Vanderbilt Journal of Transnational Law

Volume 30
Issue 3 *May 1997*

Article 6

5-1997

Realizing the Re-Emergence of the Chinese Stock Market: Fact or Fiction?

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ABSTRACT

The stock market which currently exists in the People's Republic of China (PRC) is a product of the "open door policy" introduced by Deng Xiaoping in 1978, following the death of Mao Zedong, to promote economic development over class struggle. Following limited experimentation with stock issuance at the local level, the Shanghai and Shenzhen stock exchanges opened in 1990 and 1991 respectively. Since its recent inception, China's stock market—which comprises the trading of domestically owned A-Shares and foreign-owned B-Shares—has experienced impressive growth together with periods of volatility as well as lackluster performance. Recent performance of A-Share trading has been strong, while B-Share trading has been riddled with problems due to the lack of enforcement of the "foreign ownership only" rule. In February of 1997, the death of Deng Xiaoping, the architect of China's current socialist market economy, surprisingly did not cause any significant downturn in the stock market.

This Note first offers a brief history of the recent re-emergence of the stock market in China, which has thrived several other times in China's long history. Second, the author questions the Chinese market's future viability as an internationally competitive stock market. In determining what the future holds for China's stock market, the author first examines the PRC's commitment to resolving the ideological "counter-socialist dilemma" presented by the introduction of capitalist reforms into China's socialist economy. Although Chinese leaders disagree as to how to resolve the counter-socialist dilemma, they are committed to resolving it. The Note suggests that in order to truly realize the re-emergence of its stock market, the PRC must enact and enforce a national securities law and repeal its policy of censoring all foreign news and financial information entering the country. Until such steps are taken, the author concludes that China's stock market will remain an inefficient and highly risky emerging market.

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I. INTRODUCTION

The People's Republic of China (PRC) is positioned to make significant future economic strides, including the re-emergence of an internationally recognized stock market, based on its impressive track record over the past decade. However, the actual realization of the stock market's re-emergence may be a product of fiction, unless Chinese leaders resolve the inherent conflict between state ownership and efficient markets for privately-owned stock.

Section II gives a brief history of the recent development of the Chinese securities market. China entered the 1980s with a desperate need for capital to support the growth of its then anemic centrally planned industrial and agricultural economy. Following state-controlled experimentation with stock issuance and trading in the late 1980s, the Chinese stock market "re-emerged," after more than forty years in dormancy, in the early

1990s, when two stock markets sprang to life in Shanghai and Shenzhen.[1] As a result, individuals currently may purchase publicly-traded shares of joint-stock companies.[2] Despite the impressive development of the stock market since 1990,[3] the nascent Chinese stock market has not truly re-emerged due to the limited number of publicly traded shares.

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1. The stock exchange in Shanghai was closed in 1949 upon the founding of the PRC by the Communists under the leadership of Mao Zedong. Tan Lay Hong, *Capitalism in the People's Republic of China?: A Survey of the Re-Emerging Securities and Financial Markets*, 16 COMPANY LAW. 72, 72 (1995). Domestic stock exchanges also existed briefly in Beijing and Tianjin from 1949 until 1952. *Id.*

2. Individual shares represent only 25% of the total corporate shares held in China, with the government owning the remaining 75%. K. Matthew Wong, Note, *Securities Regulations in China and Their Corporate Finance Implications on State Enterprise Reform*, 65 FORDHAM L. REV. 1221, 1238 (1996). In addition, individuals may not possess over 0.5% of common stocks issued by a listed company. Interim Regulations on the Issue and Trading of Shares, State Council (issued and effective April 22, 1993), art. 46, *translated in* Chinese Stock Trading Regulations, BBC SUMMARY OF WORLD BROADCASTS, at C1 Special Supp., May 20, 1993, *available in* LEXIS, News Library, Bbcswb File [hereinafter 1993 Interim Regulations].

3. In 1995, Professor Xiao Zhuoji, a Chinese economist, articulated the following ten "breakthroughs" that the Chinese securities market had experienced since 1990:

> [(1)] The traditional ownership structure has been upgraded. New models with public ownership as the bulk, coexisted with other sectors, have been developed from social development to the organization of business.
> [(2)] The socialization of capital ownership, in which the public can own the capital of one or several enterprises by buying stocks.
> [(3)] The stock market has changed the traditional distribution system in that stock holders are allowed to get income other than their work.
> [(4)] Issuing of stocks and bonds has changed the traditional means of raising funds such as bank loans and financial allocation by the government.
> [(5)] Residents have more ways to store their financial assets, ways others than owning deposits and cash.
> [(6)] Through issuing B shares reserved for overseas investors and listing companies in Hong Kong, the United States and Singapore, China has widened channels to raise foreign funds in a simpler and more efficient way.
> [(7)] The traditional methods of managing financial assets have been modernized. The public turns deposits and cash into various securities so as to get higher profits on the basis of safety and mobility.
> [(8)] Stock market, instead of government assessment, has become an important method in rating enterprises.
> [(9)] Stock trading has promoted the re-organization of capital structure, making it possible to produce better returns.
> [(10)] The stock market has changed people's attitude towards such concepts as capital, profit, bonus, risk, speculation and investment.

Economist on Breakthroughs of China's Stock Market, Nov. 27, 1995, Xinhua News Agency, *available in* 1995 WL 7716434.

Section III examines the PRC's long-term commitment to resolving the ideological "counter-socialist dilemma" presented by capitalist reform and to developing an independent and internationally competitive stock market. While China has already made impressive strides in developing its socialist market economy, conservative Communist leaders have signaled their reservations about the pace of capitalist-laden reforms. Consequently, the PRC has enacted various regulations that effectively cabin the capitalist experimentation by limiting Chinese enterprises' access to the emerging stock market, restricting the flow of information to the stock market, and maintaining a high level of state ownership in publicly-traded stock companies. However, despite the ideological quagmire confronting Chinese leaders, evidence shows that they are committed to resolving the "counter-socialist dilemma," some more conservatively than others, in order to move China forward in the global marketplace. It is now a question of *how* to resolve this dilemma, rather than *whether* to resolve it.

Assuming that the ideological barriers are not insurmountable and that Deng Xiaoping's successors will continue to implement economic reforms, China should take certain fundamental steps in the near future to realize the true re-emergence of its stock market in the twenty-first century. Section IV shows that in order to enable the Chinese stock market to attract the abundant personal savings of Chinese nationals,[4] as well as foreign investors, China must stabilize and improve the efficiency of its stock market through the enforcement of a comprehensive national securities law and the repeal of its censorship policy.

II. CAPITALISM IN CHINA? THE DEVELOPMENT OF THE CHINESE STOCK MARKET

A. *From Mao to Markets*

China has supported a stock market during several recent periods[5] in its long history,[6] but none has ever grown into an

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4. China's household savings rate is among the world's highest at about 40% of disposable income. MEI XIA ET AL., THE RE-EMERGING SECURITIES MARKET IN CHINA xii (1992).

5. Stock markets existed in China from the late 19th century until the 1920s, from the 1930s until 1949, and from 1949 until 1952. Andrew Xuefeng Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities*

"independent institution"[7] strong enough to survive China's political turmoil. For instance, during the 1940s, the Shanghai Securities Exchange was the largest stock market in Asia and more influential and internationally supported than that of Hong Kong,[8] but the 1949 Communist takeover[9] caused its abrupt demise. Under the rule of Mao Zedong, the Communist Party believed that capitalist stock markets contributed to corruption, bureaucracy, and smuggling.[10] Once again, political forces in China effectively wiped out the securities market.[11]

Although Chairman Mao and his supporters had used tightly centralized control with some degree of success in restoring

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Regulatory Regime in China, 12 UCLA PAC. BASIN L.J. 62, 64 & nn.6-8 (1993). *See also* Hong, *supra* note 1, at 72 (describing the origin of the stock market in China).

6. Records dating back about 3,500 years make China the oldest continuous major world civilization. 1 COUNTRIES OF THE WORLD AND THEIR LEADERS YEARBOOK 1996 at 412 (Gale Research, Inc. ed., 1996) [hereinafter COUNTRIES OF THE WORLD]. The preamble to the PRC's 1982 Constitution begins with the following statement: "China is one of the countries with the longest histories in the world." XIANFA [constitution], preamble (1982), *translation available in* LEXIS, Intlaw Library, Chinalaw File, No. 141.

7. Qian, *supra* note 5, at 65.

8. XIA, *supra* note 4, at 61; FRANCIS A. LEES & K. THOMAS LIAW, FOREIGN PARTICIPATION IN CHINA'S BANKING AND SECURITIES MARKET 54, 61-62 (1996).

9. In 1949, Communist leader Mao Zedong and his armies took over the country and established the PRC, instituting a centrally planned economy modeled after the former Soviet Union. COUNTRIES OF THE WORLD, *supra* note 6, at 414. From 1953 through 1957, Chairman Mao centralized the country's economic system under the first five-year plan through the following steps:

> 1. Private enterprises were first controlled and then incorporated into state-owned enterprises;
> 2. Land was redistributed, then collectivized in 1955-56, and finally the commune system was established in rural areas in 1958;
> 3. The currency (Yuan) was made inconvertible and external trade was monopolized in order to insulate the economy from the possible external effect;
> 4. Investment was incorporated into the planning process with the state determining both the quantity and direction of investments;
> 5. The use of cash was restricted. Enterprises were forced to conduct most of their business through account transfers with state-owned banks; and
> 6. Private consumption was regulated by wage and price controls, commodity rationing schemes, and denial of consumer credit.

XIA, *supra* note 4, at 19-20.

10. Qian, *supra* note 5, at 64 n.8. In the 1960s and early 1970s, Chairman Mao spearheaded the Great Proletarian Cultural Revolution in order to purge all capitalist and elitist cultural influences from China. COUNTRIES OF THE WORLD, *supra* note 6, at 414.

11. This pattern of political turmoil followed by the demise of the stock market began with the first stock exchange which opened in Shanghai in 1891 and closed in 1912 when the new Republic, founded by Dr. Sun Yat-Sen, shut down all existing Chinese stock exchanges. Hong, *supra* note 1, at 72.

China's ailing post-war economy in the 1950s and 1960s,[12] post-Mao leaders of the PRC realized that such strict Communist rule had stifled the country's economic development over time. Thus, in late 1978, under the leadership of Deng Xiaopeng,[13] the Communist Party of China (CPC) announced its "open door policy," under which the CPC would focus its attention on economic development, rather than class struggle.[14] The economic reforms sought three main objectives: (1) to decentralize the economy; (2) to bolster reliance on market forces and on material incentives as a means for achieving desired economic behavior and resource allocation; and (3) to encourage foreign investment.[15] Following decades of economic isolation, these pragmatic policy reforms created a literal "opening to the outside world" for China.[16]

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12. Following two generations of war and social conflict, Chairman Mao and his leaders garnered support by decreasing inflation, reviving the economy, and repairing damaged industrial facilities. COUNTRIES OF THE WORLD, *supra* note 6, at 414.

