I. INTRODUCTION

The corporatization of state-owned enterprises (SOEs) began as a self-initiated experiment by a group of small-scale state enterprises. Later it became a limited experiment under the control of the government, and finally was allowed to spread to the entire country. From 1984 when the first joint-stock company was established in Shanghai, until 1993 when various provinces obtained quotas to openly issue shares, China has gradually formed a corporate law framework. This framework—which constrains company formation, financing, management, and the mechanisms for issuing and trading shares—comprises law (faliü), regulations (jigui), rules (guizhang), customary practices (guanli), and institutionalized state practices related to corporatization.

It is difficult to understand the current legal framework without taking into consideration its context. From the beginning, the transitional economy produced by China's economic reforms has been characterized by a series of intense conflicts: between the divergent...
orientations of market and planned economies; between the disparate interests of decentralization and re-centralization; between appeals for contractual autonomy and the persistence of state control; and between transplanted law and indigenous circumstances. Instead of accommodating the diversity of interests and varieties of circumstances while maximizing individual and local autonomy, the current legal framework aims to unify and normalize (guifanhua) by shaping this unprecedented nation-wide experiment to a previously designed system. The ambitious endeavor of legal normalization and unification results in an omnipotent state that mandates artificial transformation of social structure and individual life according to an ideal model designed by a select group of elites. This approach both replicates the features of a planned economy and totally disregards the possibility that the benefits will be substantially outweighed by the cost.

This Article is intended to elucidate a number of questions: Does this legal framework comport with China's goal of developing a "socialist" market economy? What influence has it and will it have on corporatization? Until now, has China depended on legal reform to form procedures and rules of behavior that differ from those during the time of a planned economy? What sort of influence will the Company Law, which took effect on July 1, 1994, have on the current legal framework? Are there new directions that will help China improve the current legal framework and resolve the problems created as China goes through the process of trying to find its way down the road from planned economy to privatization?

It is my firm belief that in exploring the above questions one must thoroughly study promulgated written laws and the background that produced them. But it is often unreliable to base one's description, analysis, and judgments solely on written law. In reality not all efficacious rules ineluctably become written law. This circumstance arises not simply because legislators cannot anticipate all the legal questions that may arise, but also because of the gap between reality and the written law. Written law that has taken effect is not in fact always efficacious, and concrete legal problems often are resolved by following rules that are outside the written law. Procedural questions are frequently settled by force of inertia (an organization or an organization's power). This sort of administrative influence will not disappear simply because a law has been issued. Moreover, the reliability of rules lies not in how they are expressed in legal provisions, but rather in whether they are helpful to people in resolving the actual problems that confront them. Therefore, this
Article gives equal attention to the legal questions raised by disputes among the participants in the corporatization experiment and to how these legal questions may be resolved. The Article also attempts to identify in the facts of the disputes, questions worth considering that the participants themselves have not raised.

Part II of this Article examines the formation of the legal framework in the course of the experiment in corporatization. Part III addresses the classification of stocks and the market accessibility of different kinds of stocks. Part IV considers the relationship between the shareholding rights and the power to control. Part V analyzes the litigation concerning Yuanye Industrial and Runtao, and thereby demonstrates how law becomes reality through adjudication. Part VI is an examination of the relationship between the Company Law and the prior legal framework as well as the extent to which the Company Law will change it. Part VII both concludes the Article and provides several suggestions for addressing some of the problems elucidated in this Article.

II. EXPERIMENTATION IN CORPORATIZATION AND THE FORMATION OF A LEGAL FRAMEWORK

A. Primitive Experiments and Local Legislation

In the mid 1980s the central government's decision to tighten the money supply forced state enterprises to find ways to raise funds other than through bank loans. One approach was through corporate restructuring. Some SOEs first reorganized themselves into "joint operations" (lianying) and then transformed themselves into "shareholding system enterprises" (gufenzhi qiye) open to investment by individuals. The earliest steps in this direction were taken during 1984 and 1985 by SOEs in southern China's Special Economic Zone of Shenzhen, in Shanghai, and in the northeastern industrial city of Shenyang.2
Compared to the so-called “standardized” companies, that is, companies listed in the 1990s under the Opinions on Standards for Limited Liability Joint-stock Companies (the Standards Opinion), these early experimental companies were distinguished by their dispersed stock ownership and small scale. For example, Yanzhong, Feile Audio, and Aishi—the three joint-stock companies incorporated in Shanghai—had total capital of RMB 5 million, RMB 500 thousand, and RMB 300 thousand respectively. The percentage of shares held by individual investors was 94%, 70%, and 69%, respectively. There are respectively 16,000, 500, and 300 individual shareholders of each

