading Rules*, *supra* note 97, § 3.3 Art. 3.3.5, § 3.4 Arts. 3.4.5, 3.4.13.

- or switched to a limit order at the last sale price; and, failing an execution at the last sale price, switched to a limit order at the price of the current best-priced same side order;

—at the election of the customer.¹¹⁹ Regardless of the price range of any particular stock, the minimum pricing variation or MPV governing order submission is invariably CN¥0.01 for A-shares, and US\$0.001 for B-shares.¹²⁰ Such a single, across-the-board MPV could give rise to the troubling phenomenon of using an economically infinitesimal amount to front-run an order with time priority, depending on the share price range of a particular stock.¹²¹

Intended to control transitory volatility caused by “noise trading,”¹²² rather than limiting fundamental volatility induced by changes in fundamentals, all orders—both limit orders and market orders—must comply with applicable price bands which differentiate between IPO stocks and non-IPO stocks, as summarized in the Price Band Chart of the Shanghai and Shenzhen Stock Exchanges.¹²³

119. *Id.* § 3.4 Art. 3.4.4.

120. *Id.* § 3.4 Art. 3.4.11.

121. Professor Harris observes that a small tick size “reduces the costs of front-running and quote-matching strategies.” Larry Harris, *The Economics of Trading and of Regulated Exchanges*, in *REGULATED EXCHANGES: DYNAMIC AGENTS OF ECONOMIC GROWTH*, 90 (Larry Harris, ed., 2010).

122. Professor Stoll identifies three “motives for trading,” i.e., “liquidity trading” or trading due to the need to smooth consumption overtime or for risk adjustment; “informational trading” by traders who have private information that implies a price change; and “noise trading” by traders who do not have fundamental information but have trading information. Noise traders “mimic information traders when they want to influence price, and mimic liquidity traders when they want to limit the price effect of their trading.” Stoll, *supra* note 117, at 77–78.

123. See, e.g., SHSE, *Trading Rules*, *supra* note 97, §§ 3.4, 3.7; SHSE, *Notice of Enhanced Regulation of IPO and Aftermarket Trading Activities* (Dec. 13, 2013), available at http://www.sse.com.cn/aboutus/hotandd/ssenews/c/c_20131213_3757310.shtml, ¶ 1; see also INNOVATION LAB OF THE SHANGHAI STOCK EXCHANGE, *PRICE BANDS AND MARKET EFFICIENCY—AN EMPIRICAL STUDY OF THE SHSE-LISTED STOCKS* (2006), available at <http://www.sse.com.cn/researchpublications/research/c/research20060401d.pdf>. The Shanghai Stock Exchange does not operate a circuit breaker system with respect to non-IPO stocks, but began applying a circuit breaker system for IPO stocks from December 13, 2013. See SHSE, *Notice of Enhanced Regulation of IPO and Aftermarket Trading Activities*, *supra*, ¶ 2.

Price Band Chart of the Shanghai and Shenzhen Stock Exchanges	
<p>Non-IPO Stock Price Band:</p> $P_{\text{Band},0} = \left[P_{c,-1} \times (1 - 10\%), P_{c,-1} \times (1 + 10\%) \right]$	<p>IPO Stock Price Bands:</p>
<p>Public Auction Market:</p> <ul style="list-style-type: none"> ● Opening Cross (SHSE; SZSE): ✓ Limit Orders ● Continuous Auction Sessions (SHSE; SZSE): ✓ Market Orders ✓ Limit Orders ● Closing Cross (SZSE): ✓ Limit Orders 	<p>Public Auction Market:</p> <ul style="list-style-type: none"> ● Opening Cross: Limit Orders (SHSE; SZSE) $P_{\text{POP}} \times 80\% \leq P_{\text{L.o.}} \leq P_{\text{POP}} \times 120\%$ ● Continuous Auction Sessions: Limit Orders SHSE: $P_{\text{POP}} \times 64\% \leq P_{\text{L.o.}} \leq P_{\text{POP}} \times 144\%$ $P_{\text{POP}} \times 80\% \leq P_{\text{L.o.}} \leq P_{\text{POP}} \times 120\%$ (applicable from 2:55 p.m. to 3:00 p.m.) SZSE: $P_{\text{Last Sale}} \times (1 - 10\%) \leq P_{\text{L.o.}} \leq P_{\text{Last Sale}} \times (1 + 10\%)$ ● Closing Cross: Limit Orders (SZSE) same as Continuous Auction Sessions
<p>Block Trading System: SHSE; SZSE (Bilaterally Negotiated Trading)</p>	<p>Block Trading System: SHSE; SZSE (Bilaterally Negotiated Trading) $P_{\text{L}} \leq P_{\text{Block}} \leq P_{\text{H}};$ $P_{\text{POP}} \times (1 - 30\%) \leq P_{\text{Block}} \leq P_{\text{POP}} \times (1 + 30\%)$</p> <p style="text-align: center;">OR</p>
<p>Block Trading System: SHSE; SZSE (Bilaterally Negotiated Trading)</p>	<p>Block Trading System: SHSE; SZSE (Bilaterally Negotiated Trading) $P_{\text{L}} \leq P_{\text{Block}} \leq P_{\text{H}};$ $P_{\text{POP}} \times (1 - 30\%) \leq P_{\text{Block}} \leq P_{\text{POP}} \times (1 + 30\%)$</p> <p style="text-align: center;">OR</p>
<p>SZSE (After-Hours Continuous Crossing Session): public auction market closing price or full-day VWAP SHSE (After-Hours Call Crossing Session): public auction market closing price or full-day VWAP (expected April 2014)</p>	<p>Block Trading System: SHSE; SZSE (Bilaterally Negotiated Trading) $P_{\text{L}} \leq P_{\text{Block}} \leq P_{\text{H}};$ $P_{\text{POP}} \times (1 - 30\%) \leq P_{\text{Block}} \leq P_{\text{POP}} \times (1 + 30\%)$</p> <p style="text-align: center;">OR</p>
<p>$P_{\text{Band},0}$: price band on current trade day. $P_{c,-1}$: closing price of the previous day. P_{POP}: IPO stock public offering price. $P_{\text{L.o.}}$: limit order price. $P_{\text{Last Sale}}$: last sale price. P_{Block}: block trade price.</p>	<p>$P_{\text{Band},0}$: price band on current trade day. $P_{c,-1}$: closing price of the previous day. P_{POP}: IPO stock public offering price. $P_{\text{L.o.}}$: limit order price. $P_{\text{Last Sale}}$: last sale price. P_{Block}: block trade price.</p>

The SHSE runs a special session for “Special Treatment” stocks, which are indicated by:

- The notation “*ST” appended to the stock name, where the issuer is facing “delisting risk” due to financial difficulties; or
- The notation “ST,” where the issuer is facing “other risks” due to factors such as a lack of trading activity in the issuer’s stock for a substantial period of time; or
- A two-Chinese character notation *tui shi* meaning “Pending Delisting,” where the issuer is “in delisting process.”¹²⁴

Trading in Special Treatment stocks has special requirements with respect to investor suitability such as use of limit order only, limit on buy order quantity, application of special price bands, and public disclosure of remaining days before the onset of delisting for a particular stock.¹²⁵ An ST stock caused by inactive trading will trade in the special session for 120 trading days, to either recover or deteriorate into an *ST stock. An *ST stock will trade in the special session until its recovery or downgrade into a Pending Delisting stock. A Pending Delisting stock will trade in the special session for a transitional period of 30 trading days before its delisting and moving onto the OTC market for non-listed public companies.¹²⁶

3. OTC-Style Block Trading on the Exchange Floor

The “block trading business” began on the Shanghai Stock Exchange in 2003. Since June 1, 2009, the exchange has been running two block trading sessions: orders may be entered during 9:30 a.m. to 11:30 a.m. and 1:00 p.m. to 3:00 p.m.—contemporaneously with the SHSE’s public auction sessions; during 3:00 p.m. to 3:30 p.m.,

124. See, e.g., SHSE, *Stock Listing Rules*, *supra* note 99, at Ch. 13, § 14.3; SHSE, *SHSE 2012-72-A1: Interim Rules Governing Trading in Special Treatment Stocks*, Art. 2 (Jan. 1, 2013), available at http://www.sse.com.cn/lawandrules/sserules/trading/stock/c/c_20121217_3669125.shtml.

125. See SHSE, *SHSE 2012-72-A1*, *supra* note 124, at Arts. 6-7, 10, 14.

126. See, e.g., SHSE, *Stock Listing Rules*, *supra* note 99, § 14.3; SHSE, *SHSE 2012-72-A2: Rules Governing Stock Trading and Related Matters During Pre-Delisting Transitional Period*, Arts. 7, 10 (Dec. 14, 2012), available at http://www.sse.com.cn/lawandrules/sserules/listing/stock/c/c_20121217_3669120.shtml.

executions will take place on the system while orders may continue to be entered.¹²⁷

A “Block Order” eligible to participate in block trading on the SHSE is defined by the SHSE trading rules. It refers to any single order for at least 500,000 shares of stock, whether A-shares or B-shares, or for any quantity of stock having the market value of at least CN¥3 million in the case of A shares or US\$300,000 in the case of B shares.¹²⁸ Buyer and seller may negotiate their block trade price, provided that the resulting price is within the applicable “block trade price band,” which is derived from the public auction market pricing, as described in the Price Band Chart of the Shanghai and Shenzhen Stock Exchanges.¹²⁹

127. See, e.g., SHSE, *Announcement of Commencement of Block Trading Business* (Jan. 2, 2003), http://www.sse.com.cn/disclosure/announcement/general/c/c_20120914_47319.shtml; SHSE, *SHSE 2009-10: Announcement of Two Block Trading Sessions* (May 20, 2009), http://www.sse.com.cn/lawandrules/sserules/trading/universal/c/c_20120918_49670.shtml; SHSE, *Trading Rules*, *supra* note 97, § 3.7.

On October 18, 2013, the Shanghai Stock Exchange amended its Trading Rules, which, as related to block trading:

- (1) lower the “Block Order” thresholds from 500,000 shares to 300,000 shares for A and B shares, from CN¥3 million to CN¥2 million for A-shares, and from US\$300,000 to US\$200,000 for B-shares;
- (2) add an extended session from 4:00 p.m. to 5:00 p.m. for bilaterally negotiated trading;
- (3) add an after-hours crossing session from 3:00 p.m. to 3:30 p.m., applying either the closing price of the public auction market or alternatively its full day VWAP.

As so revised, the SHSE block trading mechanisms become similar to the SZSE block trading mechanisms as the latter were revised in August 2013. The amended Shanghai Stock Exchange Trading Rules are to become effective on December 19, 2013, while the new block trading and pricing mechanisms will not be implemented until the technology readiness is achieved, expected to occur in April 2014. See, e.g., SHSE, *SHSE 2013-9: Shanghai Stock Exchange Trading Rules (2013 Amendment)*, § 3.7 (Oct. 18, 2013), available at http://www.sse.com.cn/lawandrules/sserules/trading/universal/c/c_20131021_3746516.shtml; SHSE, *SHSE Announces New Trading Rules* (Oct. 19, 2013), http://www.sse.com.cn/aboutus/hotandd/ssenews/c/c_20131021_3746515.shtml. This Article’s discussion of the SHSE block trading system is based on its current operations.

128. See SHSE, *Trading Rules*, *supra* note 97, at Art. 3.7.1.

129. *Id.* at Art. 3.7.6; see also *supra* notes 123, 127 and accompanying text.

The table below shows the relative weights of retail and institutional trading on the Shanghai Stock Exchange in 2012.¹³⁰

Distribution of Stock Trading and Brokerage Accounts Between Institutional and Retail Customers Shanghai Stock Exchange (2012)		
	% of Total Trading Value (for year 2012)	Total Number of Brokerage Accounts (at year end 2012)
Individuals	80.78%	30,401,300
Investment Funds	8.02%	800
Other Institutional Investors or Legal Persons	11.2%	64,300

Two types of order are used for block trading:

- indications of interest or IOIs; and
- paired execution orders.¹³¹

Where an IOI does not specify the price, the IOI is deemed to be priced at the lowest price in the case of a buy, and the highest price in the case of a sell, permissible under the applicable block trade price band. Where an IOI does not specify the quantity, the IOI is deemed to be for the minimum quantity meeting the Block Order definition.¹³² An IOI entered into the exchange's block trading system is viewable by all system participants, but is hidden from the view of the public participating in the exchange's auction market. If one or more system participants respond to an IOI in accordance with the terms of the IOI, the IOI transmitter is required to trade with at least one of such system participants. The block trading system provides features whereby the IOI transmitter and the responder may negotiate terms of the trade; and, after a deal is reached between them, the buyer and the seller shall each send a "paired execution order," identified by a Pair ID and designating the stock, price, and quantity, to the system for execution. The block trading system will execute the paired orders regardless of any better priced orders or any same-priced orders with time priority standing in

130. See SHSE, 2013 SHANGHAI STOCK EXCHANGE ANNUAL STATISTICS, 424 (2013), available at http://www.sse.com.cn/researchpublications/publication/yearly/c/tjnj_2013.pdf.

131. See SHSE, *Trading Rules*, *supra* note 97, at Art. 3.7.3.

132. *Id.* at Art. 3.7.4.

the system.¹³³ Price and quantity of each block trade are neither revealed in the real time market data released by the exchange, nor are they included in the exchange's index calculation. Not until the end of the trading day will the exchange publicly release, with respect to each block trade, the stock name, price and quantity, and member firms' specific branch offices representing the buyer and the seller or anonymously marking "Institution" where applicable.¹³⁴

Thus, there appears to have neither pre-trade transparency of block orders for the benefit of the exchange's public auction market, nor real-time post-trade transparency with respect to block trades to any market participant. The specter of a two-tiered market structure between the public auction market and the institutional market is real. In addition, the paired order execution feature of the block trading system inhibits the ability of orders to freely interact with superiorly priced orders, results in trade-throughs within the institutional market, and reduces the incentive to enter aggressively priced limit orders on the block trading system.¹³⁵

Under the SHSE trading rules, only "qualified market participants" are eligible to participate in the block system trading, and they are:

- SHSE member firms, who may trade for both proprietary and agency accounts;

133. *Id.* at Arts. 3.7.5, 3.7.7; *see also* SHSE, SHANGHAI STOCK EXCHANGE MULTI-PRODUCT PLATFORM: SYSTEM USERS' GUIDE FOR MARKET PARTICIPANTS (VERSION 1.32), § 2 (May 2013), *available at* <http://www.sse.com.cn/marketservices/tradingservice/platform/tradingtech/historicaldata/c/3716876.pdf>.

134. *See* SHSE, *Trading Rules*, *supra* note 97, at Arts. 3.7.10-3.7.11, 5.4.4.

135. The concept of "trade-through" does not exist in the rules governing the Chinese market structure. Under the U.S. Regulation NMS—Regulation of the National Market System, "trade-through" is defined to mean "the purchase or sale of an NMS stock during regular trading hours, either as principal or agent, at a price that is lower than a protected bid or higher than a protected offer." NMS Security Designation and Definitions, 17 C.F.R. § 242.600, (b)(77) (2013). Financial economists have concluded that "protecting limit orders against trade-throughs is important because trade-throughs discourage liquidity provision." Thierry Foucault & Albert J. Menkveld, *Competition for Order Flow and Smart Order Routing Systems*, 63 J. FIN. 119, 121 (2008). Limit orders are ranked by "degrees of aggressiveness" relating order price and size to the prevailing price and depth of bid and ask quotes. Aggressive orders are designed to achieve immediate executions; the more aggressive types of limit order are more likely to result in immediate execution. *See* Bruno Biais, Pierre Hillion & Chester Spatt, *An Empirical Analysis of the Limit Order Book and the Order Flow in the Paris Bourse*, 5 J. FIN. 1655, 1668–69 (1995).

- insurance companies and insurance assets management firms;
- management companies of social security funds and other retirement funds;
- State assets management companies;
- trust and investment companies, finance companies, and other assets management companies; and
- Qualified Foreign Institutional Investors or QFIIs;

—provided that QFIIs may not trade “directly” on the block trading system as “system participants,” but shall “trade through exchange members acting as broker for them.”¹³⁶

Social security fund management companies were authorized by the CSRC in 2002 to “rent trading seats from the stock exchanges for the exclusive use of the social security funds’ investment operations.”¹³⁷ Insurance companies and insurance assets management firms were authorized by China Insurance Regulatory Commission (“CIRC”) in 2005 “to purchase from the stock exchanges, or to rent from exchange members, special seats as independent seats on the exchanges for insurance institutional investors to participate in trading.”¹³⁸ Investment management companies joined the foray in 2007 when they were authorized by the CSRC to “rent exchange trading seats from securities firms that are well-regulated, financially solid, and having good research capability.”¹³⁹ In August 2011, the Shanghai Stock Exchange, the

136. See, e.g., SHSE, *SHSE 2008-12: Announcement of Commencement of Block Trading Session and Issuance of Qualified Participant Certificates* (June 11, 2008), <http://www.sse.com.cn/lawandrules/guide/jyznlc/jytz/c/3679141.shtml>; SHSE, *SHSE 2008-4: Operational Guide for Use of Block Trading System to Transfer Shares Tradable Pursuant to A-Shares Reform*, Arts. 2-5 (Apr. 23, 2008), available at http://www.sse.com.cn/lawandrules/sserules/trading/stock/c/c_20120918_49681.shtml; SHSE, *Rules Governing Securities Trading by QFIIs on the Shanghai Stock Exchange*, Art. 4 (Dec. 1, 2002), available at http://www.sse.com.cn/lawandrules/sserules/trading/universal/c/c_20120918_49677.shtml.