13. In August of 1977, the Chinese Communist Party reinstated Deng Xiaoping to the government positions (the concurrent posts of Politburo Standing Committee member, People's Liberation Army Chief of Staff, and Vice Premier) he had held prior to his being ousted by Chairman Mao on the basis of his alleged responsibility for political disorder, following an anti-Deng campaign organized by Mao's wife, Jiang Qing, and three pro-Cultural Revolution accomplices (later arrested and referred to as the "Gang of Four"). COUNTRIES OF THE WORLD, *supra* note 6, at 414-15. Deng's "new, pragmatic leadership emphasized economic development and renounced mass political movements." *Id.* at 415. Although the elderly Deng had officially retired in November of 1989 and was in poor health, he was, nevertheless, considered the "paramount leader" in China until his death on February 19, 1997, at the age of 92. *See generally* Orville Schell, *Deng's Revolution*, NEWSWK, Mar. 3, 1997, at 20-25 (overviewing Deng's leadership role in China and discussing his recent death).

14. Communique of the Third Plenum of the 11th Central Committee of the Communist Party of China (adopted Dec. 22, 1978), *cited in* Donald C. Clarke, *What's Law Got to Do With It?: Legal Institutions and Economic Reform in China*, 10 UCLA PAC. BASIN L.J. 1, 4 n.5 (1991). The main defects of the PRC's socialist system at that time included the following:

> (1) lack of clear division between the role of government and enterprise;
> (2) disregard for the role of market forces causing lack of communication between production and market forces;
> (3) excessive egalitarianism in the distribution of income preventing any link between performance and reward; and
> (4) defects in economic structure due to uniform, state-owned modes of operation.

XIA, *supra* note 4, at 21. These defects suppressed creative expression by enterprises and individuals which consequently strengthened the need for a centralized economy, and increased the rigidity of government which once again suppressed creative expression. *Id.* at 22.

15. XIA, *supra* note 4, at 22.

16. *Id.* at 27. In 1982, following the promulgation of its open door policy, China adopted a new Constitution which reads, "[t]he future of China is closely

The Chinese government has gradually implemented economic reforms in the form of experiments at both local and national levels. China initially overhauled its financial sector by allowing the state-controlled banks to allocate financial resources more efficiently[17] and by creating non-bank financial institutions.[18] Prior to 1979, China's financial system had consisted of only a few specialized banks[19] which had acted merely as "the government's cashiers," while the state had controlled almost all resource allocations.[20] The later transformation of China's banking sector inevitably led to the re-emergence of its financial markets.[21]

China represents the first known example of a centrally planned economy supporting a securities market.[22] China's financial markets re-emerged primarily as a result of the decentralization and rationalization of investment activities and the increase in the financial autonomy of enterprises.[23] Debt securities first appeared in 1981 when the PRC issued government bonds to finance its budget deficit.[24] In the latter half of the 1980s, the national economic policy reforms led to the emergence of joint-stock companies and stock issuance.[25] After the opening of the first over-the-counter (OTC) stock exchange in Shenzhen on August 5, 1986, other regional markets quickly

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linked with that of the whole world." XIANFA [constitution], preamble (1982), *translation available in* LEXIS, Intlaw Library, Chinalaw File, No. 141.

17. In 1984, the People's Bank of China (PBOC) was restructured to serve as the country's central bank, playing a dominant role in creating and implementing monetary policies. XIA, *supra* note 4, at 38. *See also id.* at 44-45 (table showing the major functions of financial institutions in China today).

18. Significant experimentation is currently being undertaken in developing non-banking institutions such as investment and trust companies, pension funds, and insurance companies. *Id.* at 46-47. However, most financial sector activities in China are performed by the banking system. *Id.* at 46.

19. The PBOC, China's principal bank, functioned as both a central and commercial bank. Additional specialty banks included the Agricultural Bank of China, the Construction Bank of China, the Bank of China, and the People's Insurance Company. *Id.* at 36.

20. *Id.* at 27-28.

21. *Id.* at 37.

22. *Id.* at 19.

23. *Id.* at 58.

24. Hong, *supra* note 1, at 73.

25. *Id.* at 75. China experienced many "firsts" during this time: The first public share certificates (1983), the first joint-stock company (July 1984), the first joint-stock company to issue shares under a standardized shareholding limited liability company (November 1984), and the first financial institution to adopt the shareholding system and raise capital through the public issuance of shares (1989). *Id.*

developed in Beijing, Chongqing, Guangzhou, Shanghai,[26] Tianjin, and Wuhan.[27] During this same year, a reorganized state-owned enterprise publicly issued shares for the first time.[28] The subsequent emergence of the national securities exchanges in Shanghai and Shenzhen occurred on December 19, 1990,[29] and July 3, 1991,[30] respectively. As of December 31, 1996, 237 and 293 joint-stock companies had listed their A-Shares on the Shanghai and Shenzhen exchanges respectively.[31] Furthermore, a total of eighty-six companies had issued their B-Shares on the two exchanges.[32]

B. *Chinese Stock Market Participants*

On July 1, 1994, the 1993 Company Law of China,[33] which combines the Chinese socialist market economy with Western forms of capitalism, took effect, creating a law with distinct "Chinese characteristics."[34] The main goal of the Company Law

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26. In September of 1986, Shanghai Trust and Investment Corporation began trading the stock of two collective enterprises, Shanghai Yanzhong Enterprise Ltd. and Shanghai Feile Audio Co. Ltd. Qian, *supra* note 5, at 66 n.16.

27. Benjamin R. Tarbutton, *China—A National Regulatory Framework for the PRC's Stock Markets Begins to Emerge*, 24 GA. J. INT'L & COMP. L. 411, 414 (1994).

28. Shenyang Jinbei Auto Industrial Shareholding Corporation, a reorganized shareholding company, issued stock to its employees. *Id.* at 414 n.19. Although the state maintained its majority ownership position, it hoped that employee ownership would increase productivity. *Id.*

29. *Shanghai Securities Exchange Opens*, Xinhua News Agency, Dec. 19, 1990, *available in* LEXIS, News Library, Xinhua File.

30. *Shenzhen Securities Exchange Opens*, Xinhua News Agency, July 3, 1991, *available in* LEXIS, News Library, Xinhua File.

31. *China Has 530 Listed Companies*, Xinhua News Agency, Jan. 3, 1997, *available in* 1997 WL 899194.

32. *China Selects 33 More Enterprises to List B Shares*, Xinhua News Agency, Jan. 8, 1997, *available in* 1997 WL 8992118. In addition, 33 more joint-stock companies have obtained approval to list their B-Shares on one of the two national exchanges. *Id.*

33. The Company Law of the People's Republic of China (enacted Dec. 29, 1993), *reprinted in* CHINA'S COMPANY LAW: THE NEW LEGISLATION 9-56 (Guiguo Wang trans., 1994) [hereinafter Company Law]. In adopting the Company Law, the Eighth National People's Congress consulted various forms of Western corporation law as models, although the resulting business entities are not presently comparable to U.S. corporations. Robert C. Art & Minkang Gu, *China Incorporated: The First Corporation Law of the People's Republic of China*, 20 YALE J. INT'L L. 273, 274 (1995).

34. Art & Gu, *supra* note 33, at 275. The unique Chinese characteristics include:

> [the] 'legal representative,' an individual who has the authority to bind a legal entity and who is personally liable for misconduct[;] . . . an extraordinarily extensive grant of power to shareholders and provision for a

is to provide a unified standard for more efficient and productive modern corporate organizations operating under non-state-controlled management.[35] In furtherance of this multi-faceted goal, the Company Law (as a supplement, modification,[36] and codification of prior regulations) regulates the public issuance of stock by any company organized as a "company limited by shares," commonly referred to as a "joint-stock company" (JSC).[37] Pursuant to the Company Law, a JSC can issue shares to the public only after obtaining permission from the State Council and meeting fairly strict requirements, such as having a minimum of fifty million yuan (approximately six million U.S. dollars) in capital, having at least 1,000 shareholders, and having earned profits during the preceding three years.[38] Due to the state's retention of majority ownership in JSCs,[39] the Company Law should be viewed as the catalyst for "corporatization" rather than "privatization."[40]

Various types of business enterprises compose China's economic system. The non-stock business forms currently operating in China include state-owned enterprises (SOEs),[41]

> 'board of supervisors' to oversee the board of directors[;] . . . workers play a role in determining corporate policy[; and] . . . the Law relies primarily on administrative sanctions rather than on derivative actions to deter and punish misconduct by managers.

Id.

See Matthew D. Bersani, *Privatization and the Creation of Stock Companies in China*, 1993 COLUM. BUS. L. REV. 301, 302 ("China has historically proven itself a master at adopting western concepts and adapting them to suit its own needs. Perhaps the most notable example of this is the transformation of Soviet communism by the People's Republic of China (PRC) into 'communism with Chinese characteristics'—a system strikingly different from the one on which it was based.").

35. *See* Art & Gu, *supra* note 33, at 274-75 ("The primary purposes of the [Company] law are (1) to restructure the organization and management of state-owned enterprises; (2) to address serious, chronic, and seemingly intractable problems of inefficiency; (3) to promote competition and productivity; and (4) to remove the state from detailed management of business operations.").

36. The Company Law superseded some central and local stock issuance regulations. *Id.* at 274 n.4.

37. *See id.* at 291 n.109.

38. Company Law, *supra* note 33, at art. 152.

39. *See supra* note 2.

40. Art & Gu, *supra* note 33, at 282-86.

41. SOEs make up a small percentage of total enterprises, but produce a majority (yet decreasing) percentage of China's national (primarily industrial) production. XIA, *supra* note 4, at 69-71. In 1993, for example, SOEs accounted for only 19% of China's total enterprises. However, SOEs produced 53% of all industrial output, employed 108.7 million workers and generated 67% of the state's revenue. Art & Gu, *supra* note 33, at 276-77 & n.11. Unfortunately, about one-third of all SOEs are losing money. *Id.* at 277.

collectively owned enterprises (COEs),[42] private enterprises (PEs),[43] and foreign investment enterprises (FIEs).[44] Under China's Company Law, stock companies may exist in two forms: limited liability companies (LLCs)[45] and JSCs.[46] These stock companies are owned by stockholders,[47] managed under the direction of a board of directors, and characterized as limited liability enterprises. While LLCs may privately issue stock, only JSCs may access the stock markets,[48] assuming they meet the

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Most large SOEs are manufacturing enterprises supervised for the most part by industrial ministries in Beijing, while the more numerous medium and small-sized SOEs may be owned by the central or local government, or jointly by both. XIA, *supra* note 4, at 71. The latter SOEs have relatively more flexibility in making decisions. *Id.*

42. COEs are a combination of PEs and SOEs. XIA, *supra* note 4, at 71. Most COEs are partnerships sponsored by local government whose participating partners are responsible for raising capital, but many COEs reorganized as semi-SOEs in the late 1950s and early 1960s. *Id.* Due to the industrial reform in the mid-1980s, these COEs now compete for means of production and funds from SOEs. *Id.* at 71-72. Between 1978 and 1988, output from COEs grew from 22% to 36% of total production. *Id.* at 26. In 1993, COEs employed 35.5 million workers. Art & Gu, *supra* note 33, at 276 n.11.