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General Principles of the Civil Law (promulgated in 1987), in fact include corporate, partnership, and contractual forms of cooperation. From 1980-84, 26,000 enterprises registered as “joint operation.” See Gongshang xingzheng guanli zazhi [Industrial and Commercial Administration] 1985, at 35. The very first enterprise in the country to issue shares to the public—Shanghai Feiyue Acoustics—was originally established in August 1980 as a “joint operation.”

The State Commission for Reform of the Economic System proposed that “among horizontal joint operation and collective enterprise groups and newly established enterprises, the share system should be promoted.” See Fagui Huibian [Compilation of the new laws and regulations of the People’s Republic of China], 1988, vol. 1, at 272. We can see that “joint operation” played an accelerating role in the development of the share system.

The favorite word of contemporary Chinese economics, share system (gufenzhi), is used as a juxtaposition to state-owned (guoyou) and collectively-owned (jiti suoyou). Suited to the reform of the state-owned economy, the share system is designed to carry out an ownership reform of state enterprises. See generally CHINA’S ECONOMIC STRUCTURAL REFORM: CHINESE LAW AND GOVERNMENT, Winter, 1989-1990; Han Zhiguo, LUN CAICHAN GUFENZHI [ON THE PROPERTY SHARE SYSTEM], 1988.

In many legal documents, the term “share system” is used without additional definition. The regulations of ministries and commissions under the State Council, for example, call both joint-stock companies (gufen gongsi) and limited liability companies (youxian zeren gongsi), “share system enterprises” (gufenzhi qiye) and fail to make a distinction between the two.

The regulations of the State Administration for Industry and Commerce (SAIC) treat “share system” as one of the nine forms of ownership. At the time of registration, a company must indicate whether the form of ownership is state, collective, private, individual, joint operation, share system, foreign invested, Hong Kong, Macao, or Taiwan compatriot invested, or other. SAIC, Guanyu jingji leixing guafende zanxing guiding [Temporary regulations on distinctions among economic forms], 1992.

At the end of 1994, China had a total of 7.92 million registered enterprises. Among them were 25,800 share system enterprises: 15,100 joint-stock companies (gufen gongsi) and 10,700 limited liability companies. Of the 15,100 joint-stock companies, 801 had listed their individual and B shares on the Shanghai and Shenzhen exchanges. NEW CHINA NEWS AGENCY, Feb. 7, 1995.

3. Gufen youxian gongsi guifan yijian [Opinion on Standards for Companies Limited by Shares] [hereinafter Standards Opinion], reprinted in CHINA’S NEW COMPANIES VOLUME I: NATIONAL FRAMEWORK at 11 [text is in Chinese and English] [hereinafter CHINA’S NEW COMPANIES].
company. Each shareholder holds shares worth about RMB 250 (face value) on average.⁴

Although few of the measures employed in the early local laws and regulations to regulate and control joint-stock companies have been retained in the current legal framework, these flexible practices provided a relatively forgiving environment that helped to transform struggling, small enterprises into joint-stock companies. To underscore the later retreat from these more open rules, it is worth noting the beneficial elements that distinguished them from the "standards" implemented in the 1990s by the central government.⁵ Under the old system:

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⁵ In this Article, "laws and regulations" (fagui) and "rules" (guizhang) have the same meaning as similar terms in the 1979 Difang renmin daibiao dahui he difang renmin zhengfu zuzhifa [Organic Law of Local People's Congresses and on Local People's Governments], the 1987 Xingzheng faguizhiding chengxu zanxing tiaoli [Temporary Rules for Procedures in Enacting Laws and Regulations], and the 1990 Fagui, guizhang bei'an guiding [Regulations on Laws and Regulations, Rules, and Registers]. Fagui refers to local laws and regulations enacted by the State Council and to local laws and regulations enacted by the local people's congresses. Guizhang refers to rules established by the commissions, committees and ministries under the State Council and to the local rules established by local administrative agencies.