137. See CSRC, *CSRC 2002-3: Announcement Concerning Trading Seats and Related Matters with Respect to Social Security Funds* (July 11, 2002), available at http://www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080305_78010.htm.

138. See China Ins. Reg. Comm’n (“CIRC”), *CIRC 2005-13: Announcement Concerning Insurance Institutional Investors’ Participation in Stock Trading* (Dec. 26, 2005), available at <http://www.circ.gov.cn/tabid/106/InfoID/21442/ftid/3871/Default.aspx>.

139. See CSRC, *CSRC 2007-48: Announcement Concerning Standardizing the Trading Seats Used by Investment Companies* (Feb. 16, 2007), available at http://www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080304_78218.htm.

Shenzhen Stock Exchange, and the SD&C, outraged at the “violation by the insurance companies and insurance assets management firms of the Securities Law, by participating in exchange trading while not members of the stock exchanges,” jointly issued an ultimatum to the insurance companies and insurance assets management firms, counseling them to “recognize the proper roles of, and the dividing line between, the insurance industry and the securities industry,” and ordering them to “gradually exit their currently occupied exchange seats and trading booths, and use exchange members as their brokers.”¹⁴⁰ The two exchanges offered the insurance companies and insurance assets management firms that, “on condition that they become brokerage customers of the exchange member firms, the member firms may provide their exchange trading booths to the insurance companies and insurance assets management firms as special brokerage customers to meet the latter’s specialized trading needs.”¹⁴¹

The SHSE’s block trading system seems to be in a legal Catch-22. On the one hand, pursuant to Article 39 of the Securities Law and Article 1.2 of the Shanghai Stock Exchange Trading Rules, all SHSE-listed stocks shall be traded exclusively on the exchange—thus the system may not legally exist outside the exchange as an OTC trading platform.¹⁴² On the other hand, Article 102 of the Securities Law mandates that a stock exchange shall utilize “centralized trading” mechanism, and Article 110 of the Securities Law mandates that “any

140. See SHSE, SZSE & SD&C, *SHSE 2011-24: Joint Announcement Concerning Securities Trading by Insurance Firms* (Aug. 23, 2011), available at http://www.sse.com.cn/lawandrules/sserules/member/c/c_20121226_3675987.shtml.

141. *Id.*

In addition to serving as a type of OTC market for institutional trading in SHSE-listed stocks away from the SHSE’s public auction market, the SHSE’s block trading system is also used by underwriters and dealers to “auction away” their unsold portions of underwriting allotments, and by large shareholders to sell their control stocks. Due to the scope of this Article, the Author does not address the implications of such practices under the Chinese securities laws governing securities offerings. See, e.g., SHSE, INTERIM GUIDE FOR BLOCK TRADING SESSION PARTICIPANTS (May 27, 2008), available at <http://www.sse.com.cn/lawandrules/guide/jyznlc/jyzn/c/3676006.pdf> (selling by underwriters via the system); SHSE, *SHSE 2008-4*, *supra* note 136 (selling control stocks via the system); Xi Zhu, *The Evolution of the Shanghai and Shenzhen Block Trading Systems and Their Trading Characteristics*, 2 FIN. & ECON. 41 (2004) (selling by underwriters via the systems).

142. See, e.g., CHINESE SECURITIES LAW, *supra* note 35, at Ch. 3 Art. 39; SHSE, *Trading Rules*, *supra* note 97, at Ch. 1 Art. 1.2.

person participating in centralized trading on the exchange shall be an exchange member,”—thus the system, assuming *arguendo* that it meets the “centralized trading” criteria, may exist on the exchange but may not accept any system participants who are not exchange members but are institutional investors.¹⁴³ The solution to this legal predicament would seem to be this: giving legal recognition to the concept of OTC transactions in listed stocks, and allowing the SHSE’s block trading system to exist as an independent, competitive trading venue, to evolve, and to be subject to the tiered regulation structure along the lines of the U.S. Regulation ATS—Alternative Trading Systems.¹⁴⁴

4. Margin Buying and Short Selling in SHSE-Listed Stocks

Prior to its 2005 amendment, the Securities Law expressly prohibited any securities firms from lending funds or securities to customers. The 2005 amendment to the Securities Law provides: “Securities firms providing margin and securities lending services in connection with customers’ securities trading shall be governed by regulations promulgated by the State Council and shall have approval from the securities regulatory agency under the State Council.”¹⁴⁵ After two pilot programs in 2006,¹⁴⁶ in 2008 the State Council adopted

143. See, e.g., CHINESE SECURITIES LAW, *supra* note 35, at Ch. 5 Arts. 102, 110.

144. See Regulation ATS—Alternative Trading Systems, 17 C.F.R. §§ 242.300 *et seq.* (2013).

145. Compare CHINESE SECURITIES LAW, *supra* note 35, at Art. 142, with SECURITIES LAW OF THE PEOPLE’S REPUBLIC OF CHINA, Art. 141 (2004), available at <http://edu.westlawchina.com/maf/china-cn/app/document?&docguid=i3cf76ad3000001205d6faac360e4ed65&hitguid=i3cf76ad3000001205d6faac360e4ed65&srguid=ia744dc1e00000141e924f9f011455e9&spos=2&epos=2&td=7&crumb-action=append&context=55&lang=cn&crumb-label=%E6%96%87%E4%BB%B6>, and SECURITIES LAW OF THE PEOPLE’S REPUBLIC OF CHINA, Art. 141 (1999), available at <http://edu.westlawchina.com/maf/china-cn/app/document?&docguid=i3cf76ad30000011ef35156de633ee7bb&hitguid=i3cf76ad30000011ef35156de633ee7bb&srguid=ia744dc1e00000141e926131e011455fb&spos=3&epos=3&td=7&crumb-action=append&context=63&lang=cn&crumb-label=%E6%96%87%E4%BB%B6>.

146. See, e.g., CSRC, *CSRC 2006-69: Rules Governing Securities Firms’ Margin and Securities Lending Pilot Programs* (June 30, 2006), available at www.csrc.gov.cn/pub/newsite/xxfw/fgwj/gfxwj/200701/t20070108_77574.htm; SHSE, *SHSE Announces Implementation Rules Governing Margin and Securities Lending Pilot Program* (Aug. 21, 2006), http://www.sse.com.cn/aboutus/hotandd/ssenews/c/c_20121024_50824.shtml; SZSE, *SZSE and SHSE Announce “Implementation Rules Governing Margin and Securities Lending Pilot Programs”* (Aug. 21, 2006),

Regulation of Securities Firms, which not only contains detailed provisions governing the operational and risk management aspects of margin and securities lending business of securities firms, but also authorizes “the use by securities firms of a third party re-financing firm in the event the securities firms themselves do not have sufficient funds or securities to lend to customers for trading,” immediately adding: “the establishment and dissolution of any such securities finance corporation shall be decided by the State Council.”¹⁴⁷

On October 26, 2011, the CSRC issued two sets of regulation governing securities firms and “securities finance corporations” respectively, including *Regulation of Margin and Securities Lending Business of Securities Firms*, which officially allows all eligible securities firms to apply to the CSRC for a “Margin and Securities Lending Business License,” and *Provisional Regulation of Securities Re-Financing Business*, which officially authorizes and regulates “Securities Finance Corporations” and their margin and securities refinance business.¹⁴⁸ Two days later, on October 28, 2011, China Securities Finance Corporation Limited (“CSF”) was jointly formed by the SHSE, the SZSE, and the SD&C “pursuant to the decision of the State Council and the approval by the CSRC as a securities-type financial institution,” “for the purposes of providing re-financing services to and monitoring the margin and securities lending business of securities firms, and of macro monitoring the margin and securities lending market and controlling its risks pursuant to the authorization of the CSRC,” operating as a “non-profit corporation.”¹⁴⁹

<http://www.szse.cn/main/aboutus/bsdt/9155.shtml>; see also CSRC, *CSRC 2010-3: Guidance Concerning Securities Firms’ Margin and Securities Lending Pilot Programs* (Jan. 22, 2010), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201001/t20100122_175838.htm.

147. See State Council, *SC 2008-522: Regulation of Securities Firms*, § 45 Art. 56 (June 1, 2008), available at www.gov.cn/zw/gk/2008-04/24/content_952736.htm.

148. See, e.g., CSRC, *CSRC 2011-31: Regulation of Margin and Securities Lending Business of Securities Firms*, Ch. 2 (Oct. 26, 2011), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201110/t20111028_201127.htm; CSRC, *CSRC 2011-75: Provisional Regulation of Securities Re-Financing Business*, Ch. 2 (Oct. 26, 2011), available at www.csrc.gov.cn/pub/zjhpublic/G00306201/201110/t20111028_201132.htm.

149. See, e.g., China Sec. Fin. Corp. (“CSF”), *About Us*, <http://www.csf.com.cn/publish/main/1001/1002/index.html>; CSRC, *CSRC 2011-75*, *supra* note 148, at Arts. 6, 10; see also CSF, *Interim Operational Rules of China Securities Finance Corporation Governing Re-Financing Business* (Aug. 27, 2012), available at

Each securities firm's eligibility for margin and securities lending business is determined by the CSRC. The suitability of margin trading and short selling for any customer shall be decided by each securities firm, as directed by the CSRC rules. Marginable securities, eligible collateral, and applicable haircuts shall be decided by each stock exchange.¹⁵⁰ Effective September 16, 2013, the marginable stocks on the SHSE are the top 400-ranked A-share stocks from its over 900 A-share stock universe, which meet the SHSE "marginable stock criteria" benchmarked to factors including minimum listing period, number of stockholders, public float, daily trading value, daily turnover rate, daily volatility rate, and daily price movement width; and which are then selected by the application of the following weighted formula:¹⁵¹

$$2 \times \frac{\text{Average public float of the stock during the specified period}}{\text{Average public float of all SHSE-listed A-share stocks during the specified period}} + \frac{\text{Average trading value of the stock during the specified period}}{\text{Average trading value of all SHSE-listed A-share stocks during the specified period}}$$

All margin trading and short selling in SHSE-listed marginable stocks shall take place exclusively in the exchange's public auction market and not in the block trading sessions. Each brokerage customer shall use one SHSE member to handle all its margin buying and short

<http://www.csf.com.cn/publish/main/1040/1045/index.html>; CSF, *Interim Rules of China Securities Finance Corporation Governing Margin and Securities Lending Data Collection and Risk Monitoring* (Aug. 27, 2012), available at <http://www.csf.com.cn/publish/main/1040/1045/index.html> [hereinafter CSF, *Data Collection Rules*].

150. See, e.g., CSRC, *CSRC 2011-31*, *supra* note 148, at Ch. 2; CSRC, *CSRC 2011-32: Guide for Internal Control of Margin and Securities Lending Business of Securities Firms*, Art. 9 (Oct. 26, 2011), available at www.csrc.gov.cn/pub/zjhpublic/G00306201/201110/t20111028_201128.htm; SHSE, *SHSE 2011-46: Shanghai Stock Exchange Rules Governing Margin Trading and Securities Lending*, Chs. 3, 4 (Nov. 25, 2011), available at http://www.sse.com.cn/lawandrules/sserules/trading/universal/c/c_20120918_49661.shtml [hereinafter SHSE, *Margin Trading Rules*]; SZSE, *Shenzhen Stock Exchange Rules Governing Margin Trading and Securities Lending*, Chs. 3, 4 (Nov. 25, 2011), available at www.szse.cn/main/disclosure/rzrqxx/ywgg/39746790.shtml [hereinafter SZSE, *Margin Trading Rules*].

151. See, e.g., SHSE, *Margin Trading Rules*, *supra* note 150, at Arts. 23-24, 59; SHSE, *Notice of Expanded List of Marginable Stocks* (Sept. 16, 2013), http://www.sse.com.cn/disclosure/magin/ssereport/c/c_20130906_3740311.shtml.

selling orders; the maximum term of any open margin or securities borrowing position shall be six months.¹⁵² For margin trading, interest charged by a securities firm to its customers is mandated by the CSRC rules to be at a rate no lower than the benchmark rate set by the People's Bank of China for a bank loan of similar term.¹⁵³ For short selling, all orders must be limit orders and market orders are prohibited. Similar to the tick test applied in the U.S. markets prior to May 2010, at all times the limit order price shall be no lower than the price of the last sale; or, if there is no such price at the time of the short sale, than the closing price of the previous day. If a customer effects a long sale of a stock in which it has an open short position, the long sale is also subject to the price limitation of the short sale, to the extent of the amount of its open short position. Any short sale order with a non-compliant price shall be invalid, and will be rejected through front-end controls built into the order entry systems.¹⁵⁴ At any time during the trading day when the total margin amount outstanding attributable to margin purchases hits 25% of the market value of a stock's public float, or when the total open short positions hit 25% of the public float of the stock, the SHSE may announce suspension of all margin purchases or short selling in the stock effective on the next trading day, to be resumed the day after the open margin or short sale level drops below 20% of the stock's public float.¹⁵⁵

Each member firm shall submit daily margin and stock lending data to the exchange,¹⁵⁶ a monthly margin and stock lending business report to both the stock exchange and the CSRC,¹⁵⁷ and standardized statistical data and reports to the CSF periodically and on an *ad hoc* basis.¹⁵⁸ The CSF will perform macro and micro risk analyses with respect to marginable securities, collateral securities, customer margin performance, and securities firm business performance.¹⁵⁹ The CSF data are categorized into "Confidential" and "For Public Release." With

152. See SHSE, *Margin Trading Rules*, *supra* note 150, at Ch. 2 Arts. 2-3, 7, 17, 20.

153. See CSRC, *CSRC 2011-31*, *supra* note 148, at Art. 13.

154. *Id.* at Art. 36. Compare SHSE, *Margin Trading Rules*, *supra* note 150, at Ch. 2 Arts. 11-12, with Amendments to Regulation SHO, 75 Fed. Reg. 11,232 (Mar. 10, 2010) (adopting circuit breaker-based price test to replace tick test).

155. See SHSE, *Margin Trading Rules*, *supra* note 150, at Ch. 6 Arts. 49-50.

156. *Id.* at Ch. 5.

157. See CSRC, *CSRC 2011-31*, *supra* note 148, at Ch. 6 Art. 42.

158. See CSF, *Data Collection Rules*, *supra* note 149, at Ch. 2.

159. *Id.* at Ch. 3 Arts. 9-12.

respect to the latter category, the CSF may periodically release the following types of information to the marketplace: (1) volume of margin buy versus outstanding margin amount, and volume of short sale versus open short positions; (2) number of customer margin accounts versus number of brokerage customers; and (3) number and market values of collateral securities.¹⁶⁰ The CSF may, on a need basis, provide the following information to securities firms: (1) a list of collateral securities where the market value of the collateral hits 30% of the total market value of such security; (2) with respect to each marginable security, ratio of margin buying and short selling volumes to the stock's total trading volume; (3) with respect to the market as a whole, ratio of margin buying and short selling volumes to the market's total trading volume.¹⁶¹ In addition to its market monitoring role, the CSF also performs a “self-regulatory” function with respect to margin and securities lending business of the securities firms.¹⁶² To close the loop, as the only securities finance corporation authorized to lend to the borrowing securities industry who in turn lends to the margin trading and short selling investors, the CSF finances its own securities refinance business by borrowing securities from the lending investors—as the only securities finance corporation eligible to borrow the SHSE-listed stocks on the Shanghai Stock Exchange from the securities lending investors.¹⁶³

160. *Id.* at Ch. 4 Art. 22.

161. *Id.* at Art. 23.

162. It is interesting to note that, while neither the State Council nor the CSRC accords the Securities Finance Corporation an SRO status, the CSRC authorizes “the stock exchanges, the securities clearing and depository agency, and the Securities Finance Corporation to perform regulatory, self-regulatory, or monitoring and analytical functions” with respect to the margin trading and securities lending business of securities firms. *See* CSRC, *CSRC 2011-31*, *supra* note 148, at Ch. 6 Art. 43. *Cf.* State Council, *Regulation of Securities Firms*, *supra* note 147, § 4.5 Art. 56, and CSRC, *CSRC 2011-75*, *supra* note 148, at Ch. 2.

163. *See, e.g.*, CSRC, *CSRC 2011-75*, *supra* note 148, at Ch. 1 Art. 2, Ch. 4; SHSE, *SHSE 2012-129: Shanghai Stock Exchange Rules Governing Securities Lending to Securities Finance Corporation (Interim)*, Ch. 2 (Aug. 27, 2012), available at http://www.sse.com.cn/lawandrules/sserules/trading/universal/c/c_20121010_50365.shtml; SHSE, *Margin Trading Rules*, *supra* note 150, at Ch. 1 Art. 2.

C. TRADING IN SZSE-LISTED STOCKS

1. Listing Boards of the Shenzhen Stock Exchange

The Shenzhen Stock Exchange runs three boards: the Main Board (listing A-share and B-share issuers), established in December 1990 featuring large, blue chip issuers; the SME Board (listing A-share issuers only), formed in June 2004 serving the small-and-medium-sized enterprises; and the ChiNext Market (listing A-share issuers only), added in October 2009 catering to the entrepreneurial, growth-type enterprises.¹⁶⁴ Based on the industry and enterprise classification standards jointly formulated by the Ministry of Industry and Information Technology (“MIIT”), National Bureau of Statistics (“NBS”), National Development and Reform Commission (“NDRC”), and Ministry of Finance (“MOF”), “small and medium sized enterprises” are assigned into three groups: the medium-sized, the small-sized, and the micro-sized.¹⁶⁵ Each group is defined by the application of two classifications: a classification of an enterprise to an industry; and a classification of the enterprise within that industry to a group by a set of benchmarks specifically applicable to that industry, measured by the number of employees, the level of revenues, and the amount of assets. An enterprise with the relevant industry benchmarks above those for the medium sized enterprises in that industry is a “large enterprise.”¹⁶⁶ The following statistics present a summarized view of issuers listed on the SZSE’s three boards as of year end 2012:¹⁶⁷

164. See, e.g., SZSE, *About Us*, <http://www.szse.cn/main/aboutus/bsjs/bsjj/index.shtml>; SZSE, SHENZHEN STOCK EXCHANGE FACT BOOK 2012, *supra* note 21, at 1, 3.

