

# THE PERCEIVED UNREASONABLE MAN—A RESPONSE TO FANG LIUFANG

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## I. INTRODUCTION

Professor Fang Liufang's Article<sup>1</sup> (Fang's Article) purports to be a comprehensive description of the present legal structure of the corporatization process of state-owned enterprises (SOEs) as endorsed or acquiesced by the Chinese government since 1984. Fang's Article succeeds in accomplishing its objective to some extent, largely as a result of the author's judiciousness and thoroughness. However, the Article's arguments are not compelling because the large majority of them contain no basis in reality and have no practical application.

My Article is not intended to generally commend the successfulness of Fang's Article in dealing with the formidable task of trying to provide a thorough analysis of the legal structure of China's corporatization process. Nor does the following purport to be an overall critique of the inadequacies or misunderstandings contained in the Article. Rather, I have concentrated on the few issues where I fear that lack of qualification might generate excessive confusion and misconceptions concerning China's corporatization framework. Having been a participant in the creation of this framework, I would like to take this opportunity to point out that some of the issues which may seem problematic to the observer are, in fact, useful for the practitioner. In addition, the measures were adopted in an effort to insure the continued and successful development of the corporatization process.

Throughout Fang's Article, the quixotic, irrational, stubborn, bureaucratic, and autocratic designer of China's present corporate

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1. Fang Liufang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149 (1995).

legal system looms large in the background. This perceived unreasonable person set out from the very beginning to formulate a corporate system for China that is, as is frequently portrayed by Fang's Article, unworkable, unenforceable, unpredictable, paternalistic, and self-perpetuating.

It is apparent, when one peruses the section of Fang's Article describing the history of the Chinese corporate legal system, that professor Fang clearly favors the "system" (if there was one) before the centralization and regularization process began. Fang's Article suggests that in the early stages there were fewer mandatory rules and regulations than exist today, and that most of the rules were elective rather than mandatory.<sup>2</sup> The fact that professor Fang appears to be very critical of the application of the mandatory rules throughout his Article seems to suggest that the earlier system was better.<sup>3</sup> Fang's Article thus implies that life was easier with no rules. This implication is both simplistic and naive. Furthermore, the Article attributes the apparent disparity between the old and new systems to a perceived unreasonable man—a person who has established a universal model to be applied to any situation without considering the context.<sup>4</sup> Among the more serious atrocities committed by this unreasonable man are:

- (1) the establishment of one prophetic criterion against which the successfulness of the corporatization experiment is to be evaluated—namely, whether or not "public ownership" (which, in China, refers to the system of state and collective ownership) was strengthened. Even today, public ownership or state ownership carries a connotation of political correctness.<sup>5</sup>
- (2) The retroactive application of laws, regulations, and impetuous policy changes to companies that were established long before the promulgation of the same laws and regulations.<sup>6</sup>

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2. *Id.* at 152-55.

3. *Id.* at 265-66.

4. *Id.* at 152-55.

5. *Id.* at 156.

6. *Id.* at 162-63, 169-71.

(3) The hair-splitting division of power (hence, tangible interests) among the various government ministries, as well as central and local governments and business entities.<sup>7</sup>

(4) The unconstitutional, and ultra vires, delegation of power by the State Council to the State Council Securities Policy Committee (SCSPC) with regard to the formulation of securities-related laws and regulations, and to the China Securities Regulatory Commission (CSRC) with regard to its regulatory and enforcement power.<sup>8</sup>

(5) The establishment of a draconian agency—the CSRC—with extensive regulatory power that is neither subject to the checks and balances of the administrative appeal nor the judicial review process.<sup>9</sup>

(6) The creation of a public offering approval system that stands on its own head, primarily because of Catch-22-type requirements for companies aspiring to issue shares to the public. The system also purportedly predetermines candidates, a practice that vitiates any necessity for a system of approval based on merit or quality of a company.<sup>10</sup>

(7) The creation of a listing approval system that gives de facto approving power to the CSRC without subjecting it to any liabilities.<sup>11</sup>

(8) The institution of a wasteful, inefficient, unfair and irrational lot drawing (plus mandatory underwriting) system for public offerings that promotes gambling; a system that deprives the company of capital as potential investors spend money on lottery tickets that could otherwise go to the company. The lottery system also forces new investors to pay unreasonably high prices for their new shares.<sup>12</sup>

(9) The institution of an ineffective and anti-market stock-offering quota system.<sup>13</sup>

(10) The unreasonable, controversial, and self-serving mandatory use of legal, accounting and other professionals

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7. *Id.* at 166-69.