43. The few PEs that survived nationalization in the early 1950s were small service operations such as barber shops and street vendors located primarily in eastern and southern China. XIA, *supra* note 4, at 72. Private enterprises (generally small and in rural areas) emerged in great numbers in the 1980s, totaling over six million by the end of 1989. *Id.* Output from private enterprises increased dramatically between 1978 and 1988, from essentially zero to about seven percent. *Id.* at 26. While generally small and in rural areas, some private enterprises have recently grown to significant sizes. Lee B. Spencer, Jr., *Chinese Issuers and the U.S. Market* (PLI Corporate Law and Practice Course Handbook Series, May 12-13, 1994), *available in* WESTLAW, PLI-COMM Database, 845 PLI/Corp 203. In 1993, China's private sector employed 14.9 million workers. Art & Gu, *supra* note 33, at 276 n.11.

44. FIEs have exploded since the enactment of China's Foreign Investment Law in 1979, with joint ventures between China enterprises and foreign companies totaling over 20,000 by the end of 1991. XIA, *supra* note 4, at 73. Most FIEs are organized as either equity or contractual joint ventures, but foreign companies have also established wholly foreign-owned enterprises. *Id.* at 74.

45. LLCs are similar to closely held or private corporations in the United States, but not to U.S. limited liability companies. Art & Gu, *supra* note 33, at 291 & n.108. By the end of 1994, China had a total of 10,700 LLCs. Fang Liufang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149, 152 n.2 (1995).

46. JSCs also provide limited liability to their shareholders (like LLCs), but more closely resemble larger U.S. corporations, including those whose stocks are listed on a stock exchange. Art & Gu, *supra* note 33, at 291 & n.109.

47. Enterprises owned by foreign stockholders may be subject to any of three laws in addition to the Company Law: Law on Joint Ventures Using Chinese and Foreign Investment, Law on Wholly Foreign-Owned Enterprises, and Law on Chinese-Foreign Contractual Joint Ventures. Art & Gu, *supra* note 33, at 291 & n.111 (citing translations of these laws *available in* LEXIS, Intlaw Library, Chinalaw File, Nos. 41, 345, 463).

48. Company Law, *supra* note 33, at art. 99.

relevant national and local regulations in force at the time of the issue.[49] Non-stock enterprises, including SOEs, cannot issue stock, unless they do so through a stock-form holding company or reorganize into an LLC or JSC before such issuance.[50]

Both national and foreign investors may participate in the Chinese stock markets, although they must purchase different types of shares. Chinese individuals can own the A-Shares of a company, while foreign investors[51] can purchase B-Shares. The first B-Shares, which are denominated in reminbi, but traded in foreign currency,[52] began trading on the Shanghai and Shenzhen Exchanges in February of 1992.[53] A-Shares trade among domestic shareholders on various local or OTC markets as well as the national stock exchanges. B-Shares, on the other hand, trade only on the Shanghai and Shenzhen stock exchanges among foreign investors. Besides these differences, A and B shareholders enjoy the same rights.[54]

Upon regulatory approval by the state, Chinese companies may also list their stock on foreign exchanges, such as in Hong Kong[55] or the United States.[56] For investors weary of the

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49. *See infra* note 176 and accompanying text.

50. Spencer, *supra* note 43. *See* Art & Gu, *supra* note 33, at 292-93 ("When the sole investor in an LLC is from a state investment company or department, the LLC is termed a 'wholly state-owned company' . . . [which] is essentially an administrative unit of a government agency, clothed in a corporate form.").

51. Foreign investors include foreign residents and foreign investment corporations both inside and outside China. Qian, *supra* note 5, at 90 & n.110.

52. On the Shanghai Exchange, B-Shares trade in Hong Kong dollars, while on the Shenzhen Exchange, B-Shares trade in U.S. dollars. Craig S. Smith, *China Struggles to Attract Foreigners to Manic-Depressive Class B Shares*, WALL ST. J., Jan. 17, 1997, at A7.

53. Andrew Browne, *Shanghai Buries Ideology, Promotes Stocks*, Reuter Library Rep., Feb. 23, 1992 (discussing the issuance of B-Shares on the Shanghai Exchange by Shanghai Vacuum Electron Device Co.) *available in* LEXIS, News Library, Txtnws File; *B Shares Sell Briskly in Shenzhen*, Xinhua News Agency, Feb. 28, 1992 (discussing the issuance of B-Shares on the Shenzhen Exchange by Southern Glass, Ltd.), *available in* LEXIS, News Library, Xinhua File. To date, 86 companies have issued B-Shares on the two stock exchanges in Shanghai and Shenzhen. *China Selects 33 More Enterprises*, *supra* note 32.

54. Qian, *supra* note 5, at 90.

55. Chinese joint-stock companies may list H-Shares on the Hong-Kong Stock Exchange. Today, a total of 23 companies have listed H-Shares. *Chinese Petrochemical Giant Sells Shares in Hong Kong*, Xinhua News Agency, Jan. 13, 1997, *available in* 1997 WL 8992266.

56. In October of 1992, Brilliance China Automotive Holdings became the first Chinese company, *via* Bermuda, to be listed on the New York Stock Exchange (NYSE). Today, only two Chinese companies are listed on the NYSE. For general information about the various American Depository Receipts (ADR) programs available in the United States, see *Investors Prefer Bonds*, CHINA ECON. REV., Aug. 1, 1996, *available in* 1996 WL 9692286.

speculative Chinese stock markets, these investment alternatives are attractive because they provide the upside of China's strong economic growth without the unpredictability of its still emerging stock market. Section IV suggests some steps China should take to increase the efficiency and stability of the Chinese stock markets in order to attract these important foreign investors.

C. *Current Legal Framework for the Stock Markets*

Since 1979, China has undergone a major transformation of its legal system, characterized by one commentator as a shift from "policy and propriety" to "codified law and legal institutions."[57] Within this general transformation, the legal framework supporting the securities markets has evolved from a regional to a national base of laws, rules, and regulations. Until the enactment of provisional national securities laws and the Company Law in 1993, the central government and municipalities competed for control over the emerging financial markets, resulting in confusing and potentially contradictory regulatory measures.[58] This legal transformation was in part the PRC's intention:

> With a view to ensuring the smooth progress of the reform of the economic structure and the implementation of the open policy, the Third Session of the Sixth National People's Congress has decided to authorize the State Council to formulate, promulgate and implement, whenever necessary, interim provisions or regulations concerning the reform . . . [which] shall be made into law by the National People's Congress or its Standing Committee *after they are tested in practice and when conditions are ripe.*[59]

Today, the national securities laws, which are still far from comprehensive, are implemented locally and supplemented by detailed, and sometimes stricter, municipal and exchange measures in Shanghai and Shenzhen.

The open door policy introduced in 1979 did not envision an efficient, capitalist stock market. Rather, the central

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57. Art & Gu, *supra* note 33, at 274. Under Confucius teachings, social norms (*li*) are superior to formal laws (*fa*). *Id.* at 274 n.5. However, due to pressures by foreign investors, the National People's Congress (NPC), the legislative branch of the PRC, has codified many social standards into legislation. *Id.* In 1995, the NPC was involved in drafting or deliberating over 150 laws, about one-third of which were economic regulations. *Id.* at 274 n.6.

58. Wong, *supra* note 2, at 1235-36.

59. Decision of the Third Session of the Sixth National People's Congress on Authorizing the State Council to Formulate Interim Provisions or Regulations Concerning the Reform of the Economic Structure and the Open Policy (issued April 10, 1985), *translation available in* LEXIS, Intlaw Library, Chinalaw File, No. 276 (emphasis added).

government's primary motive behind the development of an equity market was to raise capital to support China's ailing state enterprises and to curb inflation by decreasing consumer spending through the channeling of personal savings into capital investment.[60] Likewise, China's securities laws reflect the desire to effectuate economic modernization without having to relinquish state control—a situation that shall be referred to as the "counter-socialist dilemma."

In 1983, the State Council of the PRC officially recognized the issuance of corporate stock to employees of collective enterprises as well as the reorganization of SOEs into shareholding entities.[61] By late 1986, under the supervision of local branches of the People's Bank of China (PBOC),[62] governments in Beijing, Guangdong province, and Xiamen special economic zone had passed separate regulations defining the concept of stocks and prescribing the eligibility requirements for issuing stocks, procedures for such issuance, and guidelines for stock transfers and dividend distributions.[63] In the midst of this widespread local growth, on March 27, 1987, the State Council promulgated the first national securities regulation entitled, "Interim Regulations Governing the Issuance of Bonds for State-Owned Enterprises" (hereinafter 1987 Interim Regulations),[64] which authorized SOEs to issue bonds and conspicuously lacked any reference to stock issuance. On the following day, the State Council released the Directive of the State Council on Reinforcement of Administration on Stocks and Bonds (hereinafter 1987 Directive)[65] which set forth only three circumstances under which enterprises could issue stock: (1) issuance by COEs, subject to control by the national government; (2) issuance by SOEs, which had issued public stock prior to the

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60. Wong, *supra* note 2, at 1240-41.

61. 1983 Interim Provisions of the State Council on Several Policy Issues Concerning Urban Collective Economy (issued March 14, 1983), *cited in* Jianfu Chen, *Securitisation of State-Owned Enterprises and Ownership Controversy in the PRC*, 15 SYDNEY L. REV. 59, 60-61 & n.9 (1993).

62. Tarbutton, *supra* note 27, at 414-15. "The PBOC was authorized to regulate stocks, bonds, and negotiable instruments, and to administer the PRC's financial markets under Article 5, §11, of the Interim Regulations of Banks of 1986." *Id.* at 415 n.26.

63. XIA, *supra* note 4, at 64.

64. Interim Regulations Governing the Issuance of Bonds for State-Owned Enterprises (promulgated March 27, 1987), *translation available in* XIA, *supra* note 4, at 167-72.