165. See MIIT, NBS, NDRC & MOF, *MITT 2011-300: Classification Standards for Small-and-Medium-Sized Enterprises*, Art. 2 (June 18, 2011), available at <http://www.szse.cn/main/rule/bmgz/qt/qt/39746143.shtml>.

166. *Id.* at Arts. 3-4, 7.

167. See SZSE, SHENZHEN STOCK EXCHANGE FACT BOOK 2012, *supra* note 21, at 6-7.

Three Listing Boards of the Shenzhen Stock Exchange (for year 2012)			
Statistical Indicators	Main Board: A-share and B-share issuers	SME Board: A-share issuers only	ChiNext Market: A-share issuers only
Number of stock issuers; % of total SZSE stock issuers	A-share issuers: 472 B-share issuers: 53 33.21%	701 44.34%	355 22.45%
Market value; % of total SZSE stock market value	A-shares: CN¥ 3.333 trillion; B-shares: CN¥ 79.65 billion 47.62%	CN¥ 2.880 trillion 40.20%	CN¥ 873.120 billion 12.18%
Trading value; % of total SZSE stock trading value	A-shares: CN¥ 6.447 trillion B-shares: CN¥ 45.465 billion 43.25%	CN¥ 6.189 trillion 41.23%	CN¥ 2.330 trillion 15.52%

Listing conditions for B-share issuers are the same at the SZSE and SHSE.¹⁶⁸ Listing conditions for A-share issuers are the same for the Main Board as for the SME Board, and are similar to those for the SHSE Blue Chip Board.¹⁶⁹ Compared with the Main Board and SME Board, the A-share issuers listed on the ChiNext Market are subject to lower financial threshold and equity level, and are required to be principally engaged in one line of business.¹⁷⁰ Complementary to the less stringent listing conditions for the ChiNext Market issuers, securities firms are required by the CSRC, the SZSE, and the SAC rules to adopt special suitability measures with respect to retail investors

168. See *supra* notes 100-103 and accompanying text.

169. See SZSE, *Shenzhen Stock Exchange Stock Listing Rules*, Art. 5.1.1 (July 2012), available at <http://www.szse.cn/main/files/2012/07/18/730589652605.pdf>; see also *supra* note 99 and accompanying text.

170. See, e.g., CSRC, *CSRC 2009-61: Provisional Regulation of Initial Public Offering and Listing on the ChiNext Market*, Arts. 2, 10, 12 (May 1, 2009), available at http://www.csrc.gov.cn/pub/zjhpublic/cyb/200911/t20091117_170416.htm; SZSE, *SZSE 2012-77: Shenzhen Stock Exchange Stock Listing Rules for the ChiNext Market*, Art. 5.1.1 (2012), available at <http://www.szse.cn/main/files/2012/04/20/164761054973.pdf>.

trading the ChiNext stocks. Interestingly, there does not appear to exist an institutional investor suitability concept.¹⁷¹

2. The SZSE Trading Structure

While the Shenzhen Stock Exchange runs three separate boards, the three boards share the same trading structure.¹⁷² The basic trading structure of the SZSE is built parallel to that of the Shanghai Stock Exchange:

- A Central Order Book is used for the public auction market, consisting of call auction for the opening cross and closing cross, and continuous auction for the day's trading; and an OTC-style block trading system for the institutional market, which came into being in 2004, was expanded and renamed in 2009 as the "SZSE Multi-Product Negotiated Trading Platform," and was supplemented in October 2013 by a closing price and full day VWAP-based after-hours trading facility.¹⁷³

171. See, e.g., CSRC, *CSRC 2009-14: Provisional Measures Governing ChiNext Market Investor Suitability* (July 15, 2009), available at http://www.csrc.gov.cn/pub/newsite/tzzbh/tzzfw/tzzsdx/201204/t20120418_208901.htm; SZSE, *SZSE 2009-17: Implementation Rules Governing ChiNext Market Investor Suitability* (July 15, 2009), available at www.szse.cn/main/chinext/cybgzfront/39744268.shtml; SZSE, *Operational Guide for ChiNext Market Investor Suitability*, Arts. 1.5-1.6, 3.1 (July 2, 2009), available at www.szse.cn/main/chinext/cybgzfront/39744187.shtml; Sec. Assoc. of China ("SAC"), *SAC 2009-112: Mandatory Investment Risk Disclosure Relating to ChiNext Market* (July 15, 2009), available at www.sac.net.cn/tzgg/200907/t20090701_21315.html. Cf. FINRA, FINRA MANUAL RULE 2111: SUITABILITY (2013).

172. See SZSE, *Trading Rules*, *supra* note 97, at Art. 1.2.

173. See, e.g., SZSE, *Trading Rules*, *supra* note 97, §§ 2.1, 2.4, 3.6; SZSE, *SZSE 2008-177: Rules Governing Trading on the Multi-Product Negotiated Trading Platform* (Dec. 19, 2008), available at www.szse.cn/main/ints/ywgzyxcl/39739186.shtml [hereinafter SZSE, *Negotiated Trading Platform Rules*]; SZSE & SD&C-Shenzhen, *SZSE 999999-TG18: REVISED SYSTEM GUIDE TO SECURITIES FIRM TECHNOLOGY INTERFACING WITH AFTER-HOURS FIXED PRICE TRADING FACILITY (VERSION 1.00)* (Oct. 28, 2013), available at www.szse.cn/main/files/2013/10/29/153557294261.pdf; see also SZSE, *Historic Events on the SZSE—March 19, 2002: First Manual Block Trade Took Place on the Exchange*, <http://www.szse.cn/main/aboutus/dsj/10003.shtml>; SZSE, *Block Trading System Commences Operation on the SZSE* (July 30, 2004), www.szse.cn/main/aboutus/bsyw/6180.shtml.

- Market orders may not be used for IPO stock first day trading, or for any stock's opening cross or closing cross. Both market orders and limit orders are subject to price bands that distinguish between IPO stocks and non-IPO stocks, and between the public auction market and the block trading system.¹⁷⁴
- A separate session trades "Special Treatment" stocks, whether they come from the Main Board, the SME Board, or the ChiNext Market.¹⁷⁵
- Margin trading, short selling, and securities refinance trading programs are run in ways similar to the SHSE's programs. The top 300-ranked A-share stocks out of the SZSE's total of over 1,500 stocks are marginable, selected from an application of criteria and formula similar to the SHSE's. A brokerage customer engaged in margin trading and short selling must borrow funds and securities exclusively from its broker, which in turn must borrow funds and securities to finance its margin and securities lending business exclusively from China Securities Finance Corporation, and the CSF in turn is exclusively eligible to borrow the SZSE-listed stocks on the

Whereas the SHSE does not operate a closing cross, the SZSE runs a three-minute closing cross by way of a call auction. *Compare* SHSE, *Trading Rules*, *supra* note 97, at Art. 2.4.2, *with* SZSE, *Trading Rules*, *supra* note 97, at Art. 2.4.2.

174. *See, e.g.*, SZSE, *Trading Rules*, *supra* note 97, §§ 3.3, 3.4, 3.6; SZSE, *Negotiated Trading Platform Rules*, *supra* note 173, at Ch. 4. As with the Shanghai Stock Exchange, the Shenzhen Stock Exchange does not operate a circuit breaker system with respect to non-IPO stocks but applies a circuit breaker system for IPO stocks. However, while the SHSE's circuit breaker system applies to IPO stocks' 10-day aftermarket trading period, the SZSE's circuit breaker system only applies to IPO stocks' first day trading. *See, e.g.*, SZSE, *Trading Rules*, *supra* note 97, § 4.3; SZSE, *SZSE 2013-142: Notice of Circuit Breaker Applicable to IPO Stock First Day Trading* (Dec. 13, 2013), *available at* http://www.szse.cn/main/disclosure/bsgg_front/39750955.shtml; *see also supra* note 123 and accompanying text.

175. *See, e.g.*, SZSE, *Stock Listing Rules*, *supra* note 169, at Ch. 13; SZSE, *Stock Listing Rules for the ChiNext Market*, *supra* note 170, at Ch. 13; SZSE, *Trading Rules*, *supra* note 97, § 4.5; SZSE, *SZSE 2012-422: Special Rules Governing Stock Trading and Related Matters During Pre-Delisting Transitional Period* (2012), *available at* <http://www.szse.cn/main/files/2012/12/16/410997426531.pdf>; SZSE, *Transitional Period Management Program for Main Board and SME Board Issuers Facing Delisting* (June 28, 2012), *available at* <http://www.szse.cn/main/rule/bsywgz/39747994.shtml>.

Shenzhen Stock Exchange from the securities lending investors.¹⁷⁶

Whereas the SHSE is equipped with a physical trading floor, mirroring the NYSE, the SZSE employs a “virtual trading floor,” mirroring the NASDAQ—in an architectural sense.

For the public auction market, compared with the two sub-types of market order specified by the SHSE, the SZSE allows five sub-types of market order, i.e., a market order specified to:

- be priced equal to the best-priced same side standing order in the Central Order Book;
- hit against the best-priced contra standing order in the Central Order Book;
- hit successively against the five displayed best-priced contra standing orders in the Central Order Book, with any unexecuted balance immediately canceled;
- hit successively against all contra standing orders in the Central Order Book, with any unexecuted balance immediately canceled; or
- have an all-or-none execution.¹⁷⁷

Intriguingly, the SZSE employs the same pricing rule for the continuous auction market that appears to reward the liquidity taker and penalize the liquidity provider, as the SHSE.¹⁷⁸

The SZSE’s block trading system is accessible only to “eligible system participants” except that QFIIs must trade through SZSE member firms, similar to the SHSE’s access rules.¹⁷⁹ Compared to the two types of order employed by the SHSE block trading system, i.e.,

176. See, e.g., SZSE, *Margin Trading Rules*, *supra* note 150, at Art. 1.2; SZSE, *Shenzhen Stock Exchange Rules Governing Securities Lending to Securities Finance Corporation (Interim)*, Ch. 2 (Aug. 27, 2012), available at <http://www.szse.cn/main/disclosure/bsgg/39748356.shtml>; SZSE, *SZSE 2013-92: Notice of Expanded List of Marginable Stocks* (Sept. 6, 2013), <http://www.szse.cn/main/files/2013/10/14/379229469565.pdf>.

177. See SZSE, *Trading Rules*, *supra* note 97, § 3.3 Art. 3.3.4.

178. *Id.* § 3.5 Art. 3.5.3; see also *supra* notes 116, 117 and accompanying text.

179. See, e.g., SZSE, *Negotiated Trading Platform Rules*, *supra* note 173, at Ch. 2; SZSE, *SZSE 2002-123: Rules Governing Securities Trading by QFIIs on the Shenzhen Stock Exchange*, Art. 4 (Dec. 1, 2002), available at <http://www.szse.cn/main/rule/bsywgz/jyl/ybgd/39744211.shtml>; SZSE, *SZSE 2008-41: Notice Concerning Implementation of “CSRC Guidance for Transfer of Shares Tradable Pursuant to A-Shares Reform”* (Apr. 21, 2008), available at www.szse.cn/main/rule/bsywgz/ssgs/sgsty/39744165.shtml.

IOIs and paired execution orders, the SZSE block trading system provides two trading mechanisms:

- after-hours crossing session; and
- bilaterally negotiated trading.¹⁸⁰

To participate in the after-hours crossing session, orders must be submitted after market close and during 3:05 p.m. to 3:30 p.m. Orders are continuously matched and executed as they arrive strictly in the order of time priority, at either the auction market closing price or its full-day VWAP (volume weighted average price), as specified by each order.¹⁸¹

For bilaterally negotiated trading, three types of order are permitted:

- an “IOI,” which is not firm, and may be backed away;
- a “priced order,” which cannot back away when hit, to the extent of its displayed price and quantity, by one or more “execution orders” responding and lining in the queue strictly in the order of time priority; any unexecuted portion of the priced order may be cancelled;
- an “execution order,” which either responds to a specified priced order, or designates a contra execution order through an identifying Pair ID; an execution order may be canceled before execution by the system.¹⁸²

IOIs and orders participating in bilaterally negotiated trading must be entered during 9:15 a.m. to 11:30 a.m. and 1:00 p.m. to 3:30 p.m. Executions will take place after market close during 3:00 p.m. to 3:30 p.m., at the bilaterally negotiated prices subject to the applicable block trade price bands, which are derived from the public auction market pricing.¹⁸³

Thus, for both after-hours fixed price trading and bilaterally negotiated trading, the block system pricing mechanisms ride on the public auction market price discovery. The closing price-based fixed price trading feature added in August 2013, however, is not accompanied with targeted regulatory requirements designed to prevent

180. SZSE, *Trading Rules*, *supra* note 97, § 3.6 Art. 3.6.2.

181. *Id.* at Arts. 3.6.3, 3.6.8.

182. *Id.* at Arts. 3.6.5-3.6.6.

183. *Id.* at Arts. 3.6.3-3.6.4, 3.6.7. *See supra* note 123 and accompanying text for the Price Band Chart of the Shanghai and Shenzhen Stock Exchanges. By definition, orders participating in the after-hours crossing session specifying auction market closing price or its full-day VWAP are not subject to the block trade price bands.

manipulation and closing price distortion.¹⁸⁴ Furthermore, the strict time priority rule applied to the multiple “execution orders” responding to a single “priced order” and the “paired execution order” feature both allow trade-throughs of better priced standing orders in the block system. In addition, the specter of a two-tiered market structure is made real on the SZSE, by its rules expressly allowing arbitrage trading between the public auction market and the block trading system: a system participant is allowed to buy stock shares on the system on T day and sell the purchased shares in the auction market on T+1, for both A-shares and B-shares, and vice versa—despite the different settlement cycles of T+1 for A-shares and T+3 for B-shares.¹⁸⁵ This arbitrage trading takes place on an asymmetrical information infrastructure in favor of the institutional market, as summarized in the table below:¹⁸⁶

184. Compare SZSE, *Trading Rules*, *supra* note 97, § 3.6, Ch. 6 (Aug. 5, 2013), with SZSE, *SZSE 2012-143, Trading Rules of the Shenzhen Stock Exchange*, § 3.6, Ch. 6 (Nov. 30, 2012), available at www.szse.cn/main/files/2012/11/30/754939359998.pdf.

185. SZSE, *Negotiated Trading Platform Rules*, *supra* note 173, at Ch. 5 Art. 21; see also SD&C SHENZHEN, OPERATIONAL GUIDE FOR CLEARANCE AND SETTLEMENT OF SECURITIES, 28 (2012), available at http://www.chinaclear.cn/old_files/1355385474107.pdf; SD&C Shenzhen, *SD&C SZ 95-20: Operational Rules Governing Clearing and Depository Business of B-Shares*, Art. 7.2 (Oct. 12, 1995), available at <http://www.chinaclear.cn/main/10/1009/100906/1163818915004.pdf>.

186. See, e.g., SZSE, *Trading Rules*, *supra* note 97, § 3.6 Arts. 3.6.9-3.6.11, § 5.2 Art. 5.2.2, § 5.4; SZSE, *SZSE 999999-TG04: REVISED SYSTEM GUIDE TO SECURITIES FIRM TECHNOLOGY INTERFACING WITH THE MULTI-PRODUCT NEGOTIATED TRADING PLATFORM (VERSION 1.04)*, 5–11 (2012), available at <http://www.szse.cn/main/files/2012/08/20/265482493842.pdf>.