8. *Id.* at 171-78.

9. *Id.* at 177, 236, 237, 263.

10. *Id.* at 181-86.

11. *Id.* at 186.

12. *Id.* at 187-97.

13. *Id.* at 196-97.

as a part of the approval system—a practice that creates conflict of interests and encourages corruption.<sup>14</sup>

(11) The artificial classification of company stocks by virtue of their holders' legal status as opposed to the intrinsic characteristics of the stocks themselves.<sup>15</sup>

(12) The irrational permission given to the promoters of the company to subscribe to the company stock at a substantially lower price than that for the general investing public.<sup>16</sup>

(13) The false assumption that the division of power between ownership and management, resulting from corporatization, could lead to a more efficient economic system (and that freedom of contract is thus infringed upon).<sup>17</sup>

I could add more to this list, but the absurdity of the unreasonable man is sufficiently exemplified in the above. I will try to respond to these critical comments in the rest of this Article.

## II. PUBLIC OWNERSHIP

The question of whether the corporatization experiment serves to preserve and (or) strengthen "public ownership" in China has indeed been one of the key concerns of the leadership of the country, as well as regulators, professionals, and scholars. Anyone remotely connected to the process recognizes this fact and can see that the short history of the experiment has been characterized by several pendulous swings in both the political and economic arena.

It was only three years ago, in 1992, when China's patriarch Deng Xiao-Ping made his famous southern tour calling for a "deepening of reform" and said that the stock market "experiment" should be permitted. At that time, Mr. Deng also stated his rationale for the experimentation: "we can always close it if it does not prove to be conducive to our socialist market economy." Deng's words have been quoted several times by some of the most conservative party leaders who view the stock markets as a negative influence. This faction wishes to restrict the growth of China's securities industry, as part of an overall effort to retreat from the privatization process, because it

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14. *Id.* at 197-98.

15. *Id.* at 199-212.

16. *Id.* at 193-96.

17. *Id.* at 263-65.

is one of the major components of China's current economic reform program. It is worth mentioning that the conservative forces, which just a few years ago were a formidable faction in the Chinese leadership, are dying out and have now been reduced to a whisper.

During the years since 1978—a period of reform and one marked by a rather liberal open-door policy—there have been significant incongruities between official policy and practice. This stems from a political environment where leaders have to be cautious about implementing new reform measures, if they wish to maintain their political well-being. Frequently, what is stated does not necessarily indicate the true belief of the policy makers at the time, but is necessary in order to implement the true reform measure. This approach basically assumes that the means justify the ends. Such tactics are a reflection of strategic and tactical compromises at particular historical junctures. The adoption of the so-called “public ownership” criterion is just another example of such historical compromise.

To most people involved in the process the political ramifications of the stock market experiment have become more or less irrelevant. This is due to the proclamation, by Mr. Deng (the ultimate designer of the party policies) that it is best to postpone the great debate over the wisdom of adopting a short-term capitalistic approach versus a socialist approach and leave it to future generations. The most important reason given by Mr. Deng to support this policy decision is an economic one. This decision was made in the hope that economic growth can be maintained at a level at which the social and economic problems that are a direct result of reform can be controlled, or, better yet, solved.

Some of the more obvious and threatening issues that have emerged during the reform process include the cleavages between the central and local governments, the growing disparity between the rich and the poor, and corruption. For these and other reasons, it has become almost a habit for policy makers, especially more liberal officials, to justify their policies by citing politically correct concepts, rather than addressing the substantive issues. After a while, such debate is no longer a pretence but becomes a self-fulfilling prophesy for the Party and the State. These issues, compounded by the necessity for policies that promote continued economic growth, pose serious concerns for any leader in a society as geographically and demographically enormous and as economically and educationally destitute. One is constantly reminded of the two thousand year old

Chinese saying that "the fear of the state is not poverty, but inequality." Although any modern Chinese leader would like to keep solutions simple and make life easy for everyone, the political issue of the distribution of wealth is never more than just a few blocks away. The handling (and "mouthing," so to speak) of this and related issues, therefore, will always require great political dexterity.