According to media reports, between 1979 and 1994 there were 260 laws enacted, i.e., written laws promulgated by the National People's Congress and its Standing Committee, 1200 administrative regulations, more than 3000 local laws and regulations, and more than 20,000 central government ministry and commission rules. Because the boundaries between the legislative and executive authority of the central and local governments are not clearly drawn, the disruptions of conflict of laws has become a serious problem in China's legal system. Thus, in 1994, the Standing Committee of the National People's Congress enacted the Law on Legislation to establish the validity of various types of law and draw clear lines of legislative power. See Wang Wen, Legislative Law, Law over Law, ZHONGGUO QINGNIAN BAO [CHINA YOUTH DAILY], Feb. 21, 1995, at 5.

The Law on Legislation evidences the vicissitudes of China's legislative power—concentration, dispersion, reconcentration. The 1954, 1957, and 1978 constitutions all concentrated legislative authority in the National People's Congress. Other than areas with concentrations of national minorities, local governments had no legislative power. The 1982 Constitution, however, confirmed that provincial level people's congresses and their standing committees possessed the authority to enact local rules and regulations. In 1986, the revised, Organic Law on local people's congress and local level people's governments further enlarged local government's legislative authority. This dispersion of authority reflects the thinking of Deng Xiaoping, who, in a December 1978 speech, recognized, "some laws and regulations can be enacted first at the local level and then after undergoing summarization and improvement be enacted as national laws." See DENG XIAOPING WENXUAN [COLLECTED WORKS OF DENG XIAOPING], Renmin chubanshe, 137 (1983). However, this expansion has continued to worry the central government which is continually planning to reclaim some of the legislative authority.
(1) There were no status limitations on who could promote a company. Individuals, SOEs, collectively-owned enterprises, and foreign investment companies and overseas companies were all allowed to become promoters of companies.  

(2) The company's articles of association, and not the law, determined the maximum number of shares held by individuals.  

(3) Minimum capital requirements could be as low as RMB 50 thousand to RMB 100 thousand. These amounts were .05% to .10% of the paid-in capital of companies listed in 1992.  

(4) Shares prescribed in a corporation's articles of association need not be entirely subscribed and paid-in at the time of corporate registration, but could be issued several times after the incorporation.  

(5) State shares (that is, those held in the name of the state) need not all be common shares, though, conversely, some cities wanted to make the state's shares preferred.  

(6) Capital retained by companies on the basis of law or responsibility contracts (chengbao hetong) could be divided

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7. See GUIDE TO THE STOCK SYSTEM, supra note 6, art. 12.

8. See id. art. 9.

9. See id. art. 52.

10. "[W]ith regard to the state's shares in an ordinary share system enterprise, the state's shares may be preferred ones which are not involved in operational decisions but receive only a fixed amount of return on investment." Shanghai shi Gufenzhi qiye zanxing banfa [Shanghai Municipal Temporary Measures for share system enterprises], art. 25 (1988), reprinted in GUFENZHIDE LILUN YU SHUIAN [THEORY AND PRACTICE OF THE SHARE SYSTEM, PART 1] 250-55, 262-70 (Chen Jiagui ed. 1988) [hereinafter Municipal Temporary Measures]. "The state's shares are preferred shares; other shares are ordinary shares." Sichuan sheng, Shehui zhuyi gongyouzhi qiye gufen jingying zerenzhi shixing fang'an [Provisional Plan for Stock Management Responsibility System in Socialist Publicly-Owned Enterprises] art. 9 (1986), reprinted in GUFENZHIDE LILUN YU SHUIAN [THEORY AND PRACTICE OF THE SHARE SYSTEM, PART 1] 250-55, 262-70 (Chen Jiagui ed. 1988) [hereinafter Provisional Plan].
into “enterprise shares” (qiye gu). These were shares held beneficially by the corporation for its employees.\footnote{Sichuan Province’s method was this: capital formed by state enterprises before the 1983 policy of “profits converted into taxes” (li gai shui) reverted to the ownership of the state; capital formed thereafter was separated into two parts: (1) capital formed by using state allocated “floating capital” that enjoyed tax reduction or exemption became the state’s; (2) other capital reverted to the ownership of the enterprise.}