Information Asymmetry between Public Auction Market and Block Trading System Shenzhen Stock Exchange		
	Continuous Auction Market	Block Trading System
<p>Pre-Trade Transparency</p> <p>Real time market data for auction market displayed to all market participants, and to customers via exchange members</p>	<p>Top of the book information:</p> <ul style="list-style-type: none"> ● five best-priced bids (including prices and quantities) ● five best-priced offers (including prices and quantities) 	<p><u>For Bilaterally Negotiated Trading—Release to System Participants:</u></p> <ul style="list-style-type: none"> ● IOIs are immediately viewable by and accessible to Eligible System Participants throughout the System sessions (9:15 a.m. to 11:30 a.m. and 1:00 p.m. to 3:30 p.m.) ● Priced orders are viewable by and accessible to Eligible System Participants only during the System execution period of 3:00 p.m. to 3:30 p.m. ● New IOIs and orders are displayed by the System every 15 seconds ● Total standing IOIs and orders are displayed by the System every 5 minutes
<p>Post-Trade Transparency</p> <p>Real time market data for auction market displayed to all market participants, and to customers via exchange members</p>	<ul style="list-style-type: none"> ● Last sale price ● The day's trading information: highest price; lowest price; cumulative trading volume; cumulative trading value ● Closing price of the previous trading day 	<p><u>For After-Hours Crossing Session—Release to System Participants:</u></p> <ul style="list-style-type: none"> ● Auction market closing price and its full-day VWAP ● Cumulative trading volume and trading value of the after-hours crossing session ● Real time release of after-hours order information
<p>End of Trading Day</p> <p>Data released to the general public via Internet</p>	<ul style="list-style-type: none"> ● Of non-IPO stocks whose closing price band deviates from the benchmark index price band by at least 7%, or whose price volatility rate is at least 15%, or whose turnover rate is at least 20%: top five of such stocks in each category; top five sellers and top five buyers in each such stock, including their trading values, and Trading Booth IDs or state "Institution" if not a member firm ● For each IPO stock: top five sellers and top five buyers, including their trading values, and Trading Booth IDs or state "Institution" if not a member firm ● Of stocks experiencing "unusual volatility" (as defined by the SZSE rules) continuously for 3 trading days: each such stock; its top five sellers and top five buyers during the 3 trading days determined on a cumulative basis, including their trading values, and Trading Booth IDs or state "Institution" if not a member firm 	<ul style="list-style-type: none"> ● With respect to each negotiated Block System trade: stock name, price and quantity, and seller and buyer's Trading Booth IDs or state "Institution" if not a member firm ● With respect to each security's trading in the after-hours crossing session: its cumulative trading volume and trading value; its top five sellers and top five buyers, their respective trading values, and Trading Booth IDs or state "Institution" if not a member firm ● With respect to each security's trading on the Block System: its cumulative trading volume and trading value; its top five sellers and top five buyers, their respective trading values, and Trading Booth IDs or state "Institution" if not a member firm ● Block System cumulative trading volume is included in the exchange's total daily trading volume; System trades are NOT included in the exchange's index calculation or other real time market data

II. THE UNLISTED EQUITIES MARKET

A. BUILDING “THE CHINESE SILICON VALLEY”

1. Policy Makers’ Grand Vision for 2020

Zhong-Guan-Cun, an area in the western suburb of Beijing, is the hub of China’s top research institutions, represented by the Chinese Academy of Sciences and the Chinese Academy of Engineering, and China’s top educational institutions, represented by Peking University and Tsinghua University.¹⁸⁷ In 1980, several scientists from the Chinese Academy of Sciences, inspired by the “U.S. Silicon Valley concept” and the “magic story of Apple,” started private enterprises producing electronics, which dotted and lined the main street of Zhong-Guan-Cun. The “Zhong-Guan-Cun Electronics Street,” as it hence came to be known, caught the attention of the Chinese government official newspaper, *The People’s Daily*, which gave a special report in December 1986 titled, *A Quiet Reform Brewing in Zhong-Guan-Cun—The Birthplace of China’s Future Silicon Valley*, describing the Zhong-Guan-Cun Electronics Street and its scientists-turned-entrepreneurs.¹⁸⁸

On March 13, 2009, the State Council issued *Notice Approving Development of the Zhong-Guan-Cun Science and Technology Park into a National Independence and Innovation Paradigm*. The State Council envisioned building Zhong-Guan-Cun Science and Technology Park into “a global science and technology innovation center by 2020.”¹⁸⁹ The Notice directed the Ministry of Science and Technology (“MOST”) and the Ministry of Finance (“MOF”):

- to adopt incentive policies to securitize science and technology innovation results realized by the Zhong-Guan-Cun academic and research institutions and State-owned enterprises, and award

187. See Zhong-Guan-Cun Nat’l Independence and Innovation Paradigm Zone, *Introduction to Zhong-Guan-Cun Paradigm Zone*, <http://www.zgc.gov.cn/sfqgk/56261.htm>.

188. See Xinhuanet, *China’s Silicon Valley* (Mar. 17, 2009), http://news.xinhuanet.com/theory/2009-03/17/content_11023300.htm.

189. See State Council, *SC 2009-109: Notice Approving Development of the Zhong-Guan-Cun Science and Technology Park into a National Independence and Innovation Paradigm*, ¶ 1 (Mar. 13, 2009), available at <http://www.zgc.gov.cn/zcfg10/gj/56120.htm>.

the securities to the scientists, management, and other employees who have made outstanding contributions toward achieving those results; and

- to promote science and technology-based financial reform, facilitating the quotation of unlisted Zhong-Guan-Cun issuers on an unlisted issuers brokerage trading platform, graduating in time such Zhong-Guan-Cun issuers from the OTC issuers system onto the listed markets, and organically linking the various issuer capital market access levels within the overall capital markets system.¹⁹⁰

The State Council formed a “21-Ministries Coordination Group” to implement the Notice, chaired by the Minister of Science and Technology.¹⁹¹

On February 22, 2011, the National Development and Reform Commission (“NDRC”) issued to the M-21 Coordination Group *Program of Action (2011-2020) for Building Zhong-Guan-Cun into a National Independence and Innovation Paradigm*.¹⁹² “Looking globally,” the Program of Action notes the “significant opportunities for innovation created by global financial crises, which have shifted and re-defined international competitiveness and accentuated the import of innovation. . . . Prominent international innovation centers such as Silicon Valley . . . are all vying for the strategic position of dominance.”¹⁹³ “Reviewing domestically,” the Program of Action sets the tasks of making Zhong-Guan-Cun “China’s major platform for participating in global competition and engaging in innovation cooperation, . . . China’s nurturing ground for innovation élite,” and “one of the most active entrepreneurial zones in the world,” by year 2020.¹⁹⁴ The Program of Action identifies eight industries as key areas for China to enhance its international competitiveness: electronics;

190. *Id.* ¶¶ 2(1)-2(2).

191. *Id.* ¶ 4; *see also* Ministry of Science and Technology (“MOST”), *MOST Minister Calls for Role of Coordination Group in Speeding Up Zhong-Guan-Cun National Independence and Innovation Paradigm Construction* (July 28, 2009), http://www.most.gov.cn/tpxw/200907/t20090728_71997.htm.

192. *See* Nat’l Develop. and Reform Comm’n (“NDRC”), *NDRC 2011-367: Program of Action (2011-2020) for Building Zhong-Guan-Cun into a National Independence and Innovation Paradigm* (Feb. 22, 2011), *available at* http://www.sdpc.gov.cn/zcfb/zcfbtz/2011tz/t20110224_396590.htm.

193. *Id.* at 3–4.

194. *Id.* at 7–8, 12.

biomedicine; new energy and clean energy; automobiles utilizing new energy; new materials; smart equipment; aeronautics and aerospace; and digital and other high tech applications to cultural works.¹⁹⁵ It established a “Beijing Municipality Leadership Group” and a “M21-Beijing Joint Subgroup” to implement the Program of Action.¹⁹⁶

On August 3, 2012, nine ministries and Beijing municipal government jointly issued *Opinion on Building a Science and Technology Financial Innovation Center in Zhong-Guan-Cun National Independence and Innovation Paradigm* (“STF Innovation Opinion”). The STF Innovation Opinion declares its goal of “building Zhong-Guan-Cun into a financial innovation center with global influence, becoming to its status of a global science and technology innovation center, by 2020.”¹⁹⁷ It created an “STF Innovation Advisory Committee” for implementing the STF Innovation Opinion.¹⁹⁸

In its *Twelfth Five-Year (2011-2015) Plan for Economic and Social Development of the People’s Republic of China*, the National People’s Congress set the legislative agenda of “building Zhong-Guan-Cun into a science and technology innovation center with global influence.”¹⁹⁹

2. The Issuers and Securities

Under the umbrella directive of the State Council’s Zhong-Guan-Cun National Paradigm Notice, preferential policies and stock incentive programs have been instituted in favor of the Zhong-Guan-Cun enterprises and academic and research institutions. The *Regulation Governing Zhong-Guan-Cun National Independence and Innovation Paradigm* adopted by the Beijing municipal government “encourages science and technology personnel to establish enterprises in Zhong-Guan-Cun, and to make capital contributions in the form of intellectual

195. *Id.* at 15–19.

196. *Id.* at 15, 35.

197. NDRC, MOST, MOF, PBOC, SAT, China Banking Reg. Comm’n (“CBRC”), CSRC, CIRC, SAFE & Beijing Mun. Gov’t, *BJ 2012-23: Opinion on Building a Science and Technology Financial Innovation Center in Zhong-Guan-Cun National Independence and Innovation Paradigm*, Art. 2(5) (Aug. 3, 2012), available at <http://zhengwu.beijing.gov.cn/gzdt/gggs/t1240905.htm>.

198. *Id.* at Art. 12(41).

199. See NAT’L PEOPLE’S CONG., TWELFTH FIVE-YEAR (2011-2015) PLAN FOR ECONOMIC AND SOCIAL DEVELOPMENT OF THE PEOPLE’S REPUBLIC OF CHINA, § 27.2 (Mar. 14, 2011), available at http://www.gov.cn/2011lh/content_1825838.htm.

property, R&D results, and other intangible property,”²⁰⁰ which collectively could make up 70% of an enterprise’s registered capital.²⁰¹ Political subdivisions and various government departments of Beijing municipality are instructed to:

- “support the independence and innovation activities of the select enterprises through government procurement programs”,²⁰²
- “support the Zhong-Guan-Cun enterprises and research institutions in obtaining patents, trademarks and copyrights, through subsidies and financial incentives”,²⁰³
- “support venture capital firms’ investment activities in Zhong-Guan-Cun”; “encourage commercial banks and insurance and guaranty companies to provide preferential, accommodating financial services to the small and medium-sized Zhong-Guan-Cun enterprises bidding to perform major national or local government projects, and subsidize or otherwise provide funding support to such banks and insurance and guaranty companies as necessary.”²⁰⁴

The Ministry of Finance and Ministry of Science and Technology jointly issued *Measures Governing Stock and Dividend Incentive Programs of Zhong-Guan-Cun Enterprises*, to govern securitization of R&D results via the Stock and Dividend Incentive Programs, applicable to the high-tech enterprises and academic or research institution-run enterprises in the Zhong-Guan-Cun area that are State-owned or State-controlled.²⁰⁵ Such securitization is to be effected through distributing to the employees the enterprise’s own stock, or re-distributing to the employees equity shares of third-party firms to which the enterprise

200. See BEIJING MUN. PEOPLE’S CONG., REGULATION GOVERNING ZHONG-GUAN-CUN NATIONAL INDEPENDENCE AND INNOVATION PARADIGM, Arts. 2, 12 (2010), available at <http://www.zgc.gov.cn/zgcsfqt/1q/68679.htm>.

201. See CSRC & MOST, CSRC 2012-87: *Guidance in Support of R&D Results as Capital Contribution and Recognition of R&D-based Equity Interests*, ¶ 1 (Nov. 15, 2012), available at www.csrc.gov.cn/pub/newsite/bgt/xwdd/201211/t20121116_217004.htm.

202. BEIJING MUN. PEOPLE’S CONG., *supra* note 200, at Arts. 28-30.

203. *Id.* at Art. 33.

204. *Id.* at Arts. 45-46.

205. See MOF & MOST, MOF 2010-8: *Joint Announcement of Measures Governing Stock and Dividend Incentive Programs of Zhong-Guan-Cun Enterprises*, Art. 2 (Feb. 1, 2010), available at http://www.gov.cn/zw/gk/2010-02/20/content_1537258.htm [hereinafter MOF & MOST, *Joint Measures*].

contributes its R&D results as capital.²⁰⁶ Under the MOF-MOST Measures, “the Stock and Dividend Incentive Program shall not be open to all employees of the enterprise.” “Eligible awardees” for an Incentive Program shall be confined to “key R&D personnel” who have made “outstanding contributions toward achieving the R&D results,” and “those management personnel” who have done “an outstanding job in managing at least 50% of the enterprise’s overall revenues or profits.”²⁰⁷

The equity shares awarded under the Incentive Program shall not be transferrable, whether by sale or by gift, for a period of five years from the date of receipt by the awardee. Should the awardee leave the enterprise within the five year period for whatever reason, 100% of the equity shares awarded to him shall be clawed back by the enterprise, while any purchase money he has paid up front shall be returned to him—to the extent the enterprise has funds available based on its net assets.²⁰⁸ That is, during the five year period, the awardee shall have no right to any investment appreciation with respect to the equity shares which have been “awarded” to him but shall bear all risks to his purchase money—including investment risk and credit risk of the enterprise, and at best will be granting the enterprise an interest-free loan by way of his purchase money! In a similar vein, all stock options awarded under an Incentive Program shall have a maximum term of five years, and shall not be exercisable for at least one year from the date of the option grant. If an option awardee leaves the enterprise during the five-year period for whatever reason, his unexercised options shall automatically expire, and any equity shares he has acquired through previous option exercises are clawed back in the same way, and his purchase money subject to the same investment risk and credit risk, as the equity shares awardee.²⁰⁹

Once awarded under the Incentive Program, an awardee shall not be eligible for any further award of any equity incentive for a period of

206. *Id.* at Arts. 3, 22, 43. In contrast to such “stock incentives,” “dividend incentives” refer to the enterprise’s redistribution to the employees cash dividends it receives from the third party firms. *See id.* Compare “Stock and Dividend Incentive Programs” under the MOF-MOST Joint Measures, with the U.S. concept of “statutory underwriter” in, e.g., Spin Offs and Shell Corporations, 34 Fed. Reg. 11,581 (July 15, 1969); *SEC v. Datronics Eng’g, Inc.*, 490 F.2d 250 (4th Cir. 1973); Securities Act of 1933 § 2(a)(11), 15 U.S.C. § 77b(a)(11) (2012) (definition of “underwriter”).

207. MOF & MOST, *Joint Measures*, *supra* note 205, at Art. 4.

208. *Id.* at Art. 18.

209. *Id.* at Arts. 14-15, 18.

five years, regardless of what additional value the awardee may create and bring to the enterprise.²¹⁰ Equity shares of the enterprise to be made available for the Incentive Program shall come by way of the enterprise's issuing additional shares, the enterprise's repurchases of shares from its current stockholders, or transfers by the current stockholders to the awardees.²¹¹

While initially adopted for Zhong-Guan-Cun, "the National Independence and Innovation Paradigm," the stock and dividend incentive policies are now applied to all "national-ranking independence and innovation zones" which have since sprung up in various provinces, cities, and localities throughout China.²¹² This has prompted the MOF and MOST to jointly issue *Supplement to the Measures* to require that each "Stock and Dividend Incentive Program" to be adopted by an enterprise be pre-approved by the government agency having direct authority over the assets of such enterprise, i.e., one of the following government "Assets Supervision Agencies":

- the State-owned Assets Supervision and Administration Commission;
- the Ministry of Education;
- the Ministry of Industry and Information Technology; and
- the Chinese Academy of Sciences.²¹³

The relevant Assets Supervision Agency shall examine each stock and dividend incentive program of an enterprise under its jurisdiction, to assure itself that interests of the State as a stakeholder of the enterprise not be harmed and the enterprise's sustained growth prospect not be jeopardized, by the adoption of the stock and dividend incentive program.²¹⁴

210. *Id.* at Art. 35.

211. *Id.* at Art. 16.

212. *See, e.g., id.*; MOF, *MOF and MOST Officials Explain Stock and Dividend Incentive Measures to the Press* (Mar. 2, 2010), www.gov.cn/gzdt/2010-03/02/content_1545252.htm.

213. *See, e.g.,* MOF & MOST, *Joint Measures*, *supra* note 205, at Art. 31; MOF & MOST, *MOF 2011-1: Supplement to Measures Governing Stock and Dividend Incentive Programs of Zhong-Guan-Cun Enterprises* (Jan. 10, 2011), available at http://qys.mof.gov.cn/zhengwuxinxi/zhengcefabu/201101/t20110120_421451.html.

214. *See* MOF & MOST, *Joint Measures*, *supra* note 205, at Art. 32.

B. BUILDING “THE CHINESE OTCBB”

1. *The Zhong-Guan-Cun Agency Trading System (January 2006-December 2012)*

In the early stages of the Chinese stock market, “shares for State-owned legal persons” of non-listed issuers were quoted and traded on the STAQ (Securities Trading Automated Quotations) System and the NET (National Electronic Trading) System, each operated by a different government department in Beijing.²¹⁵ “Shares for employees” were denied any liquidity outlet.²¹⁶ Breaches frequently occurred whereby non-tradable Employee Shares were illegally traded and transferred from employees to non-employees, and the restricted State-owned Legal Person Shares were illegally transferred from the State-owned entities to individuals—via the “spurious trading markets.”²¹⁷ On March 25, 1998, in light of the “rampant illegal OTC stock trading,” the State Council approved *Plan for Clean-Up of Illegal Over-the-Counter Stock Trading*, mandating shutting down of “all venues trading non-exchange-listed stocks.”²¹⁸ Employee Shares were prohibited in any public offerings of securities beginning 1998;²¹⁹ the STAQ and NET systems were closed in 1999.²²⁰

In June 2001, to provide a venue for the trading of the former STAQ and NET system issuers (“Legacy Issuers”), and issuers delisted

215. See YAO, *supra* note 3, at 45–47 (“STAQ System and NET System”).

216. *Id.* at 9–12 (“Chinese Individual Shares”).

217. See, e.g., CSRC, CHINA CAPITAL MARKETS DEVELOPMENT REPORT, *supra* note 36, § 1.1 (featuring the “Red Temple Black Trading Market”); TSINGHUA UNIV. & SHANGHAI STOCK EXCHANGE, SHJR 2012-22: NEW TRENDS IN CAPITAL MARKETS DEVELOPMENT AND RECOMMENDED AMENDMENTS TO THE COMPANY LAW, n.25 (2012), available at http://www.sse.com.cn/researchpublications/jointresearch/c/c_20120713_1132.pdf (describing the “underground trading markets”).

218. See Office of the State Council, *OSC 1998-10: Transmittal of CSRC’s Plan for Clean-Up of Illegal Over-the-Counter Stock Trading* (Mar. 25, 1998), available at <http://edu.westlawchina.com/maf/china-cn/app/document?&docguid=i3cf76ad300000130d45a96b7a853b3ef&hitguid=i3cf76ad300000130d45a96b7a853b3ef&srguid=ia744dc1e00000141e8bed3070114545b&spos=1&epos=1&td=1&crumb-action=append&context=5&lang=cn&crumb-label=%E6%96%87%E4%BB%B6>.