65. For a description of the Directive of the State Council on Reinforcement of Administration on Stocks and Bonds (promulgated March 28, 1987), see Harry Zheng, *Securities Regulation in China: Development and Conflicts*, E. ASIAN EXEC. REP., May 15, 1987, *available in* LEXIS, News Library, Easian File.

1987 Directive, upon PBOC approval;[66] and (3) issuance through horizontal investments between enterprises.[67] This restrictive regulation represents a tightening of the reigns by the PRC compared to its former open experimentation with stock issuance.

In the early 1990s, two national stock exchanges emerged under different regulations promulgated by the local PBOC branches in Shanghai and Shenzhen.[68] The first national stock exchange opened in Shanghai on December 19, 1990, under the Provisional Measures of Shanghai Municipality for Administration of the Issue and Trading of Shares (hereinafter Shanghai Measures).[69] The Shenzhen Stock Exchange began trading soon thereafter on July 3, 1991, under the Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares (hereinafter Shenzhen Measures).[70] By comparison, the Shanghai Measures were less restrictive than the Shenzhen Measures and thus offered greater financing opportunities for small to medium-sized companies interested in accessing the stock market.[71] Both exchanges subsequently issued regulations with regard to the issuance of B-Shares to foreigners.[72] Subsequent national legislation adopted these detailed regional legal measures in large part.[73]

In October of 1992, due to fraud and abuse problems[74] associated with the lack of unity between the Shanghai and

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66. Reorganized shareholding SOEs, which had experimentally issued stock only to employees, issued public stock subsequent to this Directive on the basis of this permissive grant. Tarbutton, *supra* note 27, at 414 n.24 (referring to this practice as taking advantage of "a loophole" in the 1987 Directive).

67. *Id.* at 414 n.23.

68. The regulatory differences reflect the lack of cooperation between the Shanghai and Shenzhen branches of the PBOC which controlled the stock exchanges. *Id.* at 415-16.

69. For a detailed summary of these measures, *see* 1 ENCYCLOPEDIA OF CHINESE LAW 358-59 (Chris Hunter et al., ed., Asia Law & Practice Ltd., 1993). *See also* Tarbutton, *supra* note 27, at 416-20 (describing the Shanghai Measures in terms of stock issuance, disclosure requirements, and insider trading).

70. For a detailed summary of these measures, see 1 ENCYCLOPEDIA OF CHINESE LAW, *supra* note 69, at 295-96. *See also* Tarbutton, *supra* note 27, at 416-20 (describing the Shenzhen Measures in terms of stock issuance, disclosure requirements, and insider trading).

71. Tarbutton, *supra* note 27, at 418.

72. *See Shanghai Issues Regulations on B Shares*, Xinhua General Overseas News Service, Jan. 11, 1992, *available in* LEXIS, News Library, Xinhua File.

73. *See* Qian, *supra* note 5, at 86-91 (providing an overview of the legal frameworks in Shanghai and Shenzhen).

74. Significant fraud and abuse occurred under the decentralized leadership of the PBOC, prompting citizen riots in Shenzhen on August 10, 1992. David Holley & Christine Courtney, *Would-Be Capitalists Riot in China Protests*, L.A. TIMES, Aug. 11, 1992, at 10 (describing the outbreak as "the most serious

Shenzhen Measures, the State Council Securities Committee (SCSC) and China Securities Regulatory Commission (CSRC) replaced the PBOC in regulating China's securities industry.[75] The SCSC is the policy-making body whose regulations are implemented by the CSRC.[76] Pursuant to its responsibilities, the SCSC promulgated the Interim Regulations on the Issue and Trading of Shares (hereinafter 1993 Interim Regulations) on April 22, 1993, in its first major attempt to create a national securities law.[77] Similar to the restrictive 1987 Directive, the 1993 Interim Regulations restricted corporate stock issuance to "a limited-liability company that has already been established[78] or a

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public disturbance in China since the 1989 crackdown on the pro-democracy movement in Beijing.").

75. Tarbutton, *supra* note 27, at 420. The CSRC has also been translated as the China Securities Supervision Commission. *See* 1993 Interim Regulations, *supra* note 2, at art. 5.

76. Tarbutton, *supra* note 27, at 420 & n.73.

77. *See* 1993 Interim Regulations, *supra* note 2. Article 5 of the 1993 Interim Regulations includes a description of the SCSC (". . . the national organization in charge of the country's securities market [which] exercises a unified management of the securities markets across the country according to relevant laws and regulations") and the China Securities Supervision Commission [hereinafter CSSC] (". . . an executive body which exercises supervision and management for the [SCSC] [which] manages and supervises according to relevant laws and regulations the specific activities of the issue and trading of securities"). *Id.* at ch. 1, art. 5.

78. *Id.* at ch. 2, art. 7. The 1993 Interim Regulations do not explicitly define the term "limited liability company," but it requires an established limited liability company "that openly issues stock" to meet the following conditions:

> (1) Its production and operation conform to the government industrial policies;
> (2) It will issue only one kind of common stock, and the right of the stock is the same for all holders;
> (3) The initiator of the stock shall be committed to buying no less than 35% of the total stock that the company plans to issue;
> (4) Of the total stock that the company plans to issue, the value of the stock that the initiator is committed to buy shall be no less than 30m yuan, unless the government stipulates otherwise;
> (5) The portion of the stock issued among the public shall be no less than 25% of the total stock that the company plans to issue; the portion that the workers and staff members of the company are committed to buy shall not exceed 10% of the issue for the public; if the planned stock issue of a company exceeds 400m yuan in value, the Securities Supervision Commission may consider the circumstances according to relevant stipulations to lower the proportion of the issue for the public, but the issue for the public shall be no less than 10% of the total planned stock issue of the company;
> (6) The initiator must not have any major law violation record in last three years; and
> (7) Other conditions stipulated by the Securities Commission.

limited-liability company to be established,[79] of which the establishment has been approved by the authorities."[80] In addition, the 1993 Interim Regulations set forth fairly lengthy regulations concerning stock issuance,[81] stock trading,[82] takeovers of listed companies,[83] custody, liquidation and ownership transfer,[84] disclosure requirements for listed companies,[85] investigations and penalties,[86] and arbitration of disputes.[87] Both the 1993 Interim Regulations and the Company Law[88] of China (effective on July 1, 1994), which include certain stock issuance provisions, codified, modified, and replaced prior regional regulations.[89] However, the Shenzhen and Shanghai exchanges and municipal regulations still serve an important role in implementing and supplementing the provisional national laws.[90]

In December of 1995 and May of 1996, the CSRC promulgated national regulations and detailed rules respectively governing the issue of B-Shares.[91] The regulations focus on how

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Id. at ch. 2, art. 8. *See supra* notes 45-46 (describing LLCs and JSCs, both of which are limited liability companies).

79. Enterprises reorganized as LLCs must meet not only Article 8 conditions, *supra* note 78, but also the following requirements:

> (1) Their net assets should account for no less than 30% of their total assets and their intangible assets should account for no more than 20% of their net assets at the end of the year before the stock issue. However, this condition does not apply if other regulations are provided by the Securities Commission; and
> (2) They have earned profits for the past three years in a row. If the limited-liability companies established by reorganized state enterprises issue stocks to the public, the apportionment of the shares held by the state among the total amount of capital stock to be issued shall be stipulated by the State Council or by the department authorized by the State Council.

1993 Interim Regulations, *supra* note 2, at ch. 2, art. 9.

80. *Id.* at ch. 2, art. 7.

81. *Id.* at ch. 2, arts. 7-28.

82. *Id.* at ch. 3, arts. 29-45.

83. *Id.* at ch. 4, arts. 46-52.

84. *Id.* at ch. 5, arts. 53-56.

85. *Id.* at ch. 6, arts. 57-67.

86. *Id.* at ch. 7, arts. 68-78.

87. *Id.* at ch. 8, arts. 79-80.

88. *See* Company Law, *supra* note 33.

89. Wong, *supra* note 2, at 1236-37; Spencer, *supra* note 43 (describing the Company Law).

90. Liufang, *supra* note 45, at 161. Therefore, the validity of local rules depend on the corresponding central laws or administrative regulations behind them. *Id.*

91. *First Chinese National Rules on B-Shares*, Xinhua News Agency, Jan. 3, 1996, *available in* 1996 WL 3774131; *Law: B-Share Rules*, CHINA ECON. REV., Sept. 1, 1996, *available in* 1996 WL 9692325.

to list B-Shares, while the rules set forth guidelines for the trading of B-Shares, the qualifications of institutions handling securities, the procedures for accounting and auditing, and the disclosure of information generally.[92] Under these recent national rules, B-Shares may be issued to foreign legal persons or institutions, individuals, legal persons and institutions in Hong Kong, Macao, and Taiwan, Chinese citizens living outside China, and others approved by the SCSC.[93] The effect of the enforcement of such rules and regulations has been a slowing of market expansion and a decrease in the number of B-Share listings.[94] However, Chinese officials hope such implementation, in the long run, will lead to higher quality offerings and a more efficient B-Share market.[95]

Furthermore, in late June of 1996, the SCSC promulgated rules governing the underwriting of A-Share issues.[96] These rules prescribe, among other things, that lead underwriters must have assets of at least fifty million yuan (about six million U.S. dollars) and have underwritten at least three stock issues or have at least three years of underwriting experience; that an underwriter must not have violated any laws in the past year; and that an underwriter must not encourage companies to issue shares at "unreasonably high" prices and may not retain shares gained through illegal means.[97] These recently released A and B-Share rules and regulations are the most recent examples of China's effort in forming a unified national legal framework for its securities industry. However, until the National People's Congress enacts a comprehensive national securities law, a labyrinth of local and national rules and regulations[98] will continue to control China's stock market activities.

92. *Laws: B-Share Rules*, *supra* note 91.
93. *First Chinese National Rules on B-Shares*, *supra* note 91.
94. *Law: B-Share Rules*, *supra* note 91.
95. *Id.*
96. *Id.*
97. *Id.*
98. *See* Qian, *supra* note 5, at 68-70 (describing the legal framework as one part of an emerging tripartite regulatory regime having an institutional (professional securities firms and stock exchanges), legal (rules and regulations), and administrative (agencies) framework). For descriptions of the local and national securities laws enacted through December of 1994, see 1-2 ENCYCLOPEDIA OF CHINESE LAW, *supra* note 69.