(7) Public offerings were not controlled by a planned quota, but could be made subject only to approval by the local branch of the People’s Bank of China, the central bank of the PRC.\footnote{See Municipal Temporary Measures, supra note 10, art. 10.} Because a company could either directly issue the shares itself or entrust to issue to the local bank, issuing costs were one percent or less of those in 1993.

(8) After incorporation, at least on paper, the new company was freed of its former subordinate relationship to administrative agencies in charge of that industry (hangye zhuguan bumen).\footnote{See Municipal Temporary Measures, supra note 10, art. 26; Provisional Plan, supra note 10, art 26. The planned economy in China formed this as yet substantially unchanged control system. Above every state or collective enterprise, there is an administrative agency in charge (xingzheng zhuguan bumen), which is the state’s agent, wielding government power and serving as a parent (literally, mother) company (mu gongsi) that participates in the enterprise’s policy making. The division of enterprise control authority between the national and local governments was not arranged by law but has de facto evolved over the years. The central government’s enterprises are controlled by the relevant ministry or commission under the State Council, while the relevant departments (ting) and bureaus (ju) of provincial and local governments control their own enterprises. Mao Zedong once referred to this system as “breaking things into pieces” (tiaokuai fen’ge).}

(9) Registration of the new company was subject only to the consent of the supervisory agency and the approval of the municipal government.\footnote{Shenzhen tequ guoying qiye gufenhua shidian dengji zhuce zanxing banfa [Interim Measures of the Shenzhen Special Economic Zone for Registering State-Owned Corporatization Experiment Enterprises, arts. 8, 49, (1986)], 1988; see Zhongguo fagui, guizhang huibian [COLLECTION OF CHINESE SECURITIES LAWS AND REGULATIONS AND RULES] 141-44 (Shanghai Share System Enterprises Joint Committee ed.) (1981-1992) [hereinafter SECURITIEs LAWS].}

To be sure, some of the local rules from the period of experimentation have been amended and accepted in the central government’s corporation scheme: for example, the separation of state, legal person, and individual shares according to the identity of the holder.\footnote{Municipal Temporary Measures, supra note 10, arts. 3-7.} However, as we shall show in the next section, the central government...
found the absence of a universal matrix, negligible mandatory rules, and predominance of optional clauses an unsettling consequence of local regime control. It therefore set out to reign-in the experimentation.

B. Legal Measures Enacted to Restrain the Spread of Experimentation

1. Background for Restraints. For experiments in corporatization of state enterprises to exist lawfully, they had to pass a two-part ideological litmus test: First, did they take public ownership as the base? Second, did they “preserve the leading role of public ownership,” or, as this phrase was often taken to mean, was the state the majority shareholder? Accordingly, the State limited the experiment in corporatization to certain sectors, and within these sectors made the termination or growth of the experiments contingent on whether they weakened or strengthened the leading role of public ownership.

Accordingly, between 1987 to 1992, the Central Government adopted measures to ensure the leading role of public ownership and thus limit legal experimentation in regard to incorporating SOEs. The Central Government’s actions manifested the sharp ideological disputes engendered by corporatization as well as the Chinese’s economy’s entry in 1989 into a period of “rectification and consolidation” (zhili zhengdun). As an apparent cause of the dispersion of financial resources and reduction of central government income, stock issuing became one of the important foci for rectification and consolidation.

2. Legal Structures Formed by Restrictive Measures.

a. Differential Treatment of Dissimilar Kinds of Companies. One of the chief measures adopted to prevent undermining the foundation of public ownership was to strictly limit the open issuance of shares while appropriately developing employee shareholding by employees and actively encouraging legal person shareholding.