### III. RETROACTIVITY OF LAWS

The retroactive application of laws, regulations, and government policies has occurred throughout Chinese history. Under the current regime, it was a practice that was often applied until the end of the Cultural Revolution (1976). Even though there is strong antagonism towards the practice of retroactive application as a modern legal concept, the question is not readily acknowledged in the Chinese constitution. While most members of the legal circle recognize the invalidity of this practice, it is still applied on occasion. While it is an important issue, it should not have been raised in the context of Fang's Article, because it is simply not a problem. Fang's Article, moreover, uses the term "retroactive" incorrectly.

The first example Fang's Article cites concerning retroactivity is the retroactive application of the Company Law. The State Commission for Restructuring the Economic System (SCRES), the State Assets Management Bureau (SAMB), the People's Bank of China and, later, the CSRC, joined hands in determining the legality of joint stock companies that were incorporated before May 1990.<sup>18</sup> Those "companies that existed legally before 1990, indeed which had been encouraged by local governments to form, found themselves bound by decrees that subsequently came into force."<sup>19</sup> This, according to Fang, plunged the issuing companies and shareholders into unforeseeable legal risks.<sup>20</sup>

Fang's Article then paints a more horrendous picture where a company has to go through various government agencies, each at a different time, in order for the company's legality to be recognized. Fang's Article suggests that this made it necessary for the issuer and the professionals working for the company to forge documents since

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18. *Id.* at 162.

19. *Id.*

20. *Id.*

no one could have possessed the foresight to know what today's legal requirements would be.<sup>21</sup>

From the point of view of someone who has been either closely observing or directly involved in the process, it is obvious that Fang's Article is confusing the issues involved. First of all, the so-called determination issue was not to establish the legality of those companies incorporated before a certain date—which, in fact, is December 1990, rather than May 1990—but rather the authenticity of the applicants who claim to have been incorporated before that date in order to take advantage of a pronounced state policy that grants priority to pioneer companies for listing on the stock exchanges. As for those companies that have been screened out during this process, their legality to exist and to do business with limited liability has never been threatened. The truth of the matter is, from a purely legal point of view, the Chinese legal system never provided those companies with a possible venue to get listed on a big trading board (although it did not prohibit the buying and selling of their shares through other more discreet mechanisms). Thus, the shareholders bought their shares with an assumed risk, and presumed knowledge, that the trading of their shares, if possible at all, would be limited to certain venues.

One has to bear in mind the fact that the two stock exchanges, Shanghai and Shenzhen, were only opened on an “experimental” basis in December 1990. At that time, a total of thirteen companies were listed, eight in Shanghai and five in Shenzhen. By mid-1990, the People's Bank of China and SCRES had issued several ordinances prohibiting local governments from allowing more companies to incorporate locally. This move put both the companies and their shareholders on notice that a more stringent, centralized incorporation and listing policy was on the way.

This policy of favoring the pioneers and thus discriminating against the “late-comers” is especially clear if one looks at the price differential between the Initial Public Offering (IPO) and the time of a given company's listing (an entirely different issue to be dealt with later in this Article). This differential led to a “gold rush” by all the companies, real or fake, to get listed. An opinion exists that the policy should have allowed everyone to get on board, so as to eliminate any necessity to cheat. As a macro-economic policy this could have been implemented in the 1950s, and the market might be

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21. *Id.* at 193-98.

so mature today that we would not need to worry about the possible repercussions of "shock therapy" anymore. Unfortunately, this issue was not at the top of Mao's agenda, and obviously it is too late now to discuss that possibility. If we simply allowed everyone to jump on board, the boat would sink with everyone on it.

Let us look at a few facts concerning Shanghai and Shenzhen, the world's youngest stock exchanges:

- 296 listed companies as of April 1995
- more than 360 products trading
- daily trading volume reached over RMB 18 billion (approximately U.S. \$2 billion)
- weekly trading volume over RMB 60 billion at the exchanges' peak swing

It took Japan and Hong Kong more than twenty years, and Korea and Taiwan more than thirty years, to reach these levels. Criticism of the government has been pouring in for allowing too many companies to get listed, thus diluting the thin capital market. The market regulators, meanwhile, are contemplating the tempo of IPO approvals, having to answer questions from both the market and planning-oriented factions. It has been suggested time and again by the professional regulators that the vetting function should be left to the stock exchanges to perform, and the State Council has been considering that option. However, the possible delegation of that power was made much more difficult by the Company Law which requires approval of not only all public offerings but also all listings of public companies by the State Council Securities Regulatory Agency. The most important reason given by the law makers for that provision is that the exchanges are no better than any of the government agencies, because they are regarded as part of the local governments and act in the provincial interests of the localities rather than the overall long-term interests of the general investing public.