D. *Sino-U.S. Cooperation*

As early as 1986, Chinese leaders invited Wall Street experts to China to explain to them the U.S. capital markets.[99] Based on the existence of Chinese regulations which reflect aspects of the Western capitalist market model, Chinese officials have obviously observed the stock market experiences of countries like the United States. In 1994, the United States formally offered China its assistance in the development of a national Chinese securities law by entering into a Sino-U.S. Memorandum of Understanding.[100] This short document has no binding effect of law, yet it stands as a significant symbol of China's commitment to the development of a comprehensive national securities law to support its market socialist economy. The Memorandum of Understanding sets forth specific ways in which the United States could aid China in developing its securities regulatory framework, including the Securities and Exchange Commission's assistance in drafting laws and regulations and in conducting training sessions in China or the United States, and internship programs for CSRC personnel.[101]

In 1995, Morgan Stanley & Company entered into a joint venture with the People's Construction Bank and several other partners forming China International Capital Corporation.[102] As a result, Morgan Stanley became the first U.S. investment bank allowed to participate in China's domestic capital market.[103] China hopes that allowing Morgan Stanley inside the protected Chinese markets will benefit China in terms of securities experience and market development.[104] Based on China's acceptance of Morgan Stanley's presence, Sino-U.S. cooperation is likely to grow in the future.

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99. Nikos A. Stamos, *China's Nascent Securities Market: Some Observations*, 10 HARV. J. L. & PUB. POL'Y 691, 691 (1988).

100. Memorandum of Understanding Between the United States Securities and Exchange Commission and the China Securities Regulatory Commission Regarding Cooperation, Consultation, and the Provision of Technical Assistance, April 28, 1994 [hereinafter Memorandum of Understanding], *reprinted in* Practising Law Institute: Corporate Law and Practice Course Handbook Series, *The SEC Speaks in 1995: International Developments*, March 3-4, 1995, *available in* WESTLAW, PLI-CORP Database, 882 PLI/Corp 193.

101. *Id.* §§ 7-8.

102. Dave Lindorff, *In Beijing, the Long March is Just Starting*, BUS. WK., Feb. 12, 1996, at 68.

103. *Id.*

104. *Id.*

E. *Recent Stock Market Update*

In 1996, following a lackluster market in 1995, 207 Chinese companies listed their shares on the country's two stock markets, increasing the total to 530 companies with publicly traded A-Shares.[105] The stock market saw significant improvement in 1996 compared to 1995, with a total turnover of 4.2 trillion yuan (about 505 billion U.S. dollars) last year, more than six times that in 1995.[106] The number of stock investors rose by more than eight million, reaching twenty million in 1996.[107] Upon the recent announcement of the death of China's paramount leader, Deng Xiaoping, stocks on the Shenzhen and Shanghai exchanges fell sharply, but they recovered most of the lost ground in subsequent trading.[108]

In contrast to recent A-Share performance, China's B-Share markets showed "manic-depressive" tendencies in 1996.[109] There was little change in B-Share trading until late 1996, when domestic investors dominated the market, in violation of regulations mandating only foreign investors, and drove prices up eighty percent over prior levels.[110] Subsequent warnings by regulators to enforce the foreigners-only rule resulted in about a thirty percent plummet in B-Share prices.[111] Eighty-six Chinese companies have issued and listed B-Shares on the two stock exchanges, and thirty-three new B-Share listings are currently expected.[112]

To the surprise of many, news of Deng's death resulted in a 2.3 percent surge in Hong Kong stocks.[113] Some attributed such reaction to investors' indifference to Deng's death, while others speculated that "the rally was driven by local Chinese buying."[114] In January, prior to Deng's death, the Xinhua News Agency reported a "substantial rise" in the Heng Seng China Enterprise Index, which tracks the overall performance of twenty-three Chinese state firms listed on the Hong Kong Stock Exchange, due

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105. *China Has 530 Listed Companies*, *supra* note 31.

106. *Id.*

107. *Id.*

108. Sara Webb & Leslie Chang, *Hong Kong Stocks Surge 2.3% on Deng's Death*, WALL ST. J., Feb. 21, 1997, at C12.

109. Smith, *supra* note 52.

110. *Id.*

111. *Id.*

112. *China Selects 33 More Enterprises to List B Shares*, *supra* note 32. Since December of 1995, when the central government took control of the B-Share market through the promulgation of B-Share regulations, the listing of B-Shares has been subject to approval by the SCSC rather than local regulators. *Id.*

113. Webb & Chang, *supra* note 108.

114. *Id.*

to investors' positive anticipation of Hong Kong's return to China.[115]

Just as before Deng's death, political uncertainty continues to be a risk factor in investing in the Chinese stock market. Some analysts are quite enthusiastic about the future of China's stock market in this post-Deng environment: "'[T]he confirmation of Deng's demise . . . creates a clear buying opportunity.'"[116] Yet, others believe that unless China adopts a more liberal political agenda, the market's enthusiasm will not last.[117] While the mood is somewhat upbeat at the moment, grave risk still remains: "The fate of financial-market reforms as well as the post-Deng political succession . . . remain up in the air."[118] The following sections address such concerns and suggest ways to strengthen China's stock market so that it can weather the potential political storms ahead.

III. IS CHINA COMMITTED TO LONG-TERM CAPITALIST MARKET REFORMS? THE COUNTER-SOCIALIST DILEMMA

Since the opening of China's economy in 1979, the country's Communist leaders have struggled to maintain a careful balance between economic growth and state control in developing its "market socialist economy." The PRC leadership under Deng Xiaoping welcomed the economic rejuvenation resulting from opening China to capitalist forces, but not without serious reservations regarding the loss of state control and "ownership of the means of production by the people" which is fundamental to its Communist political ideology. As stated earlier, this balancing act (or perhaps conundrum) shall be referred to as China's "counter-socialist dilemma."[119] This section examines whether

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115. *Chinese Petrochemical Giant Sells Shares in Hong Kong*, *supra* note 55.

116. Webb & Chang, *supra* note 108 (quoting Christopher Wood, Asian and emerging market strategist at Peregrine Securities International, Ltd.).

117. *Id.* (describing this viewpoint as expressed by Mark Mobius, president of Franklin Resources, Inc.'s Templeton Emerging Markets Fund).

118. Dave Lindorff & William Glasgall, *Bulls in the China Shop*, BUS. WK., Jan. 22, 1996, at 82.

119. Another author has described the Chinese leaders as "riding two horses, so to speak. One horse wishes to go in the traditional direction of public ownership; the other horse wants to take an untrod path toward complete privatization." Qian, *supra* note 5, at 97. Unless the fall of communism bestows China, Chinese leaders will not likely ever ride off into the direction of privatization. However, resolving the counter-socialist dilemma in such a way that an internationally competitive stock market can exist in China's reformed socialist society will enable Chinese leaders to continue riding both horses down one mutually agreeable course.

China has a long-term commitment to resolving this dilemma in order to develop an internationally recognized stock market.

China's counter-socialist dilemma is rooted in the conflict between socialist and capitalist economic theory. Is it feasible for China to develop a successful and efficient capitalist stock market within its "socialist market economy"? Marxist-Leninist ideology, as expressed in China's 1982 Constitution, is based on "socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people"[120] and shuns the capitalist "system of exploitation of man by man."[121] Providing welfare services to its employees has traditionally been one of the primary functions of a Chinese SOE,[122] rather than the maximization of profits. In contrast, capitalism is "an economic system characterized by private or corporate ownership of capital goods, by investments that are determined by private decision rather than by state control, and by prices, production, and the distribution of goods that are determined mainly by competition in a free market."[123] While, in theory, socialism and capitalism seem to be mutually exclusive economic systems, China has imported restricted elements of private ownership in such a way as to form a "socialist market economy" having unique "Chinese characteristics."[124]

Evidence exists both for and against the continuation of swift capitalist economic reforms in China. Therefore, any prediction of the long-term outlook of post-Deng Chinese leaders reflects to some extent the views of the speaker who, to borrow a familiar Western expression, may view the half-filled glass as half-empty or half-full. In stock trading jargon, it depends on whether the speaker is "short" or "long" on Chinese economic reform. This section reviews the evidence supporting the long-term intentions of those in power and offers predictions based on this author's "half-full" view of the Chinese stock market.

Certain signs suggest that China's controlling Communist Party leaders take a short-term or restricted view of the recent

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120. XIANFA [constitution] art. 6 (1982), *translation available in* LEXIS, Intlaw Library, Chinalaw File, No. 141.

121. *Id.*

122. *See* Art & Gu, *supra* note 33, at 278 & n.21 ("Chinese enterprises routinely provide their workers with housing, medical care, pensions, and a host of other social services and benefits as part of the 'iron rice bowl' of lifetime employment and social benefits.").

123. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 332 (1993).

124. Qian, *supra* note 5, at 92.

emergence of the stock market.[125] Those holding this view are usually referred to as the old Communist "hard-liners" or "conservatives."[126] There is evidence of political infighting among Chinese officials with regard to the open door economic reforms as well as manifestations of a mounting conservative backlash, leading some to suggest that the hard-liners will attempt to seize control.[127] Such a backlash could bury the still nascent stock market alongside Deng. Furthermore, Jiang Zemin, Deng's designated successor, has been characterized as "by nature a Marxist-Leninist" who "might be tempted to move toward tighter political controls even as he continues to promote a more open economy."[128]

One commentator has suggested that, based on the 1987 Directive, which greatly restricted the issuance of stock, "it became apparent that government policy regarding the securities market was more oriented toward solving short-term problems than encouraging long-term development of the market."[129] While subsequent legislation and policies[130] have broadened stock issuance regulations since 1987, issuers' access to the stock market is still quite limited,[131] and corporate control largely remains in the hands of the state.[132] Since an internationally recognized stock market demands significant independence from state control, based on Western economic theory, this continued retention of state control evidences a power wielded by the conservatives to prevent the development of such a market. Such control inhibits the stock market, which was originally established to help fund SOEs, from helping to assuage the state sector's increasing economic difficulties.[133]

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125. Such views imply that such capitalist experimentation is temporary or will remain inefficient or at an internationally insignificant level under the tight control of the state.

126. *See infra* notes 138-40 and accompanying text.

127. *See* Sheryl WuDunn, *Can Deng's Heirs Finish the Long March to Capitalism?*, N.Y. TIMES, Feb. 21, 1997, at A9.

128. Richard Bernstein, *Chinese Exiles Wonder How Wind Will Blow*, N.Y. TIMES, Feb. 21, 1997, at A9.

129. XIA, *supra* note 4, at 65.

130. *See* Liufang, *supra* note 45, at 153-54 (noting the beneficial elements of the "more open rules" enacted locally in the mid-1980s, as compared to the "standards" implemented in the 1990s by the central government).

131. *Id.* at 212-16.

132. *Id.* at 202-04, 223-28. *See* Wong, *supra* note 2, at 1226 ("Notwithstanding the current interest in increasing private participation in the state enterprise modernization process, it is clear from the Chinese Constitution and other laws that the government will not relinquish all of its ownership interest in this sector.").

133. *See* Wong, *supra* note 2, at 1225-29.