In March, 1987, the State Council issued an administrative order prohibiting SOEs from issuing shares to the public. The order mandated that enterprises that had been approved as “experimental units” should be inspected by local authorities. The order further determined which branch of government would review the subsequent issuance of shares by these SOEs. Issuance of more than RMB 30 million shares would be subject to approval by the Head Office of the
People’s Bank; issuance of less than RMB 30 million shares would be subject to approval by the local branch of the People’s Bank.\(^\text{16}\)

In May, 1990, the State Commission for Restructuring the Economic System (SCRES) formally proposed guidelines for differential treatment of dissimilar types of companies. These guidelines provided for active experimentation where enterprises hold each other’s shares but limited experimentation in the issuance of shares where internal employees held shares. The guidelines further provided for systematic experimentation in Shanghai and Shenzen, leaving experimentation elsewhere squarely under control of the central government.\(^\text{17}\)

b. Appropriately Developing Employee Shareholding. SCRES policy in regard to employee shareholding changed by the year. In 1989, employee and legal person shareholding were on par as the main forms of experimentation in corporatizing SOEs.\(^\text{18}\) In 1990 and 1991, SCRES stopped experimentation while concentrating on improving existing experiments.\(^\text{19}\) However, in 1992, SCRES determined that there should be a planned incremental expansion in the scope of experiments in employee shareholding.\(^\text{20}\) In the

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\(^{17}\) Guojia tigaiwei, guanyu zai zhili zhengdunzhong shenhua qiye gaig4 qianghua qiye guanlide yijian [Opinion of the State Commission on Reform of the Economic System Concerning The Deepening of Reform and the Strengthening of Enterprise Management During the Correction and Consolidation], \textit{Renmin ribao} [People’s Daily], June 13, 1990, at 2.


following year, 1993, the SCRES tightened its control over employee shareholding practices. Most recently, in February of 1994, the State Council decided to “temporarily suspend the issuance of internal employee shares.”

c. Actively Fostering and Aiding Legal Person Shareholding.
SCRES has consistently adopted a policy of encouraging and assisting legal person shareholding. The focus of encouragement and assistance fluctuated among different kinds of legal person shareholding organizations. SCRES, at different times, emphasized joint-stock companies, enterprise groups, and limited liability companies. SCRES emphasis on legal person shareholding resulted in the emergence of 6,000 joint-stock companies established through “directed offerings” (dingxiang muji). These companies have issued approximately RMB 252 billion (face value) non-publicly negotiable shares. However, in June 1994, SCRES prohibited the establishment of new companies through directed offerings.

3. Central Government Organization in Charge of the Issuance and Trading of Stocks. Although in the mid-1980s the local measures regulating joint-stock companies all admitted the final approval power of the local People’s Bank branch in the issuance and trading of stocks, these measures also recognized that the private placement of shares to internal employees and other enterprises need not be subject to the approval of the People’s Bank. Furthermore, municipalities proceeded upon the assumption that local branches of the People’s Bank need not seek approval from the Provincial branches or headquarters of the People’s Bank when exercising their power to approve the issuance of stock.

The People’s Bank has since come to develop a highly centralized management system derived from the 1986 State Council Interim

23. Directed, or fixed channel, offerings are offerings made to a specific audience, such as legal persons.
25. ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], June 25, 1994, at 1.
Regulations on Banking Management. Article 5 of the Regulations empowered the People's Bank to administer stocks, bonds, and negotiable instruments as well as manage financial markets. The People's Bank's centralized management system has led to a shift in power away from the local branches of the Bank to the Head Office.26

By December, 1990, local branches of the People's Bank were deprived of the power to approve the public offering of any shares. In Shanghai and Shenzhen, the issuance of new shares by SOEs with outstanding public shares became subject to the approval of the local branch of the People's Bank. New initial public offerings are subject to approval of the Head Office of the People's Bank.27

The internal fund raising measures of enterprises were also brought under the unified control of the headquarters of the People's Bank. Provincial branches of the People's Bank are responsible for enacting the headquarter's rules at the local level. Provincial branches distribute the quotas for internal fundraising distributed by headquarters and exercise their assigned powers within the scope of the quota.28

The headquarters further exercises its authority by banning the establishment of securities companies or other financial institutions without its approval29 and by requiring that it approve the listing of shares by joint-stock companies in Shanghai and Shenzhen.30