219. See CSRC, *CSRC 1998-297: Announcement of Prohibition Against Further Issuance of Employee Shares* (Nov. 25, 1998), available at www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080303_77898.htm

220. See CSRC, CHINA CAPITAL MARKETS DEVELOPMENT REPORT, *supra* note 36, at 178.

from the Shanghai or Shenzhen stock exchange (“Delisted Issuers”), the Securities Association of China authorized by the CSRC established a “Shares Agency Transfer System” to be used by securities firms for agency trading in the Legacy Issuer and Delisted Issuer securities (“2001 SAC System”).²²¹ On January 23, 2006, marking auspiciously the “incubator for a future Chinese OTCBB,”²²² the “Zhong-Guan-Cun Issuer Quotations and Agency Trading System”—an “expanded version” of the 2001 SAC System, started operation at the Shenzhen Stock Exchange via a platform separate from the SZSE’s listed platforms, when two high-tech enterprises from Zhong-Guan-Cun debuted on the system.²²³ At the end of 2012, a total of 200 issuers were quoted and traded on the Zhong-Guan-Cun System, spanning industries from biomedicine, computer and electronics, clean energy, new materials, and telecommunications to other, mostly innovative, industries.²²⁴

221. See, e.g., SAC, *Trial Measures Governing Securities Firms’ Provision of Shares Agency Transfer Services* (June 12, 2001), available at www.csrc.gov.cn/pub/newsite/xxfw/fgwj/zyzlgz/200803/t20080314_78255.htm (providing a call auction market for Legacy Issuers); SAC, *Notice of Enhanced Services of the Shares Agency Transfer System* (Aug. 29, 2002), available at <http://edu.westlawchina.com/maf/china-cn/app/document?&docguid=i3cf76ad30000011ef34aa2606337fc25&hitguid=i3cf76ad30000011ef34aa2606337fc25&sruid=ia744dc1e00000141e92a0a4c9a867141&spos=1&epos=1&td=1&crumb-action=append&context=76&lang=cn&crumb-label=%E6%96%87%E4%BB%B6> (adding Delisted Issuers to the 2001 SAC System).

222. See RESEARCH INSTITUTE OF THE SHENZHEN STOCK EXCHANGE, SZRI-0090: ON THE STRATEGIC DEVELOPMENT OF THE SHARES AGENCY TRANSFER SYSTEM (2004) (copy available from the SZSE Research Institute). The 2004 SZSE research report recommended the “U.S. OTCBB” model as the “strategic position” for the Zhong-Guan-Cun System to eye for. *Id.* at 3, 8–9, 47–51.

223. See SZSE, *SZSE Historic Events for Year 2006—January 23, 2006*, <http://www.szse.cn/main/aboutus/dsj/10007.shtml>.

The “Zhong-Guan-Cun System” is popularly known as “The New Tertiary Market,” and the “2001 SAC System” as “The Old Tertiary Market”—reflecting the new versus the old stage in the development of a unified OTC equities market in China. See SZSE, *Investor Education: “The New Tertiary Market,”* <http://www.szse.cn/main/investor/fwrx/39745887.shtml>; SZSE, *Investor Education: “The Old Tertiary Market,”* <http://www.szse.cn/main/investor/fwrx/39745886.shtml>.

224. See, e.g., CSRC, CHINA SECURITIES REGULATORY COMMISSION ANNUAL REPORT 2012, 95 (July 2013), available at <http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/201307/P020130722555052657179.pdf>; Shuhua Tian, *Zhong-Guan-Cun Quotations and Trading System as Foundation for China’s National OTC Market*, at 8 (Dec. 2, 2011) (brokerage research report by China Galaxy Securities, www.chinastock.com.cn).

Modeled after the National Association of Securities Dealers (“NASD”)’s regulatory authority over the OTC market, the SAC adopted three sets of rules to regulate trading on the Zhong-Guan-Cun System, including:

- *Interim Rules Governing Securities Firms Trading on Zhong-Guan-Cun Issuer Quotations and Agency Trading System* (“Zhong-Guan-Cun System Brokerage Trading Rules”);
- *Rules Governing Securities Firms Sponsoring Issuer Quotations on the Zhong-Guan-Cun System* (“Zhong-Guan-Cun System Sponsoring Firm Rules”); and
- *Disclosure Rules Governing Issuers Whose Stocks Are Quoted and Traded on the Zhong-Guan-Cun System* (“Zhong-Guan-Cun System Issuer Disclosure Rules”).²²⁵

Investors participating in the Zhong-Guan-Cun System trading were limited to legal persons and institutional investors, and those natural persons who acquired their shares in private offerings or through their employer’s stock incentive programs, provided that such natural person investors could only buy and sell the stock of the issuer of whom they were stockholders at the time of trading.²²⁶ Trading in the Zhong-Guan-Cun System issuer stocks must take place exclusively on the system; and each customer must exclusively use the same system broker to handle all its orders.²²⁷

Before an issuer’s stock could be quoted and traded on the system, the issuer must be “sponsored” by a securities firm in accordance with

225. See SAC, *Interim Rules Governing Securities Firms Trading on Zhong-Guan-Cun Issuer Quotations and Agency Trading System* (July 6, 2009), available at http://www.sac.net.cn/dbxt/ywgz/200906/t20090623_30929.html [hereinafter SAC, *Zhong-Guan-Cun System Brokerage Trading Rules*]; SAC, *Rules Governing Securities Firms Sponsoring Issuer Quotations on the Zhong-Guan-Cun System* (July 6, 2009), available at http://www.sac.net.cn/dbxt/ywgz/200906/t20090623_30930.html [hereinafter SAC, *Zhong-Guan-Cun System Sponsoring Firm Rules*]; SAC, *Disclosure Rules Governing Issuers Whose Stocks Are Quoted and Traded on the Zhong-Guan-Cun System* (July 6, 2009), available at http://www.sac.net.cn/dbxt/ywgz/200906/t20090623_30931.html [hereinafter SAC, *Zhong-Guan-Cun System Issuer Disclosure Rules*].

226. See SAC, *Zhong-Guan-Cun System Brokerage Trading Rules*, *supra* note 225, at Ch. 1 Art. 6.

227. *Id.* at Ch. 3 Arts. 21, 23.

the Zhong-Guan-Cun System Sponsoring Firm Rules—a process akin to that of a mini-IPO.²²⁸ The sponsoring firm must:

- establish a Due Diligence Team, to consist of at least three persons: an accountant, an attorney, and a research analyst, who must prepare and sign a Due Diligence Report;
- form an Internal Audit Team, to consist of at least ten persons, who must produce an Audit Opinion verifying the due diligence and giving an opinion on whether the Internal Audit endorsed the issuer quotation on the system; and
- prepare and file the firm’s Quotation Recommendation Report with the SAC, together with the Quotation and Trading Circular prepared by the issuer.²²⁹

Post-quotation, the sponsoring firm was required by the SAC rules to “perform self-regulation” and to “exercise continuous supervision and continuous guidance” with respect to the “continuous disclosure obligations” of the quoted issuer.²³⁰ Should it find the issuer’s periodic disclosures containing any materially false or misleading statements or any material omissions, the sponsoring firm “must order the issuer to take corrective actions; and, if the issuer fails to take such corrective actions, the sponsoring firm shall publicly release an Issuer Risk Factor Statement within two quotation days.”²³¹

Different from the U.S. OTC Bulletin BoardTM market structure, there were no “OTC market makers” on the Zhong-Guan-Cun Agency System.²³² Customer orders were handled in three ways:

- an “exact price-and-quantity trading interest,” which is similar to the U.S. concept of an all-or-none limit order;

228. See SAC, *Zhong-Guan-Cun System Sponsoring Firm Rules*, *supra* note 225. Cf. Regulation A—Conditional Small Issues Exemption, 17 C.F.R. §§ 230.251 *et seq.* (2013); *id.* Offering Circular, § 230.253.

229. See, e.g., SAC, *Zhong-Guan-Cun System Sponsoring Firm Rules*, *supra* note 225, §§ 2.1, 2.2, Chs. 3-5.

230. See, e.g., SAC, *Undertakings by Sponsoring Broker to Perform Self-Regulation*, Art. 3 (June 23, 2009), available at http://www.sac.net.cn/dbxt/ywgz/200906/t20090623_30935.html; SAC, *Zhong-Guan-Cun System Issuer Disclosure Rules*, *supra* note 225, at Ch. 4.

231. See SAC, *Zhong-Guan-Cun System Issuer Disclosure Rules*, *supra* note 225, at Art. 20.

232. For the definition of “market maker” under the U.S. securities law, see Securities Exchange Act of 1934 § 3(a)(38), 15 U.S.C. §78c (2012). For the definition of “OTC Market Maker” under FINRA rules, see FINRA MANUAL RULE 6420(g) (2013).

- an “exact-price with maximum-quantity order”; and
- an “execution order pair,” whereby two customers, having privately negotiated and agreed upon their terms of trade off the system, each sent its respective leg of the execution order pair to its own broker identifying the contra broker for the other leg, for execution on the system.²³³

From time to time during the trading sessions, the system would display (1) the latest order received, including the stock, buy or sell, price and quantity, and the customer’s broker and means of contact; (2) the last sale, including the stock, price and quantity, buyer’s broker and seller’s broker. Each system broker was required to display such market data on its premises to its customers.²³⁴

2. *The NEEQ Hybrid Market Making System (January 2013—)*

In January 2013, the Zhong-Guan-Cun System “graduated” from an SAC-run, SZSE-supported incubator OTC market for the Zhong-Guan-Cun science and technology enterprises (as well as being a “home” for the Legacy Issuers and Delisted Issuers), to a State Council-approved, CSRC-regulated “national securities trading platform” under the Securities Law, under the new name NEEQ, standing for “National Equities Exchange and Quotations.”²³⁵

On September 20, 2012, a “National Small-and-Medium-Sized Enterprises Stock Shares Transfer System Co., Ltd.,” located in Beijing’s Financial Street and jointly owned by the SHSE, the SZSE, the SD&C, the Shanghai Futures Exchange, China Financial Futures Exchange, the Zhengzhou Commodity Exchange, and the Dalian Commodity Exchange, was registered with the State Administration for Industry & Commerce (“SAIC”).²³⁶ Its registered business scope is “to provide a platform for the public trading in non-listed issuers’ stocks; to provide services with respect to non-listed issuers’ primary offerings

233. See SAC, *Zhong-Guan-Cun System Brokerage Trading Rules*, *supra* note 225, § 3.2 Art. 27.

234. *Id.* § 3.6.

235. See NEEQ, *About Us*, <http://www.neeq.com.cn/html/ction.html>. The term “national securities trading platform” is undefined in the Securities Law, except that it, as well as the “securities exchanges,” shall be a venue where “publicly offered securities” shall be traded. CHINESE SECURITIES LAW, *supra* note 35, at Art. 39.

236. See NEEQ, *About Us*, *supra* note 235.

and their merger and acquisition activities; and to provide market participants with information and technology services.²³⁷

On January 16, 2013, NEEQ, run by the National Small-and-Medium-Sized Enterprises Stock Shares Transfer System Co., Ltd. (“NEEQ Operator”), gave a grand opening ceremony in its headquarters in Beijing, with a declared “200 issuers” quoted on NEEQ, i.e., issuers NEEQ inherited from the Zhong-Guan-Cun System.²³⁸ NEEQ runs two boards:

- a premier board for national innovative enterprises—an extension of the Zhong-Guan-Cun concept nationwide;²³⁹ and
- an accommodation board for the Legacy Issuers and Delisted Issuers.²⁴⁰

During a transitional period, the Shenzhen Stock Exchange will continue to provide trading and other technical facilities to NEEQ before the NEEQ System will be up and running in Beijing,²⁴¹ where China has

237. *Id.*

238. *See, e.g.*, National Small-and-Medium-Sized Enterprises Stock Shares Transfer System Co., Ltd. [hereinafter “NEEQ Operator”], *NEEQ Opening Ceremony Took Place in Beijing* (Jan. 16, 2013), http://www.neeq.com.cn/xwdt/xwdt/201301/t20130116_398844.htm; CSRC, *NEEQ Opening Ceremony Took Place in Beijing* (Jan. 16, 2013), http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201301/t20130116_220524.htm.

239. *See* NEEQ Operator, *NEEQ 2013-2: NEEQ Operating Rules (Interim)* (Feb. 8, 2013), available at <http://www.neeq.com.cn/flfg/xtgz/gfzr/gpgs/201302/P02013020858555323058.pdf> [hereinafter NEEQ Operator, *NEEQ Operating Rules*].

240. *See, e.g.*, NEEQ Operator, *NEEQ 2013-5: Notice Concerning a Separate Board for STAQ/NET Issuers and Delisted Issuers* (Feb. 8, 2013), available at http://www.neeq.com.cn/flfg/xtgz/gfzr/ywzl/201302/t20130208_407751.htm; NEEQ Operator, *NEEQ 2013-5-A1: NEEQ Trading Rules Governing STAQ/NET Issuer and Delisted Issuer Stocks (Interim)* (Feb. 8, 2013), available at <http://www.neeq.com.cn/flfg/xtgz/gfzr/ywzl/201302/P020130208591296785817.pdf> [hereinafter NEEQ Operator, *STAQ/NET and Delisted Issuer Trading Rules*].

241. *See, e.g.*, NEEQ Operator & SD&C, *NEEQ 2013-4: Notice Concerning Trading, Clearing and Settlement of NEEQ Securities During the Transitional Period* (Feb. 8, 2013) available at http://www.neeq.com.cn/flfg/xtgz/gfzr/zbqs/201302/t20130208_407780.htm; NEEQ Operator & SD&C, *NEEQ 2013-4-A1: Trading in NEEQ Securities During the Transitional Period*, Art. 4 (Feb. 8, 2013), available at <http://www.neeq.com.cn/flfg/xtgz/gfzr/zbqs/201302/P020130208590228459709.pdf>; NEEQ Operator & SD&C, *NEEQ 2013-4-A2: Clearing and Settlement of NEEQ Securities During the Transitional Period* (Feb. 8, 2013), available at <http://www.neeq.com.cn/flfg/xtgz/gfzr/zbqs/201302/P020130208590228510746.pdf>.

declared its grand vision of building a “Science-Technology-Financial Innovation Center with global influence” through combining the “Silicon Valley” with the “OTCBB.”²⁴²

On January 31, 2013, the CSRC adopted *Interim Regulation of the National Small-and-Medium-Sized Enterprises Stock Shares Transfer System Co., Ltd.* (“NEEQ Operator Regulation”).²⁴³ The NEEQ Operator Regulation defines the NEEQ market:

- declaring the NEEQ System as the Chinese OTC market for public trading in non-listed public company stocks; the NEEQ Operator as the SRO of the NEEQ market; the NEEQ-quoted issuers having the status of “non-listed public companies” within the meaning of the CSRC’s Regulation of Non-Listed Public Companies;²⁴⁴
- emphasizing “the paramount public interest and social utility role” NEEQ is to play in “serving and supporting small, innovative enterprises”;²⁴⁵ and
- setting the regulatory structure of the Chinese OTC market, subjecting that market—including the NEEQ Operator, the NEEQ market, the NEEQ issuers, and all NEEQ market participants—to the “comprehensive regulation by the CSRC.”²⁴⁶

Perhaps deserving particular notice by international stock market watchers, NEEQ’s premier board featuring science and technology

242. See *supra* notes 192-198 and accompanying text; see also Guo Shuqing, *Improving the Structure of the Capital Markets and Promoting the Healthy Development of the Economic Entities* (Feb. 2, 2012), http://news.xinhuanet.com/fortune/2012-02/02/c_122643689.htm (“The great combination of capital markets with high technology in the United States has enabled the U.S. to maintain the leadership position in science and technology.”); CSRC, *Year 2012 National Securities and Futures Regulation Conference Convened in Beijing* (Jan. 9, 2012), http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201201/t20120109_204593.htm.

243. See CSRC, *CSRC 2013-89: Interim Regulation of the National Small-and-Medium-Sized Enterprises Stock Shares Transfer System Co., Ltd.* (Jan. 31, 2013), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201302/t20130202_221078.htm [hereinafter CSRC, *NEEQ Operator Regulation*].

244. *Id.* at Ch. 1 Arts. 2-4.

245. *Id.* at Art. 5; see also CSRC, *CSRC Announces Interim Regulation of the National Small-and-Medium-Sized Enterprises Stock Shares Transfer System Co., Ltd.* (Feb. 2, 2013), http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201302/t20130202_221077.htm.