The most obvious example of anti-reform sentiment occurred with bloodshed on June 4, 1989, in Tiananmen Square. Following the thwarted attempts by ex-Premier Zhao Ziyang to accelerate price reform[134] and the death of Hu Yaobang, a protege of Deng and strong supporter of reform, students filled Tiananmen Square in April of 1989 to mourn his death and to protest against the slowing of economic reforms by Communist hard-liners.[135] When students refused to cease their protesting, the Chinese military, under Deng's orders, moved in with tanks and other armaments, killing hundreds, perhaps even thousands.[136]

Less violent anti-reform measures have been taken with the support of conservatives, such as those in the Chen Yun faction, who argue that capitalism will lead to corruption, speculation, and nepotism, undermining respect for the Communist Party. This faction believes that the ultimate failure of the economic reforms will result in masses of dissatisfied profit-seeking citizens and weakened Communist Party power.[137] Last year, certain headlines evidenced this conservatism: "New Muscle, New Boldness: Hard-Liners Set Tone for a Society in Story Change,"[138] "China's Alarming Leap Backward,"[139] and "A Chill Wind Blows From Beijing."[140] In the name of protecting socialism and communism, China performed threatening military maneuvers off the coast of Taiwan, cracked down on religious groups and human rights activists, and restricted the flow of financial information.[141] Some hard-liners support a retreat from the bold reforms advocated by Deng, pointing to social instability fed by unpaid workers' salaries, rising unemployment and falling standards of living in the poor inland provinces, and an increasingly wealthy minority.[142] New Communist propaganda has circulated within the party warning that capitalist reforms will allow foreigners and an emerging "bourgeoisie" to buy

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134. Instead of this price reform, in 1988, the government initiated an "'economic adjustment' program" based on inflationary fears under which bank credit availability decreased and operational controls on corporate entities tightened. XIA, *supra* note 4, at 26-27.

135. COUNTRIES OF THE WORLD, *supra* note 6, at 415.

136. *Id.*

137. *Id.* at 416.

138. Uli Schmetzer, *New Muscle, New Boldness: Hard-Liners Set Tone for a Society in Stormy Change*, CHIC. TRIB., Feb. 18, 1996, at 1.

139. *China's Alarming Leap Backward*, BUS. WK., Jan. 29, 1996, at 84.

140. Joyce Barnathan et al., *A Chill Wind Blows From Beijing*, BUS. WK., Jan. 15, 1996, at 44.

141. *See* Schmetzer, *supra* note 138; *China's Alarming Leap Backward*, *supra* note 139.

142. *See* Barnathan, *supra* note 140.

national assets and disband the Communist Party.[143] Today, following Deng's death, uncertainty pervades with such headlines as "Chinese Exiles Wonder How Wind Will Blow"[144] and "Can Deng's Heirs Finish the Long March to Capitalism?"[145]

One recently enacted conservative policy will negatively affect China's stock market. In January of 1996, the state mandated that the Xinhua News Agency, operating under the State Council, assume the role of "gatekeeper" for all foreign business, economic, financial news and data.[146] While the exact motives of the censorship policy are unclear,[147] it "'could have significant implications for the ability of Chinese business and financial institutions to compete in world financial markets through equal access to essential information.'"[148] As discussed below, such state censorship of financial information inhibits China from developing an efficient national stock market.[149]

In contrast to these foreboding signals from conservative Communist leaders, equally telling evidence supports the continuation of promising economic reforms. Despite the conservatives' fear of becoming politically obsolete, they cannot stop the momentum of economic reform. Economic reform has been gaining momentum since 1979, without incurring great political, social, and economic hardship, which is presumedly what the conservatives are trying to avoid. At worst, they can slow down the change, but it is change nevertheless. One commentator noted, "When the Chinese leadership debates how to introduce capital markets or dissolve inefficiencies in the state sector, the debate is not over whether these steps are allowable. Instead, they are about the concrete process of how to go about orchestrating the change."[150]

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143. Schmetzer, *supra* note 138.
144. Bernstein, *supra* note 128.
145. WuDunn, *supra* note 127.
146. Joseph Kahn, *Media: China Chokes Flow of News About Business*, WALL ST. J., Jan. 17, 1996, at B1 (describing the state's censorship policy as "Draconian restrictions").
147. *Id.*

> [I]t wasn't immediately clear whether the mandate amounted to a strategic rethinking of part of China's historic opening to the outside world or was simply an attempt by the country's monopoly wire service to protect its turf and increase its income. It was also unclear whether the policy received broad support from China's top leaders, who have been emphasizing the importance of China's economic integration with the world.

Id.

148. *Id.* (quoting Peter Kann, the Chairman and CEO of Dow Jones & Co.). *See infra* Part IV.B.
149. *See infra* Part IV.B.
150. WuDunn, *supra* note 127.

A flashback to 1992 shows political and regulatory activity signaling that capitalism is in China to stay. In January of 1992, Deng Xiaoping called for "bold experiments" with the stock market.[151] In February of 1992, the first B-Shares were issued to foreigners on China's two stock exchanges.[152] Until this monumental reversal, foreign investors had been banned from participating in China's stock markets since 1949. A U.S. reporter captured the sentiment of the day: "But not until 'B' shares changed hands was it *clear* that China's leaders have swallowed their deepest fears about private property and committed themselves to share ownership. . . . 'It signals to foreigners the [open door] policy is real and not just propaganda.'"[153] The state-controlled news service recently confirmed that "[i]t is China's long-term policy to raise foreign capital on securities markets."[154] Moreover, securities authorities announced in 1995 that attracting foreign investors to the Chinese stock market was a priority for them.[155] In 1996, the Chairman of the CSRC, Zhou Daojing, announced that regulators would choose prospective B-Share issuers on a nationwide basis in order to develop the B-Share market.[156] As promised, the SCSC recently approved thirty-three companies from various industries to list B-Shares on China's stock exchanges.[157]

Furthermore, while the government's recent move to control the flow of foreign financial news into China is problematic in that it contributes to market inefficiency, it is possible that profits, not politics, are behind its censorship policy since a fee is charged for the examination and approval of foreign news agencies' ability to publish economic information in China.[158] As a part of China's economic reforms, Beijing is cutting Xinhua News Agency's

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151. Qian, *supra* note 5, at 66 & n.17 (*citing Top Ten News Stories for China's Securities Industry*, Xinhua News Agency, Jan. 3, 1993, *available in* LEXIS, News Library, Xinhua File). *See* Bersani, *supra* note 34, at 301 (quoting Deng on his 1992 tour of southern China: "Are securities and stock markets good or bad? Is there any danger in adopting such things? Do they exist exclusively in capitalism? Can they also be adopted in a socialist system? People are allowed to consider such matters further, but resolute action must be taken to experiment with such things.").

152. *See supra* note 53 & accompanying text.

153. Browne, *supra* note 53.

154. *Fund Raising on Stock Markets Is China's Long-Term Policy*, Xinhua News Agency, Nov. 9, 1995, *available in* 1995 WL 7715940.

155. *B Share Issue to Go National*, Xinhua News Agency, Feb. 6, 1996, *available in* 1996 WL 3775131.

156. *Id.* Such a "nationwide" B-Share policy addresses the conservatives' concerns for geographic disparity in economic prosperity.

157. *China Selects 33 More Enterprises to List B Shares*, *supra* note 32.

158. *Finance News: In Brief*, CHINA ECON. REV., May 1, 1996, *available in* 1996 WL 9692231.

government subsidies by seven percent annually in an effort to make media organizations less reliant upon government handouts and to force them to compete for profits. One Xinhua representative stated that the organization welcomes the opportunity to share in the revenues of the foreign economic news services.[159] Furthermore, officials reason that the media coverage regulations are intended to prevent false reporting from influencing the market.[160] Such a policy promotes the accuracy and efficiency of the securities market.

The rapid speed of China's economic reforms is also impressive and unparalleled among the development of emerging markets. A look at the B-Share trading, for example, evidences the sheer swiftness of China's reforms. While other Eastern European and Asian countries gradually lifted restrictions on foreign investors, China's stock exchanges "furiously" worked to issue B-Shares about one year following the opening of the Shanghai exchange and much less than one year after the Shenzhen exchange began trading.[161] In addition, the U.S. stock market was slow to develop compared to the growth of China's markets.[162] In the United States, stock trading took place in the streets of Manhattan for a long while, and regulatory oversight by the SEC began over twenty years after the exchange moved inside in 1908.[163]

Behind the implementation of these swift reforms are various economic theories aimed at resolving China's "counter-socialist dilemma." Ever since the Communist Party officially endorsed economic reform in 1984,[164] China's Communist leaders have looked to scholars to resolve this dilemma.[165] Scholarly responses have shown that resolution of the counter-socialist dilemma is not as troublesome as it may seem by looking at

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159. Kathy Chen, *Chinese News Agency Faces A Quandary: Xinhua Struggles to Reconcile Politics and Profits*, WALL ST. J., Jan. 19, 1996, at A7.

160. *Media Curb*, CHINA ECON. REV., Aug. 1, 1996, *available in* 1996 WL 9692279.

161. Sheryl WuDunn, *China's Open-Door Stock Policy*, N.Y. TIMES, Dec. 24, 1991, at D1.

162. Daniel Henninger, *Where Are Shanghai's Bulls and Bears?*, WALL ST. J., Jan. 18, 1996, at A14.

163. *Id.*

164. Decision of the Third Plenary Session of the Twelfth Chinese Communist Party Central Committee on Reform of the Economic Structure (adopted October 20, 1984), *cited in* Zheng, *supra* note 65, at 604 n.388.

165. *See* Chen, *supra* note 61, at 60, 64-70 (reviewing the early proposal of the World Bank and numerous subsequent theories advocated by various Chinese scholars); Tarbutton *supra* note 27, at 413 n.12 (noting the influence of Chinese economists supporting theories of stock issuance based on Marxist teachings that stock companies represent a form of capital ownership by the organized working class).

models of pure capitalism and socialism. One commentator has observed that "[t]he sharp distinction sometimes drawn between 'planned' economies and 'market' economies is, of course, false."[166] The continuous existence of non-state sectors of the Chinese economy[167] and the heavily regulated sectors of the U.S. economy bear this out. Other scholars have distinguished "state ownership" from "social ownership" in terms of an evolutionary process from direct state ownership to contractual state ownership to indirect state ownership (social ownership) to matured social ownership.[168] Under this theory, China's economy is on its way to "social ownership" under which a combination of the state, enterprises, and individuals owns property.

According to one source, Chinese officials have undergone three "rounds"[169] of debates since 1984 concerning the theoretical resolution of the counter-socialist dilemma. During the most recent debates (from 1989 to 1992), three viewpoints emerged—the conservative,[170] the pragmatic,[171] and the policy-oriented.[172] The conclusion drawn from these debates is that while Chinese officials might "disagree about how far and how

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166. Clarke, *supra* note 14, at 2 n.2.