It is also worth noting that SCRES and CSRC made their decisions concerning the authenticity of the so-called pre-1991 joint-stock companies primarily on the basis of historical documents filed with SCRES in late 1990 by the local governments for statistical purposes (more or less on a voluntary basis). For some of the local governments to now claim that there should have been more of those companies filed with SCRES is not only unfair to most other localities, but also would open the door to forgery and deception at a time when

a determination in the affirmative could mean a windfall of tens of millions of yuan for the company.

#### IV. DIVISION OF POWER

Fang's Article indicates three sets of problems with regard to the division of power in the regulation of the companies and the securities market: (1) the turf battle among the central government ministries; (2) the tug of war between the central and local governments; and (3) the inappropriate delegation of the government's power to independent professional firms.

For those who have been working in the field, the competition for power among the different government agencies has been very much a way of life since the beginning. The same holds true for the corporate world in China. An unfortunate result of this phenomenon is the fact, that due to either ignorance or turf wars among agencies, the Company Law does not address the whole issue of overlapping and conflicting systems of approval and enforcement authorities as recognized by the now-defunct experimental system. The Company Law leaves the issue of overlapping approvals in a rather nebulous state, by not specifying the appropriate authorities in instances where it should. The securities regulations have similar, if not more serious, problems due to certain historical reasons—in fact, the necessary consensus for the opening of the stock market would never have been achieved without compromises made among certain historically powerful government agencies. Fortunately, these kind of inadequacies may still have a chance of being remedied through the pending Securities Law.

As for the conflicts between the central and local governmental regulatory agencies with regard to division of power, compromises similar to that at the central level were also made to the local governments. This was not due mainly to the failure to recognize the necessity to centrally regulate the market, but rather a reluctance to alienate the local governments especially at a time of experiment that has contributed to the present growth of regionalism.

Competition is inherent in any power structure. I know of no legal system in history that does not contain some possibility for factional/bureaucratic in-fighting. More bureaucratic in-fighting can be expected in a system that has recently been created from an obsolete yet elaborate predecessor. The present corporate and securities regulatory framework in China allows too many different forces into play, making it a cumbersome, inefficient, and frequently

confusing system. Part of the problem can be attributed to the innate nature of bureaucracy; whereas in other respects it is simply the work of necessity, that is, measures taken in order to pacify different bureaucratic forces that feel threatened by the deepening stages of the reform.

The third problem addressed by Fang's Article with regard to division of power is really a matter of varying conceptions. Professional services such as those offered by law firms and accounting firms are universally regarded as necessary for the protection of various interests involved in the public offerings of corporate securities. It is therefore a mandatory requirement for the issuers of corporate securities to hire professional firms (and pay them hefty fees!), either as a matter of investors' demand or as a matter of statutory obligation. In the case of statutory requirement, it may very well function like an approving authority since without such professional opinions, the offering could be blocked. However, such a requirement is not generally regarded as a governmental function, but rather a market function. The fact that there are now hundreds of legal and accounting firms in China licensed to provide securities-related services for foreign listings also refutes Fang's claim that the only purpose of this statutory requirement is to create jobs for lawyers.

## V. ULTRA VIRES DELEGATION OF POWER

If one tries to argue along political lines, as I have in the preceding paragraphs, the law becomes somewhat of a tangential issue. So argued, the law is but the reflection of factional or collective political will. This problem has a very different connotation as portrayed in Fang's Article: in Fang's Article, the political dimension is given definite legal status, and Fang appears to argue along the lines of constitutional power.

First, Fang's Article questions the authority of the SCSPC to formulate and draft securities-related laws and regulations. Fang's Article argues that this task should be left to the National People's congress (NPC), China's highest legislative body.