246. CSRC, *NEEQ Operator Regulation*, *supra* note 243, at Arts. 3, 7.

issuers is authorized to utilize three modes of price discovery and order handling, i.e., “market making,” “private, off-the-system negotiation,” and “auction market”—an interesting contrast to the U.S. OTCBB market structure.²⁴⁷ According to the NEEQ Operating Rules:

- If a quoted stock is set for “private negotiation” as the means of pricing and trading, NEEQ may simultaneously provide a “call auction market” for that stock—where neither procedure has been elaborated by NEEQ;
- If a quoted stock is set for “market making,” there must be at least two market makers for the stock; each market maker is required to provide a continuous two-sided market in the stock, and to execute customer orders at or within the bounds of its quotes;
- Once a stock is set for market making, no customer orders shall be allowed to bypass the market makers and effect a cross.²⁴⁸

Other than the above sketchy outline on market making and order handling, neither the CSRC’s NEEQ Operator Regulation, nor the NEEQ Operating Rules, nor any other NEEQ rules give any specifics on the operation of NEEQ as a market making or a hybrid system.²⁴⁹ The lack of any provision for the handling of superior customer limit orders, in conjunction with the express prohibition by the NEEQ Operating Rules against direct customer order interaction once a stock is set for market making, appears to be ripe for customer abuse and anti-competitive behavior. This is particularly so for a market making system with built-in entry barrier, where the issuer’s sponsoring firm is required to conduct an expensive mini-IPO type of due diligence investigation, with no piggyback exemption freely available to any would-be market makers. Interestingly, upon the announced conversion of the Zhong-Guan-Cun Agency System (which generally operated on a

247. See, e.g., *id.* at Ch. 4 Art. 24; NEEQ Operator, *NEEQ Operating Rules*, *supra* note 239, at Ch. 3 Art. 3.1.2.

248. See NEEQ Operator, *NEEQ Operating Rules*, *supra* note 239, at Arts. 3.1.3-3.1.4.

249. See, e.g., CSRC, *NEEQ Operator Regulation*, *supra* note 243, at Ch. 4; NEEQ Operator, *NEEQ Operating Rules*, *supra* note 239, at Ch. 3; NEEQ Operator, *NEEQ 2013-3-A4: Rules Governing NEEQ System Participant Firms (Interim)*, § 3.4 (Feb. 8, 2013), available at <http://www.neeq.com.cn/flfg/xtgz/gfzx/gpgs/201302/P020130208586602226816.pdf> [hereinafter NEEQ Operator, *NEEQ Participant Firm Rules*].

one sponsoring broker per issuer basis)²⁵⁰ to the NEEQ Market Making System, every NEEQ issuer has now a lineup of exactly two “quotation firms” (the “Primary Quotation Firm” being the issuer’s sponsoring firm and the “Secondary Quotation Firm” generally being selected by the former)²⁵¹ in an anticipatory move to meet NEEQ’s two-market marker requirement. As of the time of this Article, neither market making nor auction session has actually commenced on the NEEQ System; private, off-the-system negotiation without being subject to any kind of order protection rule is the only mode of order handling on NEEQ’s premier board.²⁵²

NEEQ’s accommodation board trading the Delisted Issuers and Legacy Issuers, in contrast, prohibits sponsoring firms’ “dealing” activities; only two types of trading are allowed:

- a daily call auction, for tradable shares; and
- private negotiation, for non-tradable or other restricted shares.²⁵³

Call auction on the accommodation board runs four hours a day: from 9:30 a.m. to 11:30 a.m., and from 1:00 p.m. to 3:00 p.m., during which time orders may be entered. Upon the hour at 10:30 a.m., 11:30 a.m., and 2:00 p.m., then upon every ten minutes during 2:00 p.m. to 2:50 p.m., and finally upon the minute during 2:50 p.m. to 3:00 p.m., the NEEQ System will display the “indicative equilibrium price” which would result in the maximum volume of executions. At 3:00 p.m., the market is called and all eligible orders are executed at the single equilibrium price.²⁵⁴ The frequency a stock is open for trading on the accommodation board depends on the financial and disclosure performance of the issuer, scored by a 5, 3, or 1 which is appended to

250. See, e.g., SAC, *Trial Measures Governing Securities Firms’ Provision of Shares Agency Transfer Services*, *supra* note 221, at Art. 11; SAC, *Zhong-Guan-Cun System Brokerage Trading Rules*, *supra* note 225, at Art. 10; SZSE, *Investor Education: Sponsoring Broker and Business Contingency Planning* (July 7, 2008), www.szse.cn/main/investor/tzsc/jyp/dbgfzr/cjwtdy/20422.shtml.

251. See NEEQ, *List of Quoted Issuers and Their Quotation Firms*, <http://bjzr.gfzr.com.cn/bjzr/djb.jsp?pageNo=1>.

252. Information based on Author’s conversation with NEEQ staff on NEEQ’s Public Communication Line on November 18, 2013.

253. See NEEQ Operator, *STAQ/NET and Delisted Issuer Trading Rules*, *supra* note 240, at Arts. 15-16.

254. *Id.* at Arts. 17, 28-30.

the stock symbol, to indicate good to poor performance of the issuer and the number of trading days per week for its stock.²⁵⁵

As with the Zhong-Guan-Cun System, pre-quotation, each NEEQ premier board issuer must be “recommended for quotation” by a sponsoring firm, who shall conduct a mini-IPO type of due diligence investigation; post-quotation, the sponsoring firm must perform “continuous supervision and continuous guidance with respect to the issuer’s continuous disclosures.”²⁵⁶ The oversight functions over the sponsoring firms and the issuers previously performed by the SAC are now assumed by the NEEQ Operator and the CSRC.²⁵⁷

“Public trading” on NEEQ’s premier board is restricted by regulatory requirements to the following three types of investors:

- legal persons with at least CN ¥5 million in registered capital;
- collective trust funds, investment funds, bank common trust funds, assets management plans and other similar managed financial assets; and
- any natural person investors with securities assets worth at least CN ¥3 million, and having either two years’ securities investment experience, or education or training in accounting, finance, investment, or economics.²⁵⁸

255. *Id.* at Art. 18.

256. *See, e.g.*, NEEQ Operator, *NEEQ Participant Firm Rules*, *supra* note 249, § 3.2; NEEQ Operator, *NEEQ 2013-3-A1: Rules Governing NEEQ Issuer Sponsoring Business (Interim)*, Chs. 3, 6 (Feb. 8, 2013), available at <http://www.neeq.com.cn/flfg/xtgz/gfzr/gpgs/201302/P020130218566664791500.pdf>; NEEQ Operator, *Standard Agreement Between NEEQ Issuer and Primary Sponsoring Firm Concerning Quotation Recommendation and Continuous Supervision and Guidance in Respect of Issuer Continuous Disclosures* (Mar. 14, 2013), available at <http://www.neeq.com.cn/flfg/xtgz/gfzr/wjmb/201303/P020130314605796062127.doc>.

257. *See, e.g.*, NEEQ Operator, *Regulatory Review Process for Targeted Offerings of and Public Trading in NEEQ Issuer Stocks* (Mar. 19, 2013), available at <http://www.neeq.com.cn/flfg/xtgz/gfzr/ywzl/201303/P020130319753633229415.pdf>; SAC, *Notice of Abrogation of Thirty SRO Rules, Schedules, and Forms Related to the Zhong-Guan-Cun Brokerage System* (May 16, 2013), available at http://www.sac.net.cn/tzgg/201305/t20130516_62275.html.

258. *See, e.g.*, CSRC, *NEEQ Operator Regulation*, *supra* note 243, at Arts. 9, 25; NEEQ Operator, *NEEQ 2013-3-A2: NEEQ Investor Suitability Rules (Interim)*, Arts. 3-5 (Feb. 8, 2013), available at <http://www.neeq.com.cn/flfg/xtgz/gfzr/gpgs/201302/P020130208586602145860.pdf> [hereinafter NEEQ Operator, *NEEQ Investor Suitability Rules*].

The NEEQ System also provides a platform for “targeted offerings to specified persons,” i.e., private placements, which are restricted to two groups of persons: (1) the three types of persons permitted to participate in “public trading” on NEEQ; and (2) the following five types of persons from a NEEQ-quoted issuer:

- current stockholders,
- members of the board of directors,
- members of the board of supervision,
- senior management, and
- key employees of the issuer.²⁵⁹

Any person who has acquired a NEEQ issuer’s stock through a private offering but who does not meet the “public trading” eligibility criteria is allowed to trade only that stock, and may not trade other stocks quoted on NEEQ—similar to the Zhong-Guan-Cun System trading access rules.²⁶⁰

The NEEQ System publicly releases, through open Internet access, both real time market data and end of day historical trading data, including, *inter alia*, the stock name, price and quantity, and time of submission of each order; the stock name, price and quantity, and time of each trade; the order handling broker, its contact person, and means of contact.²⁶¹

3. OTC Equities and OTC Markets: A Comparison and Contrast of Concepts

The Chinese OTC equities market presents interesting contrasts and comparisons between the Chinese and the U.S. securities laws on several key concepts, such as:

- public offerings versus private placements;

259. See, e.g., NEEQ Operator, *NEEQ Operating Rules*, *supra* note 239, § 4.3; NEEQ Operator, *NEEQ Investor Suitability Rules*, *supra* note 258, at Art. 6.

260. See NEEQ Operator, *NEEQ Investor Suitability Rules*, *supra* note 258, at Art. 7; see also *supra* note 226 and accompanying text.

261. See, e.g., NEEQ Operator, *NEEQ Operating Rules*, *supra* note 239, § 3.2; NEEQ Operator, *STAQ/NET and Delisted Issuer Trading Rules*, *supra* note 240, at Art. 33; see also NEEQ, *Market Data Release for the Premier Board*, <http://bjzr.gfzr.com.cn/bjzr/bjlb.htm> (real time market data public release); NEEQ, *Market Data Release for the Accommodation Board*, http://www.gfzr.com.cn/sshq/hqlist_updownpercent.html (end of day market data public release).

- listed equity securities, OTC equity securities, and restricted equity securities;
- exchange trading versus OTC transactions in listed equity securities; OTC public markets for OTC equity securities; OTC private markets for restricted equity securities.

a. U.S.: OTC Transactions in Listed Equity Securities

Under the U.S. market structure for the trading of equity securities, an “NMS stock,” as the term is defined in *Regulation NMS—Regulation of the National Market System*, is registered with and listed on a national securities exchange pursuant to Section 12(b) of the Securities Exchange Act of 1934 (“Exchange Act”).²⁶² An NMS stock can be traded on an exchange, and otherwise than on an exchange as an OTC transaction.²⁶³ Whether an NMS stock transaction is effected on an exchange or in an OTC market such as upstairs or an ATS, all transactions in an NMS stock are subject to the same requirement for transaction reporting, governed by NMS Rule 601 *Dissemination of Transaction Reports and Last Sale Data with Respect to Transactions in NMS Stocks*, and to the same requirement for quotation dissemination and prohibition of trade-through, as provided under NMS Rule 602 *Dissemination of Quotations in NMS Securities* and NMS Rule 611 *Order Protection Rule*.²⁶⁴ The various national securities exchanges and the OTC regulator FINRA act jointly in filing with the U.S. Securities and Exchange Commission

262. See, e.g., Regulation NMS—Regulation of the National Market System, 17 C.F.R. §§ 242.600–612 (2013); *id.* § 242.600(b)(47) (“NMS stock” definition); Securities Exchange Act of 1934 § 12. Registration Requirements for Securities, 15 U.S.C. § 78l (2012).

263. See, e.g., SROs; FINRA; . . . Order Granting Accelerated Approval to the Proposed Rule Change, . . . to Require Members to Report OTC Transactions in Equity Securities Within 30 Seconds of Execution, 75 Fed. Reg. 17,806 (Apr. 7, 2010); *id.* at 17,807 n.6 (“OTC equity transactions are: (1) transactions in NMS stocks, . . . effected otherwise than on an exchange, . . . and (2) transactions in ‘OTC Equity Securities,’ . . . (e.g., OTC Bulletin Board and Pink Sheets securities), . . .”); SROs; FINRA; Order Approving the Proposed Rule Change, . . . to Require Members to Report OTC Equity Transactions as Soon as Practicable, But No Later than 10 Seconds, Following Execution, 78 Fed. Reg. 29,190, 29,190 nn. 3, 11 (May 17, 2013).

264. See, e.g., Dissemination of Transaction Reports and Last Sale Data with Respect to Transactions in NMS Stocks, 17 C.F.R. § 242.601; Dissemination of Quotations in NMS Securities, 17 C.F.R. § 242.602; Order Protection Rule, 17 C.F.R. § 242.611.

(“SEC”) joint SRO national market system plans, for the consolidation, display, and dissemination of quotations for and reports of transactions in NMS stocks.²⁶⁵

b. U.S.: OTC Equity Securities—OTCBB, Pink Sheets, and Grey Market

In distinction from an “OTC transaction” in an NMS stock, an “OTC Equity Security” as defined by FINRA Rule 6420(f) means “any equity security that is not an ‘NMS stock’ . . . ; provided, however, that the term ‘OTC Equity Security’ shall not include any Restricted Equity Security.”²⁶⁶ Primary categories of “OTC equity securities” based on quotation platforms are the OTC Bulletin BoardTM securities, the Pink Sheets securities, and the Grey Market securities.²⁶⁷ Based on Pink Sheets’ published data as of October 24, 2013, there were seven issuers solely quoted on OTCBB; 8,589 issuers solely quoted on Pink Sheets; 812 issuers dually quoted on OTCBB and Pink Sheets; and 7,989 issuers traded in the Grey Market.²⁶⁸

The Grey Market securities are those OTC equity securities that are neither exchange-listed nor quoted on any “inter-dealer quotation system,” but are otherwise publicly traded.²⁶⁹ Grey Market securities were subject to the “Three Quote Rule,” which generally required NASD members to contact at least three dealers to obtain quotations for such securities. Effective May 31, 2012, FINRA rescinded the Three Quote Rule as “overly prescriptive,” and replaced it with a general emphasis on a member’s best execution obligations when handling an

265. See, e.g., Distribution, Consolidation, and Display of Information with Respect to Quotations for and Transactions in NMS Stocks, 17 C.F.R. § 242.603; Filing and Amendment of National Market System Plans, 17 C.F.R. § 242.608.

266. See FINRA, FINRA MANUAL RULE 6420(f) (2013) (“OTC Equity Security” definition).

267. See SROs; FINRA; Notice of Filing of Proposed Rule Change Relating to the Restructuring of Quotation Collection and Dissemination for OTC Equity Securities, 74 Fed. Reg. 61,183, 61,184 (Nov. 23, 2009).

268. See OTC Link, *Stock Screener*, <http://www.otcm Markets.com/research/stock-screener>.

269. See *supra* note 267; see also FINRA, FINRA MANUAL RULE 6420(c) (2013) (defining “Inter-dealer quotation system”); Initiation or Resumption of Quotations Without Specific Information, 17 C.F.R. § 240.15c2-11; *id.* (e)(2) (definition of “Interdealer quotation system”).

order involving any security for which there is limited pricing information available.²⁷⁰

Pink Sheets, its current official corporate name being “OTC Link LLC,”²⁷¹ historically were “a shorthand reference to the stock quotations compiled and published daily by the National Quotation Bureau, Inc.,” a private, non-registered entity then.²⁷² In 1999, the Electronic Pink Sheets began replacing the hard copy pink sheets, and became subject to SEC Rule 15c2-11 as “an interdealer quotation system.”²⁷³ Rule 15c2-11 generally requires a broker-dealer to gather and review certain specified information concerning the issuer (“15c2-11 information”) before it initiates or resumes quotation publication in “any interdealer quotation system” for OTC securities. The Rule lays out five categories of 15c2-11 information:

- (1) if the issuer has conducted a recent public offering registered under the Securities Act—a prospectus;
- (2) if the issuer has effected a recent offering pursuant to Regulation A under the Securities Act—an offering circular;
- (3) if the issuer is a reporting issuer under the Exchange Act—the issuer’s most recent annual report and subsequent quarterly reports and current reports;
- (4) if the issuer is a non-reporting issuer—16 items of information specified in the Rule, which include financial information about the issuer but are less comprehensive than a reporting issuer’s annual report;
- (5) if the issuer is a foreign private issuer not listed on a U.S. national securities exchange and relying on SEC Rule 12g3-2(b) “information supplying exemption” from registration under Section 12(g) of the Exchange Act—information that the issuer

270. See, e.g., SROs; FINRA; Order Granting Approval of Proposed Rule Change to Adopt NASD Rule 2320 (Best Execution and Interpositioning) and Interpretive Material (“IM”) 2320 as FINRA Rule 5310 in the Consolidated Rulebook, 76 Fed. Reg. 77,042, 77,042–43 (Dec. 9, 2011); FINRA, *FINRA Regulatory Notice 12-13: Best Execution* (Mar. 2012).

271. See SEC, *OTC Link LLC*, <http://www.sec.gov/answers/pink.htm>.

272. See Arnold I. Burns, *Over-the-Counter Market Quotations: Pink, Yellow, Green and White Sheets—A Gray Area in the Law of Evidence*, 52 CORNELL L. REV. 262, 262–65 (1967).

273. See SROs; NASD; Order Approving Proposed Rule Change Relating to Requirements for Recording and Reporting of Certain Quotation Data; . . . , 68 Fed. Reg. 16,328, 16,328 n.9 (Apr. 3, 2003).

has maintained a listing of its equity securities in its primary trading market located outside the United States and has published non-U.S. disclosure documents specified by Rule 12g3-2(b) in English, as well as instructions on how to obtain such non-U.S. disclosure information electronically.²⁷⁴

Importantly, and perhaps also serving as enlightenment to China's new experimentation on "a market-making system for non-listed public companies,"²⁷⁵ a broker-dealer submitting a quotation to an interdealer quotation system is exempt from Rule 15c2-11 information gathering and review requirement where the security has been both bid-and-ask quoted on the system on each of at least 12 days within the previous 30 calendar days, with no more than 4 business days in succession without such a two-way quotation—the so-called "piggyback exemption."²⁷⁶ Further, Rule 15c2-11 distinguishes a market maker's 15c2-11 obligations from an underwriter's due diligence responsibilities:

Because of its special relationship with the issuer, other distribution participants, and the investing public, an underwriter is subject to a largely separate, broad set of investigative responsibilities (commonly referred to as 'due diligence' responsibilities) under both the securities laws and the standards of the profession.