In addition to the powers of the Head Office, the State Council has further centralized power over the Chinese securities market through the establishment of the "Working Conference on the Securities Market." This body—the highest level organization in charge of the securities market—is led by the People's Bank and includes members from the Ministry of Finance, the State Planning

27. Zhongguo renmin yinhang guanyu yan'ge kongzhi gupiao faxing he zhuanrangde tongzhi [Bank of China Notice Concerning Strict Control of Share Issues and Transfers], reprinted in id. at 164.
Commission, SCRES, and other central government departments. All
public offerings and listing of stocks are subject to the approval of the

Local regulations are established by the following governmental
bodies in accordance with the Organic Law of the Local People’s
Congress and Local People’s Governments of the People’s Republic
of China:

(1) The People’s Congresses of provinces, autonomous
regions, and municipalities directly under the Central
Government.
(2) The People’s Congresses of cities where the provincial
and autonomous regional people’s governments are located.
(3) The People’s Congresses of relatively large cities subject
to approval by the State Council.

The following authorities are empowered, under the same law, to
make local administrative rules:

(1) The administrative authorities of provinces, autonomous
regions and municipalities directly under the Central
Government.
(2) The administrative authorities of cities where the provincial
and autonomous regional people’s governments are located.
(3) The administrative authorities of relatively large cities as
approved by the State Council.31

The principal function of local regulations is to temporarily fill
the interstices left open by laws and administrative regulations
promulgated by the State Council. However, since these local
regulations may neither conflict with nor have precedence over laws
and administrative regulations, when relevant laws and administrative
regulations are promulgated, local regulations are supplanted, even if

31. *Zhonghua renmin gongheguo xingzhen fagui xuanbian* [*Selection of
Administrative Laws and Regulations of the People’s Republic of China*], Beijing:
Falü chubanshe, 1990, vol. 1, at 60 [hereinafter *Collection of Administrative Laws*].
they are not expressly invalidated.\textsuperscript{32} Accordingly, if in the course of administrative litigation a judge finds a lack of congruence between local regulations on the one hand and laws and administrative regulations on the other, she may discard the former and use the latter.\textsuperscript{33} However, local regulations carry greater authority than rules promulgated by ministries because the former, unlike the latter, may be the basis for a judgment.\textsuperscript{34} Still, it should be understood that, in theory, local rules are not to fill gaps but serve merely as implementing measures based on laws and administrative regulations in effect. If a local rule exists in isolation without corresponding law or administrative regulation behind it, its validity is questionable.\textsuperscript{35}

Invalidating a local regulation, however, is not as simple as one might expect. If the State Council doubts the constitutionality or legality of a local regulation, it may appeal to the Standing Committee of the National People's Congress (SCNPC) for a determination.\textsuperscript{36} Yet, though the SCNPC is the highest administrative authority in China, it lacks the authority to control a local legislature and may not nullify or amend a local regulation on its own.