In the 1960s, the NPC delegated the promulgation of economic related laws to the State Council. Fang believes that the State Council does not possess the authority to further delegate such powers as in the case of the SCSPC with respect to the promulgation of securities-related regulations. Fang's argument has no logical foundation and no basis in reality. The State Council delegates the drafting of regulations to the relevant ministries and government

entities responsible for the particular section or industry. Recent examples of such practice include the promulgation of Regulations for Establishing Foreign Investment Companies, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the Guidelines for Foreign Investment by Sector, State Planning Commission.

In China, it is not uncommon for laws and regulations of first instance to be approved by the State Council without being passed by the NPC. While this issue presents a constitutional dilemma, it has never been challenged in the courts or questioned by the NPC (or anyone for that matter). Through its actions, the NPC has acquiesced to the authority of the State Council. As the issue of separation of power emerges in China's political structure, this may become an area of serious political debate. At this time, however, it is not.

Second, Fang's Article demands an answer for the delegation of governmental power (or the lack thereof) to the CSRC, which is presumably not a government administrative agency but rather a non-administrative organization under the aegis of the government.

The CSRC was established as the administrative, supervisory, and enforcement arm of the SCSPC. The CSRC does not have administrative status in name due to the urgent need for a regulatory body at the time of its formation. The architects of China's securities industry, both practitioners and policy makers alike, believed such a step was necessary if the market was to have any hope of developing in a healthy fashion. The current labelling of the CSRC is only that, a label. In fact, the CSRC is in every other respect an administrative body.

Fang's Article argues that as a result of the CSRC's labelling or "status," the body is not subject to administrative appeal and the judicial review process. While the CSRC has not been sued yet, civilians possess the right to sue the CSRC and threaten to do so on a daily basis. By the same token, the courts certainly have the authority to overturn any decision made by the CSRC and, in fact, have done so. A recent example of such a case was a decision made by the Hainan High Court in total disregard of CSRC policy.

It is worth mentioning in this context that the securities regulatory bodies in many other countries share similar status to that possessed by the CSRC. Examples include England, Hong Kong, and Italy, among others.

## VI. INITIAL PUBLIC OFFERING, LISTING APPROVAL, QUOTAS, AND THE NECESSITY OF PROFESSIONAL PARTICIPATION

Fang's Article characterizes the application procedure for an initial public offering as a process that is wholly unfair to the applicant. In fact, Fang claims that the process created through the interim regulations forces companies and professionals to lie. The Article contains a continuous stream of rhetoric regarding the process that is both pedantic and long-winded, reflecting little knowledge of the actual working process. While I could make extensive remarks in this area, I have selected the two points that I believe deserve the greatest attention.

First, I would like to address the importance of professionals. Chinese regulations do in fact require professional documentation in areas such as asset evaluation, auditing reports, and legal opinions. This practice is common in many other jurisdictions. Fang assumes that these professionals are hired to provide an opinion before the quota is granted to the applicant. In fact, the process involves give-and-take between the potential applicants and the relevant authorities. Only the companies that are short listed by the local government would even contemplate engaging the services of professionals. For Fang to accuse these parties of lying is pure imagination based on his own logic rather than actual experience.

The same problem applies to Fang's accusation that the applicants and underwriters sign an agreement before the company is granted an issuing quota. No agreement is actually signed, or even seriously contemplated by an underwriter or the company, until the company is given its quota and granted permission to offer shares to the public by the local government. The mandatory draft underwriting agreement exists for the following purposes: (1) to ensure that the parties involved are acting in accordance with the law, and (2) to ensure that the investors are clear regarding the relationship and interest of all parties involved.

Fang's Article correctly identifies a shortcoming in the listing approval process, but misconstrues both its origin and intention. Currently, a company that wants to make an IPO needs an accompanying listing approval. This rule makes it impossible for any company to issue shares without being listed on a stock exchange. This rule came into existence due to excessive concern for black market trading

of shares that was a common phenomenon at the time the rule was introduced in 1993.

## VII. LOTTERY SHARE DISTRIBUTION METHOD

The lottery system was established in 1990 after the exchanges were operational for close to a year. The system was implemented as a measure to solve one of the problems common to an emerging market in a state such as China: simply put, "crowd control." At the time the system was introduced, demand for new shares far outstripped supply, leading to illicit practices in share distribution at the time of IPO.

Prior to the establishment of the lottery system, subscribers with direct access to the company issuing shares would purchase large portions of the initial shares and resell them at a tremendous profit, thus depriving the public of direct access. In an ideal marketplace such profit making would be allowed. However, since such profit making in China would be attributable to monopolistic conditions, the continued existence of such a system would only perpetuate a monopolistic situation that is patently unfair to investors. The lottery system was established in an effort to level the playing field among initial investors.