In contrast, the revised requirements of the Rule do not contemplate that, before submitting or publishing quotations for [an OTC] security, a market maker must routinely conduct any independent 'due diligence' investigation concerning the issuer or its business operations and financial condition such as the investigation expected to be conducted by an underwriter. A market maker publishing

274. See Initiation or Resumption of Quotations Without Specific Information, 17 C.F.R. § 240.15c2-11, (a)(1)-(5) (2013); see also Initiation or Resumption of Quotations by a Broker or Dealer Who Lacks Certain Information, 36 Fed. Reg. 18,641 (Sept. 18, 1971) ("Rule 15c2-11 1971 Adopting Release"); Initiation or Resumption of Quotations Without Specified Information, 49 Fed. Reg. 45,117 (Nov. 15, 1984) ("Rule 15c2-11 1984 Amendment Release"); Initiation or Resumption of Quotations Without Specified Information, 50 Fed. Reg. 14,111 (Apr. 10, 1985) ("Rule 15c2-11 1985 Solicitation of Comments Release"); Initiation or Resumption of Quotations Without Specified Information, 56 Fed. Reg. 19,148 (Apr. 25, 1991) ("Rule 15c2-11 1991 Amendment Release"); Exemption From Registration Under Section 12(g) of the Securities Exchange Act of 1934 for Foreign Private Issuers, 73 Fed. Reg. 52,752, 52,762–63 (Sept. 10, 2008) ("Rule 15c2-11 2008 Amendment").

275. See *supra* notes 247-252 and accompanying text.

276. See Initiation or Resumption of Quotations Without Specific Information, 17 C.F.R. § 240.15c2-11, (f)(3)(ii).

quotations for [an OTC] security may have no relationship with the issuer of the security. The Rule does not demand that the market maker develop such a relationship in order to obtain information about the issuer. Rather, . . . the Rule specifies the information that must be gathered, and the Rule's requirements are satisfied if the market maker has a reasonable basis for believing that the information is accurate and obtained from a reliable source, after reviewing that information.²⁷⁷

Pink Sheets (or OTC Link, its new name) is currently the only centralized location where quotes on OTC equity securities of non-reporting issuers are published, although its issuer universe also includes reporting issuers.²⁷⁸ It classifies its quoted issuers into three tiers based on their financial strength and information availability: the pink-colored OTC Pink, the orange-colored OTC QB, and the green-colored OTC QX.²⁷⁹ For whichever tier of issuers, all broker-dealers publishing quotations on OTC Link, an "interdealer quotation system," must comply with Rule 15c2-11.²⁸⁰

The OTCBB, an interdealer quotation system owned and operated by the NASD (FINRA's predecessor) since 1990 for public trading in non-exchange listed equity securities, had not required a reporting issuer requirement until 1999, when concerns over fraud and manipulation in the trading and sales of thinly traded and thinly capitalized or "microcap" securities prompted it to impose an SEC reporting requirement on the OTCBB issuers.²⁸¹ There are three groups of OTC

277. See *Initiation or Resumption of Quotations Without Specified Information*, 56 Fed. Reg. 19,148, 19,151–12 (Apr. 25, 1991).

278. See, e.g., ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE U.S. SECURITIES AND EXCHANGE COMMISSION, F-1 n.2 (Apr. 23, 2006), available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>; OTC Link, *Reporting Requirements*, www.otcmarkets.com/companies-advisors/otc-company-reporting.

279. See OTC Link, *Our Three Tiered Marketplaces*, <http://www.otcmarkets.com/learn/otc-market-tiers>.

280. Today, OTC Link is not only an "interdealer quotation system," but also an ATS and a broker-dealer registered with the SEC, and a member of FINRA. See SEC, *supra* note 271.

281. See, e.g., SROs; NASD; Order Approving . . . Proposed Rule Change Relating to the OTC Bulletin Board Service, 62 Fed. Reg. 16,635 (Apr. 7, 1997); SROs; NASD; Order Granting Approval of Proposed Rule Change . . . by the National Association of Securities Dealers, Inc. Relating to Microcap Initiatives—Amendments to NASD Rules 6530 and 6540, 64 Fed. Reg. 1,255 (Jan. 8, 1999).

equity securities eligible to be quoted on the OTCBB under FINRA Rule 6530: (1) non-listed U.S. domestic equity securities, (2) non-listed foreign equity securities or ADRs, and (3) listed equity securities that are undergoing delisting from a U.S. securities exchange—in all cases, the issuer of the security must be an Exchange Act reporting issuer and is current in filing reports.²⁸²

Under the Exchange Act reporting regime, there are three classes of reporting issuers:

- “Section 12(b) issuer”—i.e., an issuer registered pursuant to Section 12(b) of the Exchange Act; as a national securities exchange listed issuer, it is subject to the full panoply of the Exchange Act reporting requirements;
- “Section 12(g) issuer”—i.e., an issuer registered pursuant to Section 12(g) of the Exchange Act, due to its having (1) total assets exceeding \$10 million, and (2) a class of equity security held of record by either 2,000 persons or by 500 persons who are not accredited investors; to allow “foreign private issuers” who have not voluntarily sought a public market in the U.S. to have their equity securities traded on a limited basis in the U.S. over-the-counter public market without registration under Section 12(g), SEC Rule 12g3-2 exempts a class of securities of a foreign private issuer from Section 12(g) if such class has fewer than 300 holders resident in the United States (i.e., Rule 12g3-2(a) exemption), or if the issuer is not already a reporting issuer, maintains a listing of such class of securities in its primary trading market outside the United States, and complies with the Rule’s “information supplying” condition (i.e., Rule 12g3-2(b) exemption);
- “Section 15(d) issuer”—i.e., an issuer registered pursuant to Section 15(d) of the Exchange Act, due to its having filed a registration statement under the Securities Act of 1933 (“Securities Act”) which has become effective.²⁸³

282. See FINRA, FINRA MANUAL RULE 6530: OTCBB-ELIGIBLE SECURITIES (2013). In addition to OTC equity securities, “DPP securities” or “direct participation program securities,” such as oil and gas programs and real estate programs that allow investors to directly participate in the cash flow and flow-through tax consequences of the underlying investments, are also OTCBB eligible. See FINRA, FINRA MANUAL RULE 6420(b).

283. See, e.g., Securities Exchange Act of 1934 § 12. Registration Requirements for Securities, 15 U.S.C. § 78l, (a), (g)(1) (2012); *id.* § 15. Registration and Regulation of

A foreign private issuer claiming Rule 12g3-2(b) “information supplying exemption” from Exchange Act reporting requirement may be quoted on the Pink Sheets, but may not be quoted on the OTCBB.²⁸⁴

c. U.S.: Restricted Securities—The PORTAL Evolution

Different from “OTC Equity Securities,” “Restricted Equity Securities” as defined by FINRA and SEC rules generally refer to securities acquired by purchasers in private placements, whether issued by reporting or non-reporting issuers, whose resale must be registered unless an exemption is available.²⁸⁵ In 1972, the SEC adopted Rule 144 setting forth specific and objective criteria (such as holding period and volume limitation) to distinguish a resale that is a “distribution” requiring registration from a resale that is “routine trading” exempt from registration.²⁸⁶ Rule 144 operates as a safe harbor for the resale of “restricted securities,” “control securities” (or securities held by an affiliate of the issuer, however acquired), and “restricted and control securities” (or securities acquired by an affiliate of the issuer in a private placement), into the public marketplace.²⁸⁷

To differentiate the institutional resale market and the public resale market, in 1990 the SEC adopted Rule 144A as a safe harbor to allow immediate resale, without registration under the Securities Act and without complying with Rule 144 exemption conditions, of restricted securities to “qualified institutional buyers” or QIBs as the term is

Brokers and Dealers, 15 U.S.C. § 78o, (d); Exemptions for American Depository Receipts and Certain Foreign Securities, 17 C.F.R. § 240.12g3-2 (2013); *see also* Exemption From Registration Under Section 12(g) of the Securities Exchange Act of 1934 for Foreign Private Issuers, 73 Fed. Reg. 52,752 (Sept. 10, 2008).

284. *See* NASD, *Notice to Members 98-7: Unregistered Foreign Equities and ADRs No Longer Eligible for Quotation in OTC Bulletin Board* (Jan. 1998).

285. *See, e.g.*, FINRA, FINRA MANUAL RULE 6420(k) (“Restricted Equity Security” definition); Persons Deemed Not to Be Engaged in a Distribution and Therefore Not Underwriters, 17 C.F.R. § 230.144 (2013); *id.* (a)(3) (defining “restricted securities”); *id.* (c)(1) (“reporting issuers”); *id.* (c)(2) (“non-reporting issuers”); *see also* SEC, *Rule 144: Selling Restricted and Control Securities*, <http://www.sec.gov/investor/pubs/rule144.htm>.

286. *See* Definition of Terms “Underwriter” and “Broker’s Transactions,” 37 Fed. Reg. 591, 592–93 (Jan. 14, 1972) (“Rule 144 Adopting Release”).

287. *See, e.g.*, Revision of Holding Period Requirements in Rules 144 and 145, 62 Fed. Reg. 9,242, 9,242 (Feb. 28, 1997); Revisions to Rules 144 and 145, 72 Fed. Reg. 71,546, 71,547 (Dec. 17, 2007).

defined in the Rule.²⁸⁸ Subject to information provision requirement, the issuer of 144A securities can be a non-reporting issuer, or a non-reporting, non-exempt foreign private issuer, as well as a reporting issuer. The 144A securities may not be fungible with a class of securities listed on a national securities exchange or quoted in an automated inter-dealer quotation system, so as to prevent any leakage of 144A restricted securities into the public market and the development of side-by-side public market and private market trading the same class of securities.²⁸⁹ The SEC also approved the establishment by the NASD-NASDAQ of PORTAL Market (“*Private Offering, Resale and Trading through Automated Linkages*” System), as an efficiency-enhancing “centralized system for the display of interest in Rule 144A securities” that was not considered, “for purposes of all rules, regulations, forms and schedules under the Securities Act and the Exchange Act,” an “automated inter-dealer quotation system” or an “electronic interdealer quotation system.”²⁹⁰

In September 2008, the PORTAL Market underwent an ownership and operational restructure, resulting in a new PORTAL Alliance, jointly owned and operated by nine Wall Street firms as well as The NASDAQ OMX Group, Inc. taking a minority interest.²⁹¹ As a 144A private equity market, PORTAL Alliance provides QIBs access to quotes, trade negotiation, transaction settlement, trade reporting, market data, issuer information, and investor qualification, for trading unregistered 144A securities among Rule 144A Qualified Institutional Buyers.²⁹²

288. See Resale of Restricted Securities; . . . , 55 Fed. Reg. 17,933 (Apr. 30, 1990) (“Rule 144A Adopting Release”).

289. See Private Resales of Securities to Institutions, 17 C.F.R. 230.144A, (d)(3)-(4) (2013); see also Resale of Restricted Securities; . . . , 54 Fed. Reg. 30,076, 30,081-82 (July 18, 1989) (“Rule 144A Re-Proposing Release”).

290. See SROs; Order Approving Proposed Rule Change . . . of the NASD, Relating to the Operation of the PORTAL Market, 55 Fed. Reg. 18,781, 18,787 n.60, 18,789 n.79 and accompanying text (May 4, 1990) (“PORTAL Adopting Release”).

291. See SROs; The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Nasdaq’s PORTAL Market, 73 Fed. Reg. 57,188 (Oct. 1, 2008).

292. See PORTAL Alliance, <http://www.portalalliancemarket.com>.

d. China: Non-Publicly Offered Equity Securities of Listed Issuers

In contrast to the specific registration and disclosure regime under Section 5 of the U.S. Securities Act of 1933, under the Chinese Securities Law which governs both primary and secondary markets, “all public offerings of securities shall meet the requirements of all applicable laws, rules, and regulations, and shall have approvals from the securities regulatory agency under the State Council or other government departments authorized by the State Council.”²⁹³ The term “public offering” is defined by the Securities Law to mean an offering falling under any of the following three categories:

1. an offering of securities to “non-specified persons” (akin to the U.S. concept of an offering to “the public”);
2. an offering of securities to “specified persons” (akin to the U.S. concept of a “private” offering), whereby the cumulative number of stockholders of the issuer exceeds 200 (thus, a private offering to one specified person by an issuer already having 200 stockholders would “become” a public offering by the operation of this provision); and
3. other types of offering which laws, rules, and regulations may prescribe as public offerings;

—where neither “specified persons” nor “non-specified persons” is defined by the Securities Law.²⁹⁴ Compared to the definition for “public offering,” the term “non-public offering” is undefined and unaddressed by the Securities Law, except by a “prohibition against any use of any advertisement, public solicitations, or other de facto public means in connection with any non-public offerings of securities.”²⁹⁵ The Securities Law grants a rule-making authority to the CSRC to regulate “public offerings and non-public offerings of securities by listed companies.”²⁹⁶

The CSRC has adopted *Regulation of Securities Offerings by Listed Issuers, Regulation of Securities Offerings and Underwriting, and Implementation Rules Governing Non-Public Offerings by Listed Issuers* (collectively, “Listed Issuer Offerings Regulation”), to govern follow-on

293. Compare CHINESE SECURITIES LAW, *supra* note 35, at Arts. 2, 10, with Securities Act of 1933 § 5. Prohibition Relating to Interstate Commerce and the Mails, 15 U.S.C. § 77e (2012).

294. CHINESE SECURITIES LAW, *supra* note 35, at Art. 10.

295. *Id.*

296. *Id.* at Art. 13.

public offerings and non-public offerings by listed issuers.²⁹⁷ Under the Listed Issuer Offerings Regulation, a “non-public offering by a listed issuer” is defined to mean “an offering by a listed issuer of its stock to specified persons in a non-public manner.”²⁹⁸ To meet the policy goal for listed issuers of avoiding any “intra-firm competition between the controlling persons and the listed company” and lessening any “opportunities for interested transactions,”²⁹⁹ “specified persons” participating in a non-public offering by a listed issuer shall meet the following conditions:

- the persons either are selected by the criteria set by a stockholder resolution or a board resolution, or are directly nominated by the board of directors;
- the total number of purchasers in an offering may not exceed 10; and
- if a purchaser is a “Foreign Strategic Investor,” such person shall have received advance approvals from the relevant government agencies under the State Council.³⁰⁰

297. See, e.g., CSRC, *CSRC 2006-30: Regulation of Securities Offerings by Listed Issuers* (May 8, 2006), available at http://www.csrc.gov.cn/pub/zjhpublic/zjh/200804/t20080418_14487.htm; CSRC, *CSRC 2013-95: Regulation of Securities Offerings and Underwriting* (Dec. 13, 2013), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/ndbg/201312/t20131213_239903.htm; CSRC, *CSRC 2007-302: Implementation Rules Governing Non-Public Offerings by Listed Issuers* (Sept. 17, 2007), available at http://www.csrc.gov.cn/pub/newsite/xxfw/flfg/bmgf/fx/zrz/201106/t20110630_196841.htm. For CSRC rules governing initial public offerings, see CSRC, *CSRC 2006-32*, *supra* note 99.

298. See CSRC, *CSRC 2006-30*, *supra* note 297, at Ch. 3 Art. 36.

299. See CSRC, *CSRC 2007-302*, *supra* note 297, at Ch. 1 Art. 2.

An “intra-firm competition” at a listed company refers to the phenomenon where the controlling (i.e., 50% threshold) or a major (i.e., a top ten) stockholder of, or any other person exercising de facto control over, the listed company, or any affiliate of any of the preceding persons, engages in a business that is, or potentially may be, in direct or indirect competition with the business of the listed company. See SEC. AND FIN. INST. OF SHANGHAI JIAOTONG UNIV. & SHANGHAI STOCK EXCHANGE, SHJR 2010-21: ON THE PHENOMENON OF INTRA-FIRM COMPETITION AT LISTED COMPANIES, 6–7 (Oct. 2010), available at <http://www.sse.com.cn/researchpublications/jointresearch/c/plan20110519q.pdf>.

300. See, e.g., CSRC, *CSRC 2006-30*, *supra* note 297, at Art. 37; CSRC, *CSRC 2007-302*, *supra* note 297, at Arts. 8, 13; see also MOC et al., *MOC 2005-28*, *supra* note 54.

The holding period and purchase price of non-publicly offered securities of a listed issuer vary, depending on the nature of the specified persons. The holding period shall be 36 months and the purchase price shall be determined by a board resolution for a specified person if it falls under one of the following three categories: the current controlling stockholder or other controlling person of the issuer, or an affiliate of any of the preceding persons; an investor who will gain de facto control over the issuer post-offering; a foreign or domestic strategic investor.³⁰¹ If the specified persons are other than the above, the holding period shall be 12 months for them; the offering price shall be determined and purchasers selected through competitive bidding.³⁰² Unless all the ten specified persons were the “top ten” stockholders pre-offering, the non-public offering “must be underwritten” by securities firms on a best efforts basis, and may not be sold directly by the issuer to the specified persons.³⁰³

Instead of setting a regulatory framework governing public resale and private resale of restricted and control stocks, the Securities Law prohibits trading in any shares subject to “any legal holding period.”³⁰⁴ A U.S. PORTAL-type of liquidity outlet for private placement securities thus could not legally develop in China, resulting in a cost of illiquidity discount to the listed issuers and an efficiency loss to the capital markets.

e. China: Equity Securities of Non-Listed Public Companies

Under the CSRC’s *Regulation of Non-Listed Public Companies*, which became effective January 1, 2013, there are two categories of “non-listed public company”—reminding one (somewhat) of Section 15(d) and Section 12(g) reporting triggers of the U.S. Securities Exchange Act of 1934:

301. See CSRC, *CSRC 2007-302*, *supra* note 297, at Ch. 2 Art. 9.

302. *Id.* at Art. 10.

303. See, e.g., CSRC, *CSRC 2006-30*, *supra* note 297, at Ch. 4 Art. 49; CSRC, *CSRC 2013-95*, *supra* note 297, at Ch. 3 Art. 22.