167. *See id.* at 5 ("Contrary to popular belief, the Chinese economy has never been completely planned from the center, and even in the past reform was substantially less planned than other centrally planned economies.").

168. *See* Chen, *supra* note 61, at 78-83.

169. These debates occurred in the following periods: 1984-85, 1987-89 and 1989-92. *See* Qian, *supra* note 5, at 72-85.

170. "The conservative group stressed the politically sensitive issue of the nature of a shareholding system and stocks. . . . They attacked the proposal of individualizing state assets and converting them eventually to a system of private ownership." *Id.* at 80-81.

171. Pragmatists "stressed the benefits of, and the urgent need for, establishing a shareholding system and stock markets without getting bogged down in an endless debate over the ideological aspects of the shareholding system." *Id.* at 81. Professor Li Yining, an established economist at Beijing University, studied the short and long-term effects of securities markets in China and concluded that "[f]or the long term, securities markets would promote a free, rational, and optimal flow of resources to the most efficient industries, regions, and enterprises, thus achieving the greater nationwide economic efficiency being pursued." *Id.* at 82-83. *See* LEES & LIAW, *supra* note 8, at 63 ("Professor Li envisages development of China's equity markets as a means of facilitating a process of corporatization and, eventually, privatization.").

172. "As a group, [the policy-oriented leaders] emphasized the practical benefits of establishing a new securities system. They did not regard a new securities system as a complete transformation, and they believed it could be implemented step-by-step under central leadership." Qian, *supra* note 5, at 83. Jing Shuping, a quasi-government official and one of the first to suggest that China try a shareholding system, and Liu Hongru, Vice Minister of the State Commission for Restructuring the Economic System, held this viewpoint. *Id.* at 83.

fast China should pursue the securities program," all of these different theoretical circles "have come to realize the tremendous need for, and potential benefits from, developing a shareholding system and stock markets."[173] The PRC's consistent commitment to market reforms on some level, despite waves of centralization and decentralization in the past, shows this to be true.

Based on the leaders' common respect for developing a stock market, it seems apparent that, under one theory or another, economic reform will continue to transform China's socialist market economy. Those in power are reformists (albeit to differing degrees) equipped with a myriad of theoretical arguments and thus are positioned to effectuate change away from the traditional ways of socialism. As one commentator recently noted, "[E]conomic restructuring is no longer an ideological question. It is more of a technical one."[174] Nevertheless, resolving the counter-socialist dilemma will continue to be a challenge for China's leaders.

The influence of politics on the economy cannot be understated. History reveals that several Chinese stock markets have failed in the past due to changing political tides. Therefore, it is paramount that China continue to move ahead with economic reforms—in particular, creating a comprehensive national securities law, increasing the efficiency and accessibility of the stock market, and repealing the censorship policy—so that the stock market will be stable enough to withstand the changing political forces.

IV. REALIZING THE RE-EMERGENCE: NATIONAL LEGISLATION AND THE FREEDOM OF SPEECH

Assuming that Deng Xiaoping's successors will proceed with the market reforms he set in motion, their efforts (or lack thereof) will dictate when, if at all, China will realize the true re-emergence of its stock market. This section provides several recommendations designed to improve the stability and efficiency of China's stock market and its socialist market economy.

A. *The Enactment of a National Securities Law*

China's government is cognizant of the country's need for a comprehensive national securities law and has been in the

173. *Id.* at 96.
174. WuDunn, *supra* note 127.

process of drafting such a law for years.[175] Effective securities laws would reduce market risk, boost investor confidence, and mitigate transaction costs for Chinese issuers. At the present time, stock market participants must follow a plethora of national and regional regulations.[176] Investors have no guarantee that the present regulations will remain in force or will be effectively enforced should problems arise. In addition, the prevalence of insider trading, limited legal recourse, and restricted tradability of shares must be addressed by national securities laws in order to foster the future growth and development of China's stock exchanges into an internationally recognized stock market.

1. Insider Trading

Along with the economic benefits of any equity market come many risks and costs, including market cycles, loss of control over the financial system, and the potential occurrence of fraud and insider trading.[177] Hard data is not presently available to measure the prevalence of insider trading in China because insider trading has not been prosecuted to any significant degree under China's current laws. However, news reports reveal that insider trading is not uncommon.[178] The cultural weight placed on personal relationships (*guanxi*)[179] in China encourages insider

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175. *See* Wong, *supra* note 2, at 1223 n.13.

176. *See Law: B-Share Rules*, *supra* note 91; Liufang, *supra* note 45; Spencer, *supra* note 43;. *B Share Issue to Go National*, *supra* note 155; Company Law, *supra* note 33, at arts. 129-158 (regulating the issue and transfer of shares of joint-stock companies). For a description of national and regional securities laws through December of 1994, see ENCYCLOPEDIA OF CHINESE LAW, *supra* note 69.

177. *See* XIA, *supra* note 4, at xii-xiii.

178. *See Foo Choy Peng Assesses the First Year's Work of the Stock Exchange's General Manager*, S. CHINA MORNING POST, Sept. 15, 1996, *available in* 1996 WL 3768043 (stating that "insider trading is not uncommon in the absence of a national securities law"); *What's News: Business and Finance*, ASIAN WALL ST. J., Jan. 21, 1997, at 1, *available in* 1997 WL-WSJA 3795256 (announcing that the CSRC had fined and publicly remanded two publicly traded companies for insider trading).

179. *Guanxi* is a Chinese word meaning "connections." One commentator has noted:

> Given the rigid division of Chinese society (into families, villages, professions, schoolmates, workplace), divisions that are difficult or impossible to cross because it is virtually taboo to make contact with someone with whom you do not have a recognized and sanctioned relationship, *guanxi*, or connections, are the oil of life. The Chinese spend a great deal of their time, energy, and income on nurturing their connections and trying to develop new ones.

BOYE LAFAYETTE DE MENTE, CHINESE ETIQUETTE & ETHICS IN BUSINESS 218 (2d ed. 1994).

trading between those persons having connections within government agencies or issuing joint-stock companies. For instance, in August of 1992, citizens rioted in the streets of Shenzhen because there were not enough stock applications available due to official impropriety.[180]

Under U.S. law, insider trading is punished severely.[181] However, the philosophy behind the strict prohibition against insider trading—"emphasis on truth-telling and fair play, the distrust of concentrated economic power, and the unease (while at the same time fascination) with privilege and status"—is difficult to articulate because the harm of insider trading is somewhat ambiguous.[182] Many other cultures do not share the U.S. obsession with punishing the act of lying in the securities context.[183] However, China has adopted the U.S. stance against insider trading.

Chinese officials anticipated insider trading and securities fraud at the advent of the stock market and enacted measures against such practices. For instance, the Shanghai and Shenzhen stock exchanges recognized limited fiduciary duties of stock brokers and placed various limitations on certain stock purchasers, such as employees of brokers, personnel of the exchange, and government employees working for agencies involved in regulating stock issuers.[184] In late 1992, as a result of the Shenzhen rioting, quasi-independent securities watchdog agencies assumed supervisory control of the securities industry, increasing the autonomy of the securities regulators from direct government involvement.[185] The State Council later promulgated the 1993 Interim Regulations, which require at least twenty-five percent of the total stock of the issuing company to be issued to the public and limit the portion allotted to workers and staff members of the issuer to ten percent of the amount issued to the public.[186] These regulations also provide monetary sanctions to

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180. *See* Holley & Courtney, *supra* note 74.

181. *See generally* Securities Exchange Act of 1934 §§ 10(b), 16, 15 U.S.C. § 78 (1994); Donald C. Langevoort, *Fraud and Insider Trading in American Securities Regulation: Its Scope and Philosophy in a Global Marketplace*, 16 HASTINGS INT'L & COMP. L. REV. 175, 176-77 (1993).

182. Langevoort, *supra* note 181, at 182.

183. *Id.* at 182-83.

184. Tarbutton, *supra* note 27, at 419-20.

185. Liufang, *supra* note 45, at 173-74; *Bodies Set Up to Govern Stock Market*, Xinhua News Agency, Oct. 26, 1992, *available in* 1992 WL 11228262.

186. 1993 Interim Regulations, *supra* note 2, at ch. 2, art. 8(5). In issues greater than four billion yuan (480 million U.S. dollars), the Securities Supervision Committee may consider lowering the proportion of the issue to the public, with a minimum amount of 10% of the total issues. *Id.* *See* Pitman B. Potter, *P.R.C. State Council Issues National Stock Regulations*, E. ASIAN EXEC. REP., July 15, 1993, *available in* LEXIS, News Library, Easian File.

be imposed against insider traders.[187] Furthermore, the CSRC promulgated tentative procedures against securities fraud in September of 1993,[188] released the Regulation Prohibiting Cheating in 1995,[189] and recently launched a new "inspection regimen" to monitor publicly traded companies' information disclosure practices, uses of initial public offering proceeds, and internal corporate governance.[190] As shown by such regulatory efforts, one scholar notes that "the intent clearly is to increase opportunities for public participation and limit the advantages enjoyed by promoters and other insiders."[191] However, such measures against insider trading must be incorporated into a comprehensive national securities law and be vigorously enforced before they will have any practical significance.[192]

2. Marginalized Individual Shareholders

Comprehensive national securities laws will reduce the risk associated with the Chinese stock market and thus encourage greater investment if they provide adequate protection of the rights of minority shareholders which is the status of all individual shareholders.[193] Despite the enactment of China's Company Law, which grants significant rights to shareholders, individual shareholders still lack legal recourse to protect their rights.

China's Company Law grants shareholders an impressive amount of power, even surpassing that given to shareholders

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187. Tarbutton, *supra* note 27, at 425 & n.115. Under Article 72 of the 1993 Interim Regulations, violators of the insider trading law must disgorge all profits made through such dealings and may incur a fine of up to 500,000 yuan (about $62,000 in 1994). *Id.* Article 81(14) defines an "insider" as a "natural person having access to insider information due to the individual's holding of the issuer's shares, being a director, supervisor, or manager of the issuer or closely related to such a person, or serving in a regulatory or professional role." *Id.*

188. *See* 2 ENCYCLOPEDIA OF CHINESE LAW, *supra* note 69, at 61 (describing the main contents of the Prohibition of Securities Fraud Tentative Procedures promulgated on September 2, 1993).

189. *Securities Market Growing Fast in China*, Xinhua News Agency, Dec. 21, 1995, *available in* 1995 WL 13484130.

190. *Regulator Launches New Way to Inspect Listed Chinese Firms*, ASIAN WALL ST. J., Jan. 21, 1997, *available in* 1997 WL-WSJA 3795248.