The lottery system had some inherent flaws from the outset. One of the more serious problems associated with the lottery system was the hoarding of tickets. Such practice certainly did not promote the goal of achieving greater investor access and equality at the time of an IPO. In an effort to further refine the system, the practice of depository certificates was introduced. The certificates discouraged speculators from purchasing vast quantities of lottery tickets, because they had to have a bank deposit ranging from RMB 250-500 for each slip. Such a practice is unappealing to speculators because it reduces cash in hand. For Fang's Article to refer to the lottery system as a gambling contract with no foreseeable future represents a shallow and inaccurate analysis. Fang's Article is correct to say that a problem did exist as a result of the local governments' practice of grouping companies together for the lottery and restricting the number of tickets. The CSRC remedied this situation by prohibiting the latter practice in the Interim Regulations; the former practice was eventually prohibited through verbal warnings.

Fang's Article aside, Americans have often levied criticism at the Chinese for the institution of a lottery system, a criticism that is inappropriate given the current circumstances in China. The criticism

of the lottery system stems from a prevailing opinion in the United States, and elsewhere, that book-building (or free-pricing) is a better means of pricing and distributing shares at the time of an IPO. For the time being, the practice of book-building cannot be employed in China for the following reason: as a result of the quota system, the company would enjoy a monopoly in share distribution, and such a situation would cause great distortion in the price at time of the IPO. This practice would be both unfair to the investors, and would not be conducive to development of a mature market mentality. We will all be happy to see China's securities industry reach a stage where the quota and lottery systems can be abolished in favor of practices such as book building, but market development is a process.

### VIII. SHARE CLASSIFICATION

The classification of ordinary shares in China was ordained by no one and is a system that was developed more or less by default. Indeed, the system of privatization in China is a process and must be recognized as such. In this process, we are transforming companies that were established under one system, that of state ownership, and trying to privatize these entities.

Classification of ordinary shares is a temporary measure that will evolve as the system progresses. While there is some legitimacy to the criticism levied in Fang's Article, it is necessary to examine the reasons for the development of such a system as justification for its existence.

At the outset of the privatization process policy makers from a variety of government agencies did not consider the long-term ramifications of share classification. In fact, in discussing the early stages of the process it would be inappropriate to say that there was any collective consideration given to the development of the privatization process—it was indeed haphazard. In devising such a plan, the government failed to realize the fact that in order to maintain control of the state assets of the enterprises it was not necessary to make a portion of the shares non-tradable.

At present, the classification of shares is no longer an important issue subject to major debate. There is almost universal agreement that such a system should not exist; the problem lies in what the secondary market is able to tolerate. In the current environment, both political and marketplace stability represent the top priorities for the central authorities in China during this "succession" phase. Until the political transition surrounding the death of Deng Xiao-Ping is

complete, central authorities will not allow any measures that may cause turmoil in the marketplace, or elsewhere, to be introduced. Until the succession phase passes, one should not expect any major changes that could potentially affect social stability.

### IX. INITIAL INVESTORS' ADVANTAGE

Fang's Article has expressed grave concern over the issue of promoters' shares. It is true that the promoters "purchase" shares at a lower price than the investing public at the time of an IPO. Fang's Article clearly does not recognize such practice is universally accepted and has been established for very good reasons.

The risks assumed by the promoters are far greater than those incurred by the investing public. This fact holds true both historically and at the time of the public offering. Comparatively speaking, promoters in China are somewhat disadvantaged due to the existence of a number of rules that favor the investing public.

First, only companies with a profit-making record of three or more years are allowed to issue shares to the general public. That fact, coupled with the auditing rule that goodwill (reputation) of a going concern is not allowed to be calculated into the value of the company, leaves the initial investors (the promoters) with only one option to realize their gain for the risk taken: selling the company as a going concern rather than at its book value.

Second, the Company Law requires the promoters of a publicly traded company to refrain from selling their shares for at least three years from the date of public offering. Presumably, such a measure is meant to give the investing public greater confidence in the company.