304. See CHINESE SECURITIES LAW, *supra* note 35, at Ch. 3 Art. 38, Ch. 11 Art. 204.

The concept of “statutory underwriter” does not exist under the Chinese securities laws. See, e.g., *supra* note 141 (selling control stocks); *supra* note 206 (selling restricted stocks). Cf. Persons Deemed Not to Be Engaged in a Distribution and Therefore Not Underwriters, 17 C.F.R. § 230.144 (2013) (“statutory underwriter” concept under the U.S. securities law).

1. a company limited by shares (i.e., a corporation) whose stock is not listed on a securities exchange (“non-listed issuer”) but is “publicly traded”—regardless of how many shareholders the issuer has (i.e., “publicly-traded” non-listed public company);
2. a non-listed issuer whose stock is “held by over 200 persons,” due to the stock offerings to or share transfers among “specified persons” causing the cumulative number of the stockholders of the issuer to exceed 200—the 200-person threshold for non-listed “public company” appears to be chosen based on the same logic as the 200-person threshold for “public offering” (i.e., “200-person” non-listed public company).³⁰⁵

To meet the policy goal for non-listed public companies of “retaining key employees of science and technology and other innovative-type enterprises through stock incentive programs,”³⁰⁶ “specified persons” for purposes of “targeted” (i.e., non-public) offerings by a non-listed public company refer to the following three types of person:

- current stockholders of the issuer;
- members of the board of directors, board of supervision, and senior management, and key employees of the issuer—where such “key employees” shall be selected through nomination by

305. See CSRC, *CSRC 2012-85: Regulation of Non-Listed Public Companies*, Ch. 1 Art. 2, Ch. 8 Art. 62 (Jan. 1, 2013), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201210/t20121011_215689.htm [hereinafter CSRC, *Non-Listed Public Company Regulation*]. Compare CHINESE SECURITIES LAW, *supra* note 35, at Art. 10(2) (200 person threshold for “public offering” definition), with CSRC, *Non-Listed Public Company Regulation*, *supra*, at Art. 2(1) (200 person threshold for “public company” definition).

There appears to exist a conceptual contradiction between Securities Law’s definition of “Public Offering,” and Non-Listed Public Company Regulation’s definition of “Targeted Offering” (a.k.a. private offering or non-public offering). Compare CHINESE SECURITIES LAW, *supra* note 35, at Art. 10 (“Public Offering” means any of the following: (i) . . . (ii) an offering of securities to specified persons causing the cumulative number of stockholders of the issuer to exceed 200; (iii) . . .”), with CSRC, *Non-Listed Public Company Regulation*, *supra*, at Art. 36 (“For purposes of the Regulation, ‘Targeted Offering’ means either of the following: (i) an offering of securities to specified persons causing the cumulative number of stockholders of the issuer to exceed 200; (ii) an offering of securities to specified persons by a non-listed public company having stockholders in excess of 200.”).

306. See CSRC, *CSRC Issues Regulation of Non-Listed Public Companies* (Oct. 11, 2012), http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201210/t20121011_215683.htm. What an amusing reversal of *Ralston Purina* by the CSRC!

the board of directors; publication of the selectee list to all employees for their comments; an express opinion delivered by the board of supervision at least one third of whose composition shall be employee representatives; and final approval by the stockholder meeting; and

- other persons meeting any suitability standards as may be specified by the CSRC;

—provided that in each targeted offering, there shall be no more than 35 purchasers who are not current stockholders of the issuer at the time of the offering.³⁰⁷

Two liquidity venues—based on public-versus-nonpublic category of the traders instead of restricted-versus-unrestricted status of the stock—are specified for trading in the stock of a non-listed public company: where the transfers are solely confined “among the specified persons,” such transfers must be effected via “private negotiations”; where the stock is “publicly traded,” such trading shall take place on a “securities trading platform lawfully established.”³⁰⁸ Launched in January 2013, the NEEQ market is designed to provide a platform “for the public trading in equity securities and convertible debt securities of non-listed public companies,” where such companies must be reporting issuers under the Regulation of Non-Listed Public Companies,³⁰⁹—thus making the NEEQ System sort of a “mirror image” of FINRA’s OTCBB in terms of “having a reporting requirement” for the system-quoted issuers. However, any similarity stops there.

FINRA’s OTCBB provides a public marketplace for the trading in “OTC equity securities” of non-exchange listed reporting issuers; it does not provide a marketplace, public or private, for the trading in “restricted securities” even if such securities are issued by Exchange Act reporting issuers. As a public marketplace, the OTCBB is open to all investors, and is not restricted to QIB investors—but the PORTAL Alliance is. The PORTAL Alliance securities are restricted securities; the PORTAL Alliance issuers can be reporting or non-reporting ones.

307. See, e.g., CSRC, *Non-Listed Public Company Regulation*, *supra* note 305, at Ch. 5 Art. 36; CHINESE COMPANY LAW, *supra* note 32, § 4.4 Art. 118. Isn’t there a Regulation D Rule 505 reminder?

308. See CSRC, *Non-Listed Public Company Regulation*, *supra* note 305, at Art. 4, Ch. 4; see also *supra* notes 258-260 and accompanying text.

309. See, e.g., CSRC, *NEEQ Opening Ceremony Took Place in Beijing*, *supra* note 238; CSRC, *NEEQ Operator Regulation*, *supra* note 243, at Arts. 1-3; NEEQ Operator, *NEEQ Operating Rules*, *supra* note 239, at Art. 1.2.

The Chinese NEEQ appears to be a mixture of the U.S. OTCBB and PORTAL. NEEQ may trade equity securities which may well constitute “restricted securities” from the perspective of SEC Rule 144 under the Securities Act of 1933 and FINRA Rule 6420(k), as long as such equity securities are issued by “non-listed public companies”³¹⁰—making NEEQ *unlike* OTCBB. Access to NEEQ is restricted to QIB-type investors³¹¹—making NEEQ *look like* PORTAL, *except for* its mandatory issuer reporting requirement,³¹² *for* its public release of real time market data,³¹³ and *for* its proclaimed “public” rather than “private” equity market status.³¹⁴

What implications such a hybrid “OTCBB-PORTAL” market structure—*vis-à-vis* the U.S. separate and distinct public versus private OTC markets structure—has in terms of investor expectation, capital markets efficiency, and investor protection, would await empirical testing and theoretical explanations.

CONCLUSION

1. Stock Exchanges and NEEQ Market: SROs or Government Agencies?

Under the *Securities Law*, the *Regulation of Securities Exchanges*, and the *NEEQ Operator Regulation*, the Shanghai and Shenzhen stock exchanges and the NEEQ market are all “lawfully established securities trading platforms” operating as “self-regulatory organizations.”³¹⁵ The Membership Assembly of an exchange or the Stockholder Assembly of NEEQ is the “highest decision-making body” of the marketplace.³¹⁶ The Board of Governors/Directors, as the “governing body” of an exchange or NEEQ, “shall have the power and obligation” to execute the

310. See *supra* notes 258-260 and accompanying text.

311. See *supra* note 258 and accompanying text.

312. See *supra* note 309 and accompanying text.

313. See *supra* note 261 and accompanying text.

314. See *supra* note 309 and accompanying text.

315. See, e.g., CHINESE SECURITIES LAW, *supra* note 35, at Arts. 39, 102; CSRC, *Regulation of Stock Exchanges*, *supra* note 73, at Ch. 1; CSRC, *NEEQ Operator Regulation*, *supra* note 243, at Ch. 1.

316. See, e.g., CHINESE COMPANY LAW, *supra* note 32, § 4.2; CSRC, *Regulation of Stock Exchanges*, *supra* note 73, at Ch. 4 Art. 17; CSRC, *NEEQ Operator Regulation*, *supra* note 243, at Ch. 3 Art. 15.

resolutions of the Membership Assembly or the Stockholder Assembly; to establish, subject to the CSRC approval, and enforce rules for the market; to accept and expel as, and to institute disciplinary proceedings against, an exchange member or a NEEQ participant firm.³¹⁷ On the other hand, both by law and in practice, no capital contribution is made or is permitted to be made by any exchange member to an exchange as a “membership organization,” or by anyone to NEEQ as a “corporation” without the CSRC’s approval.³¹⁸ Chairman, vice chairmen and a substantial number of members of the Board of Governors/Directors, and chairman of the Board of Supervision whose statutory role under the Company Law is of “an independent watchdog,” of a stock exchange or NEEQ must be “nominated” by the CSRC and “elected in accordance with the Company Law procedure.” Rules of proceedings of the Board of Governors/Directors and of the Board of Supervision shall follow the CSRC’s prescriptions. All senior managements of stock exchanges and the NEEQ market shall be appointed, removed, and replaced by the CSRC; all appointments to human resources and finance positions are subject to the CSRC’s approval; other managerial staff appointments shall be filed with the CSRC.³¹⁹

Such a proclaimed “SRO” structure has been described by some Chinese legal scholars, not without some humor, as the “partial self-regulation with the Chinese characteristics”;³²⁰ or, putting it more bluntly as others do, “a legal fiction” and “part of the government in the name of self-regulatory organization.”³²¹ Some scholars offered the

317. See, e.g., CHINESE COMPANY LAW, *supra* note 32, § 4.3; CSRC, *Regulation of Stock Exchanges*, *supra* note 73, at Ch. 4 Art. 20; CSRC, *NEEQ Operator Regulation*, *supra* note 243, at Ch. 2; SHSE, *Membership Regulation*, *supra* note 63, at Ch. 7; SZSE, *Membership Regulation*, *supra* note 63, at Ch. 7; NEEQ Operator, *NEEQ Operating Rules*, *supra* note 239, at Ch. 6.

318. See, e.g., CHINESE SECURITIES LAW, *supra* note 35, at Art. 105; CSRC, *Regulation of Stock Exchanges*, *supra* note 73, at Ch. 9 Art. 83; SHSE, *By-Laws*, *supra* note 74, at Arts. 3, 5, Ch. 8; SZSE, *By-Laws*, *supra* note 74, at Art. 2, Ch. 2, Ch. 10 Art. 41; CSRC, *NEEQ Operator Regulation*, *supra* note 243, at Art. 16.

319. See, e.g., CHINESE SECURITIES LAW, *supra* note 35, at Art. 107; CSRC, *Regulation of Stock Exchanges*, *supra* note 73, at Arts. 21-26, 29; CSRC, *NEEQ Operator Regulation*, *supra* note 243, at Arts. 17-19. Cf. CHINESE COMPANY LAW, *supra* note 32, §§ 4.3-4.4.

320. See WENDAOLU, ON THE SELF-REGULATION OF STOCK EXCHANGES, Ch. 6 § 6.2 (Beijing: Peking Univ. Press, 2008).

321. See PEKING UNIV. L. SCHOOL & SHANGHAI STOCK EXCHANGE, SHJR 2013-23: AN ANALYSIS OF STOCK EXCHANGES’ SELF-REGULATION FROM THE ADMINISTRATIVE

recipe of dressing up the exchange's SRO image by toning it down, as "an SRO following the government's guidance."³²² Others recommended "stripping the exchanges of their pseudo SRO cloak, and meeting the issue head-on of the legal status and self-regulatory functions of the Chinese stock exchanges."³²³

2. Securities Intermediary Structure: Monopoly or Competition?

Under the *Securities Law*, the State Council's *Regulation of Securities Firms*, and the CSRC's *Governance Standards of Securities Firms*, without meeting the "criteria prescribed by applicable laws, rules, regulations, and the CSRC," no person may become a shareholder in any securities firm. Without CSRC approval, no person shall hold more than 5% ownership interest in or otherwise gain de facto control of any securities firm, and no securities firm may take any equity interest in any foreign broker-dealer.³²⁴ The minimum registered and paid-in net capital required of a securities firm is ¥ 50 million (or over US\$8 million) for pure brokerage business, ¥ 100 million for securities dealing business, and ¥ 500 million for a full service firm.³²⁵ Any

LAW PERSPECTIVE, Ch. 2 § 2.2; Ch. 4 § 4.2.4 (2013), available at http://www.sse.com.cn/researchpublications/jointresearch/c/c_20130305_3686465.pdf.

322. See, e.g., LU, *supra* note 320, § 6.3; Wei Li, *Legal Jurisdiction over and Disposition of Proceedings Involving Exercise of Stock Exchanges' Regulatory Functions*, 6 PEOPLE'S JUSTICE 22 (2005).

323. See PEKING UNIV. L. SCHOOL & SHANGHAI STOCK EXCHANGE, *supra* note 321.

In raising the question "Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?" and focusing on an analysis of FINRA, Professor Karmel points to two factors as significant in concluding that FINRA is not a "government agency": (1) governance, i.e., FINRA's Directors of Board are not appointed by the SEC (although the SEC may designate the characteristics of board members), and a substantial number though not majority come from the securities industry; (2) funding, i.e., FINRA is funded by membership fees. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J. L. BUS. & FIN. 151, 170, 196-97 (2008).

324. See, e.g., CHINESE SECURITIES LAW, *supra* note 35, at Ch. 6 Art. 129; State Council, *Regulation of Securities Firms*, *supra* note 147, at Ch. 6 Art. 71; CSRC, *CSRC 2012-41: Governance Standards of Securities Firms*, Art. 2 (Jan. 1, 2013), available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201212/t20121213_219202.htm.

325. CHINESE SECURITIES LAW, *supra* note 35, at Arts. 125, 127. For the representative exchange rates between Chinese Yuan and U.S. dollar, see Int'l Monetary Fund, *Exchange Rate Archives by Month*, http://www.imf.org/external/np/fin/data/param_rms_mth.aspx.

“major stockholder” of a securities firm is required to have minimum “net assets” of ¥ 200 million, and “must possess the ability for achieving sustained profitability.”³²⁶ Without the CSRC’s approval, no person shall engage in securities business. When granting or denying an application for the formation of a securities firm or the addition of a branch office, the CSRC is to “consider the need of the securities markets and the need for fair competition”—according to the CSRC’s clairvoyance.³²⁷

As of April 30, 2012, there were a total of 111 securities firms registered with the CSRC. CITIC Securities, with its registered capital over ¥11 billion (or about US\$1.8 billion), towers on the top of the totem pole; Xiamen Securities Co., Ltd., with its registered capital ¥50 million, lies on the bottom. The median registered capital of the 111 securities firms was ¥1.413 billion (or over US\$230 million), and the mean was ¥2 billion (or over US\$326 million).³²⁸ The securities intermediary structure is described by some Chinese securities industry participants as “designed” by the government to serve the financing needs of the State-owned and State-controlled enterprises, supplementing the roles of the State-owned banks in that task. “It was so from day one, and it remains so today.”³²⁹ As such, it is no wonder that the current securities firms in China are generally formed out of four major backgrounds—all related to State ownership or government agencies:

- the State-owned commercial banks and State-owned insurance companies;
- the local government-controlled financial institutions;
- the local governments’ internal finance departments; and

326. CHINESE SECURITIES LAW, *supra* note 35, at Art. 124. None of the terms “major stockholder,” “net assets,” and “sustained profitability” is defined by the Securities Law.

327. *Id.* at Arts. 122, 128; *see also* State Council, *Regulation of Securities Firms*, *supra* note 147, at Ch. 2 Art. 16.

328. *See* CSRC, *Roster of Chinese Securities Firms (as of April 30, 2012)*, *supra* note 93.

329. *See* BEIJING TX INV. CONSULTING CO., LTD. & SHANGHAI STOCK EXCHANGE, SHJR 2004-10: ON THE SECURITIES MARKETS’ OPENING UP TO INSIDE CHINA, Ch. 2 15–16, 24 (2004), *available at* <http://www.sse.com.cn/researchpublications/jointresearch/c/plan20040201k.pdf>.

- the State-owned or government-controlled national and local trust companies.³³⁰

The industry participants called for “Opening Up to the Inside China,” a parallel version to China’s political slogan of “Opening Up to the Outside World,” recommending regulatory policy changes to admit more market forces and private capital into the securities industry.³³¹

What is the optimal design for the Chinese equity markets structure?³³² “Those who wear the shoes know best how well they fit; and the people of a country are the best judge of the way forward for their country,”—lectured the Chinese President at the Moscow Institute of International Relations.³³³

330. *Id.* at 30–32.

331. *Id.* at 45, 48. At the 3rd Plenary Session of the 18th Central Committee of the Chinese Communist Party held on November 12, 2013, the Chinese leadership decided to “reset the role of the market from ‘a basic role’ to ‘the decisive role’ . . . but not ‘an all-determinative role’”; and to “open up the financial industries to inside as well as outside China, . . . to allow private capital to set up small and medium-sized banks and other financial institutions.” *See, e.g.*, Chinese Communist Party Central Committee, *Resolutions of the Chinese Communist Party Central Committee on Certain Critical Issues Related to All-Around and Deepening Reforms*, Arts. 1(2), 3(12) (Nov. 12, 2013), available at http://www.gov.cn/jrzq/2013-11/15/content_2528179.htm; Xi Jinping, *Explanatory Note to Resolutions* (Nov. 12, 2013), available at http://www.gov.cn/ldhd/2013-11/15/content_2528186.htm.

332. In 1995, Professor O’Hara observed: “[T]he question of which market designs will, or even should, prevail is rarely asked, let alone resolved. Such a failing is perhaps not surprising given the complexity of the overall issue.” Noting the varied goals of an exchange, of a trader, and of a regulator, Professor O’Hara concluded: “[W]hile each of these goals may be important, none captures all the ways in which markets affect welfare in the economy.” O’HARA, *supra* note 117, at 268.

333. *See* Xinhuanet, *Quotations by Chinese President Xi Jinping: Address to Moscow Institute of International Relations* (Mar. 23, 2013), http://news.xinhuanet.com/world/2013-03/29/c_124515145.htm.