191. Potter, *supra* note 189.

192. *See* Art & Gu, *supra* note 33, at 274 n.6 ("Gaps in the statutory framework are readily apparent. For example, despite the pervasiveness of embezzlement, corruption, bribery, and other misconduct, China lacks laws to combat or deter these abuses.").

193. *See* Wong, *supra* note 2, at 1239 ("With only about 25% of all shares permitted to trade publicly under the current securities regulatory regime, the government effectively maintains a controlling stake in virtually every publicly traded state enterprise.").

under state corporation laws in the United States.[194] Shareholders enjoy the right to call special meetings, to elect and dismiss directors and supervisory committee members, to inspect financial reports, and to vote on the issuance of additional shares and fundamental changes in the company.[195] Unlike U.S. law, Chinese law allows shareholders to take a role in the management of the company, including approval of its budget and the distribution of dividends.[196] Shareholders in China may also sue for an injunction and damages for board action that infringes upon their legal rights.[197] On its face, China's Company Law appears to protect shareholders quite adequately.

However, in reality, individual shareholders are marginalized in their ability to oversee management decisions of the company because the majority shareholder who reaps the benefits of these generous shareholder rights provisions is the state.[198] Thus, individual domestic and foreign shareholders, the only investors whose shares are traded on the stock exchange, must buy stock with the risk that management may choose to seek unprofitable state objectives.[199]

3. Legal Recourse for Shareholders' Grievances

National securities laws must also strengthen a shareholder's ability to seek legal recourse for grievances. In the past, investors have suffered limited rights of legal redress based on the vagueness of the statutory right of action[200] and the ambivalence of the Chinese courts[201] regarding enforcement of such a right.[202] The courts' inability to enforce legal standards stems from several factors: the judges' lack of education, the prevalence of official corruption, the ability of Adjudication Committees to override a judge's opinion, the judge's vulnerability to outside political

194. Art & Gu, *supra* note 33, at 296-97.

195. *Id.* at 296 (citing corresponding provisions in the Company Law).

196. *Id.* at 297.

197. *Id.* at 297 (noting that the Company Law does not specify whether the suit can be direct or derivative in nature).

198. *See* Matthew D. Latimer, *Gilding the Iron Rice Bowl: The Illusion of Shareholder Rights in China*, 69 WASH. L. REV. 1097, 1105-07 (1994).

199. *Id.* at 1107.

200. Article 111 of the Company Law states without specificity that shareholders have a right of action if a board decision "violates laws and administrative rules, and invades the legal interests of the shareholders." Art & Gu, *supra* note 33, at 297 & n.164. It is unclear as to which laws, administrative rules, or legal interests of the shareholders may be violated.

201. The Chinese court system is not independent as in the United States. Rather, the court president and judges are chosen by the National People's Congress Standing Committee. *See* Clarke, *supra* note 14, at 19-22.

202. Latimer, *supra* note 198, at 1107-11.

pressures, and the obstacles to enforcing court judgments against well-connected defendants.[203] In addition, China has historically operated under a disciplinary (rather than a legal or adjudicative) system which focused on maintaining order rather than preserving individual rights.[204] However, one commentator notes that while the private actions are futile, the Company Law imposes a deterrent criminal liability system of "progressive discipline" ranging from fines to "administrative sanctions" to severe criminal punishment.[205]

Even comprehensive national securities laws might not be able to improve the protection of shareholder rights given the flaws of China's court system. An effective alternate forum may be arbitration. In February of 1995, the China International Economic and Trade Arbitration Commission appointed a panel of arbitrators to settle disputes between brokerages, or between brokerages and stock exchanges.[206] However, individual investors still have only one (ineffective) way to redress their grievance: Chinese courts. Therefore, a comprehensive national securities law should take into account their lack of legal recourse and make alternate dispute forums available to individual shareholders.

4. Transferability of Shares

Despite the incredible growth in China's securities markets over the last decade, its stock issuing activities are still very limited. The small number of listed companies and the restricted transferability of different classes of shares present barriers to the development of a truly competitive stock market. Shares are distinguished by the identity of the shareholder—state shares, legal person shares, individual shares (A-Shares) and foreign shares (B-Shares, H-Shares, and N-Shares).[207] With the

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203. Clarke, *supra* note 14, at 57-69.

204. Latimer, *supra* note 198, at 1108 ("Under a legal system, the emphasis is on justice and securing the rights of the individual. A disciplinary system, on the other hand, strives to maintain order, to achieve common objectives, and to quell disputes.").

205. Art & Gu, *supra* note 33, at 299. In 1994, for example, the president of a Chinese company who embezzled about $375,000 was executed. *Id.* at 299-300 n.185.

206. *China Appoints Securities Arbitration Panel*, 6 WORLD ARB. & MEDIATION REP. 76, 76 (1995), *available in* WESTLAW, WAMREP Database.

207. *See* Liufang, *supra* note 45, at 202-12 (giving a detailed description of each class of shares); Wong, *supra* note 2, at 1238-44 (describing the share classification system and its effects on corporate finance).

exception of institutional investing,[208] only individual shares and foreign shares are transferable on the Chinese stock markets.[209] While unlisted shares may be traded on the experimental OTC markets in such provinces as Hubei, Liaoning, and Shandong,[210] such OTC trading will not improve the stability of the two stock exchanges.

The limited transferability of shares has led to a misleading calculation of the stock price index (which incorrectly treats all shares of a listed company as transferable), a low trading volume and turnover rate (which conceals short-term speculation and skews investors' risk assessments), and an increased danger of market manipulation or arbitrage (based on the smaller number of shares needed to manipulate).[211] Furthermore, the share classification system distorts the fair pricing function of an efficient stock market because it creates four different prices for securities of the same entity.[212] This results in a host of corporate finance problems for Chinese companies and their investors.[213] In sum, restricted transferability increases risk for investors. To combat these negative effects, the national securities law should allow for a broadening of the trading of shares, either through increased individual share issuance or the trading of the state and legal person shares.

B. *Freedom of Speech: Censorship's Effect on Market Efficiency*

China's 1982 Constitution includes a freedom of speech clause.[214] However, China's Constitution has never been regarded as a description of reality. Instead, it is a likely indication of significant change to come.[215] Likewise, China's

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208. Liufang, *supra* note 45, at 215. The Shanghai and Shenzhen exchanges permitted institutional investing on October 16, 1992, and September 4, 1993 respectively. *Id.*

209. *Id.* at 212.

210. *See Over-the-Counter Stock Market Booming in Wuhan*, Xinhua News Agency, Jan. 23, 1996, *available in* 1996 WL 3774674.

211. Liufang, *supra* note 45, at 214.

212. Wong, *supra* note 2, at 1240.

213. *Id. at* 1240-44.

214. "Citizens of the People's Republic of China enjoy freedom of speech, of the press, of assembly, of association, of procession and of demonstration." XIANFA [constitution] art. 35 (1982), *translation available in* LEXIS, Intlaw Library, Chinalaw File, No. 141.

215. *See* William C. Jones, *The Constitution of the People's Republic of China*, 63 WASH. U. L.Q. 707 (1988).

> The written constitution was not the place to start if one wanted to know what the government of China was really like. . . . This is not to say that written constitutions play no role in the Chinese polity. They clearly have one function: The adoption of a constitution is a signal that a significant

inefficient market prices do not truly reflect the value or risk of its stocks, based on the lack of available information to Chinese investors.[216] In order to increase the efficiency of China's stock market and move closer to achieving the goals set forth in its 1982 Constitution, China must abandon its exclusive control of financial information.

On January 16, 1996, the Chinese government announced its policy to control the distribution of all financial information entering China from outside news sources.[217] Foreign news organizations believe that the state-controlled Xinhua News Agency offers inferior economic news compared to its international rivals based on scope, timeliness, and quality.[218] Therefore, this information gatekeeper policy will inevitably decrease the efficiency of China's stock market as well as the accuracy of its pricing. This in turn prevents China from competing on equal ground with more efficiently informed foreign markets.[219] Based on economic theory rooted in the "efficient capital market hypothesis,"[220] an efficient stock market cannot emerge if it operates by using imperfect or delayed information. In more poetic terms, "Until China's markets are watered with accurate and plentiful information, only the poisonous weeds will flourish."[221]

Some commentators speculate that profits motivated the gatekeeper policy, following the cutback on Xinhua News

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> change has taken place in the government or in society, and that it is conceived to be long-lasting. . . . [C]onstitutions also tend to show the direction that their promulgators plan to take in governing China.

Id. at 711-13.

216. This argument assumes the validity of the efficient capital market hypothesis (ECMH). *See* LEWIS D. SOLOMON ET AL., CORPORATIONS LAW AND POLICY 899-904 (3d ed. 1994) (discussing the ECMH, which is based on the premise that security prices fully reflect available information).

217. Kahn, *supra* note 146.

218. *Id.*

219. *Id.*

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> 'The efficient market hypothesis' is the term used to describe the proposed (hypothesized) relation between security price movements and information available to investors in the market. . . . An efficient market is one in which the interaction of a large number of buyers and sellers results in prices that fully reflect publicly available information about the goods traded and that react virtually instantaneously to reflect new information as it becomes available.

FASB, *The Efficient Market Hypothesis: Tentative Conclusions of Objectives of Financial Statements of Business Enterprises*, ¶¶ 122-30 (1976), *quoted in* COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 34 (1991).

221. Editorial, *Review & Outlook: China's Closed Door*, WALL ST. J., Jan. 18, 1996, at A14.

Agency's state subsidization, because Xinhua now charges fees to foreign news services.[222] Other journalists believe that the Chinese government seeks to avoid the detrimental market effects caused by rumors, such as the 1995 rumor regarding the death of Deng Xiaoping, which caused a sharp downturn in the markets.[223] Another equally plausible explanation is that the state fears losing control over the securities markets. Whatever the motivation behind China's censorship policy, this policy detrimentally affects the development of an efficient and internationally competitive stock market and should be repealed.

V. CONCLUSION

China has a long way to go before its fledgling stock markets develop into independent and internationally recognized exchanges. However, based on the swift rate of ideological, political, and economic changes since the advent of China's open door policy in 1979, China is well positioned to truly realize the re-emergence of its stock market in the early part of the twenty-first century. Patience is perhaps the best word of advice for pro-reformists frustrated by recent signs of conservatism. In the words of Confucius:

> Do not be in too much of a hurry to get things done. Do not see only petty gains. If a man hurries too much, things will not be done well or thoroughly. If he sees only minor advantages, nothing great is accomplished.[224]

China has already shown great accomplishments in building stock markets in Shenzhen and Shanghai. The development of a world class stock market is within China's reach if its leaders continue to make steady gains in improving the efficiency and stability of its stock market.

Ann P. Vandevelde

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222. Kahn, *supra* note 146.
223. *Id.*
224. DE MENTE, *supra* note 179, at preface page.