Furthermore, the promoters' advantage is a natural function of the marketplace. In China the promoters do possess a certain advantage as a result of short supply, primarily due to the temporary quota system. It should not be forgotten that in almost all newly developed markets, demand always outstrips supply. It is only fair that the promoters be permitted to sell their company at a price higher than book value. If the promoters did not possess such an advantage, little incentive would exist for enterprises to transform themselves into share holding companies.

### X. SEPARATION OF OWNERSHIP AND MANAGEMENT

Fang's Article questions the wisdom of China's current policy that attempts to separate the ownership from the management of a

company. The most efficient companies, Fang argues, are the Taiwan and Hong Kong family owned and operated companies. Fang's Article suggests freedom of contract and abolition of excessive and wanton government interference as a solution for the non-efficient companies. While I do not purport to be an expert in either economics or business administration, I would like to respond simply in terms of historical logic and the virtue of the law.

Fang's Article claims that the separation of ownership and management has failed to produce greater efficiency, and is not necessarily an appropriate structure for Chinese companies. Fang's Article cites examples of ten listed companies that have not performed well as joint-stock companies. The foundation of his argument being that the transformation has brought about little change in management style. Fang's Article thus insinuates that these companies reflect the management and performance situation of all joint-stock companies, vitiating the necessity of establishing joint-stock companies.

Fang's Article states that all the institutionalized rules and habits embodied in the SOEs have been incorporated into the joint-stock companies. While there may be some residual rules and habits that carried over from the former system into the newly formed entities, Fang should recognize that such a transformation is a process, and that this process takes time. It seems only logical that companies that were established as private entities from the outset stand in an advantageous position because the ownership-management question was settled from the beginning. However, those companies making the transition should be commended for their efforts. Not only that, but the numbers show that several of the listed companies are indeed performing quite well. Further, even those companies that are not doing well are forced to report their performance accurately, and are made accountable to their shareholders. If the shareholders do not like what they see, there is no law preventing them from selling their shares.

Fang's criticism of wanton and excessive interference on behalf of the government is irrelevant to the management/ownership question. Of course, everyone, including the government, denounces excessive and wanton interference in the management and operation of SOEs. In fact, authorities are obsessed with the issue of reforming SOEs and making them self-sufficient independent operators that respond to the needs of the marketplace. For the past fifteen years the government has been moving in this direction; in more recent

years the pace has been accelerated. I must emphasize the point again, that the transformation of a system, inclusive of all sectors, that is wholly based in state ownership to one that functions by the rules of the marketplace, takes time and effort. China's efforts to promulgate a bankruptcy law are a further indication of the seriousness of intent. Likewise, the enactment of the State Owned Industrial Enterprise Law, reduces the government's level of interference in enterprise management to an absolute minimum. Also, as China prepares to enter the World Trade Organization it will be forced to quicken the pace of enterprise reform in order to compete in a barrier-free trade regime.

As far as the issue of family ownership and management is concerned, let us recall the origins of China's current regime. One of the more important objectives (and a reason for the success of the Chinese revolution in 1949) was to overthrow a feudalistic society where a few corrupted families controlled the economic (and political) lifelines of the whole country. The ensuing socialist movement to nationalize the economy greatly boosted the morale of the masses, as well as the efficiency of the companies for a period of time. The establishment of a national system of state ownership proved to be a temporary solution, pulling China out of a very difficult period. However, this solution is no longer appropriate in such a comprehensive fashion. It is crippling the reform of the financial sector (a top priority of the State) and is costing the state vast sums of money to maintain. If a country has already experienced (or perceived to have experienced) so much hardship and disillusionment under other systems, it is only natural that it would want to experiment with something new. Viewed in this light, it is not surprising that Deng Xiao-Ping initiated an economic revolution, along with its policy of separating ownership from management.

Since China's demographic and geographic vastness does not allow the experiment to proceed too rapidly, it would seem logical to start reducing total control of the economy by the government in an incremental manner. This is the rationale for the current pace of the policy to separate ownership from management.

## XI. CONCLUSION

Fang's Article does not prove to my satisfaction that the present corporate and securities legal system is as problematic as the Article would have us believe. What is more significant is that Fang is either unwilling or perhaps unable to enlighten us with an alternative

solution under the present circumstances. One should not make general sweeping criticisms of an elaborate system without first familiarizing oneself with the system and taking into consideration all the relevant circumstantial factors. This is especially true when one considers the fact that the system is still being established and that it will necessarily undergo many changes in the years to come.