\begin{itemize}
\item[32.] The special economic zones of Guangdong and Fujian provinces are an exception. Based on authority granted in 1981 by the Standing Committee of the National People's Congress, the legislative organs of the two provinces may, based on principles in laws, ordinances and policies, enact economic laws and regulations that apply solely to the special economic zones. Thus laws, policies, and regulations do not naturally supersede the zones' local laws and regulations. \textit{Id.}, vol. 2, at 2,645.
\item[33.] Zuigao renmin fayuan guanyu renmin fayuan shenli xingzheng anjian dui difangxing fagui yu fa yizhi he xingzheng fagui bu yizhide yingdang zhixing faltu he xingzheng faguide fuhan [Reply of the Supreme Court Stating that in Hearing Administrative Cases, if People's Courts Encounter Inconsistency between Local Laws and Regulations with National Laws and Administrative Laws and Regulations, They Ought to Carry Out the Provisions of the [National] Laws and Administrative Laws and Regulations]; \textit{SIFA WENJIAN XUAN [SELECTED JUDICIAL DOCUMENTS]}, Beijing: Renmin fayuan chubanshe, 1993, vol. 6, at 37. Zuigao renmin fayuan, guanyu renmin fayuan shenli xingzheng anjian dui difangxing fagui yu fa yizhi he xingzheng faguide fuhan [Supreme People's Court, Response Concerning what Courts Hearing Administrative Cases Should do When there are Problems for which there Legal Basis to Consult], Selected Judicial Documents, 1994, vol. 6, at 44.
\item[34.] \textit{Zhonghua renmin gongheguo xingzheng susong fa} [Administrative Litigation Law of the People's Republic of China], art. 53, § 1, \textit{reprinted in COMPILATION OF NEW LAWS, supra} note 18, 1989, no. 2, at 3.
\item[35.] Article 52 of the \textit{Difang geji renmin daibiao dahui he difangji renmin zhengfu zuzhi fa}, [Organic Law on Local People's Congresses and Local People's Governments] stipulates that "local administrative agencies may enact rules based on the law and on the administrative rules and regulations of the State Council." \textit{Guowuyuan yinhang guanli zanxing tiaoli} [Interim Rules on Bank Management], \textit{reprinted in COLLECTION OF LAWS SUPP. VOL., supra} note 16, at 785.
\item[36.] \textit{See} Guowuyuan fagui guizhang bei'an guiding [Regulations of the State Council on Laws and Regulations and Records], art. 8, \textit{reprinted in COMPILATION OF NEW LAWS, supra} note 18, 1990, no. 1, at 34.
\end{itemize}
On the other hand, because the State Council's administrative power is superior to that of the local administrative authorities, the State Council may nullify or demand the amendment of a local regulation when such a regulation is in conflict with an administrative regulation or a rule of a ministry or commission. Ministries and commissions under the control of the State Council may not themselves invalidate or demand the local administrative authorities to amend their local regulations, but may only issue orders to the relevant executive organs of the local governments.

In the course of corporatization neither these rules on restricting local rules and regulations nor the distinctions between central and local jurisdiction were completely observed. In 1987, the State Council stipulated that local governments had to amend their regulatory measures for the issuance of stocks enacted prior to 1987 and put them on record with the People's Bank. In May, 1990, a document issued by the General Office of the State Council (Guowuyuan bangongting) and SCRES actually nullified local regulations and rules governing the issuance of stocks and debentures. After May, 1990, the Central Government treated the approval of any public offering on the basis of local regulations alone as an ultra vires act and declined to recognize its validity.

Owing to this change, which retrospectively limited the effectiveness of local regulations and rules, issuing companies and shareholders faced unpredictable legal risks. The legality of companies whose offerings prior to May, 1990, had been based on local government approval now had to be reaffirmed by SCRES, the State Bureau for

37. Id.
38. See COLLECTION OF LAWS SUPP. VOL., supra note 16, at 350.
39. Guowuyuan bangongting guanyu xiang shehui gongkai faxing guipiaode.gif gufenzhi shidian wentide tongzhi [Notice of the Central Office of the State Council Concerning Problems in Share System Experiment Enterprises Issuing Stock to the Public], 1990; Guojia tigaiwei guanyu xiang shehui gongkai faxing guipiaode.gif gufenzhi shidian qiyechongixin shemipientongzhi [Notice of the State Commission on Reforming the Economic System Concerning Renewed Approval for Share System Experiment Enterprises Issuing Shares to Society], reprinted in GUFENZHI SHIDIAN ZHENGCE FAGUI HUIBIAN [COLLECTION OF POLICIES, LAWS AND REGULATIONS FOR SHARE SYSTEM EXPERIMENTS] (Shanghai Office for Reform of the Economic System ed., 1992) [hereinafter SHARE SYSTEM EXPERIMENT POLICIES]. In the aforementioned notice from the Central Office of the State Council, it was stipulated: "Other than the two stock exchanges at Shanghai and Shenzhen which have already been permitted to issue shares to society, all others which have been approved by local governments but which have not been through the approval procedures of the concerned ministries and agencies of the central government, must within the designated period report to the State Commission on Reform of the Economic System, the State Bureau for the Management of State Property, and the People's Bank of China to once again undertake approval procedures."
the Administration of State Assets (SBASA), and the Headquarters of the People's Bank before the issued shares could be listed on the Shanghai and Shenzhen Stock Exchanges. Thus, corporations which existed legally before 1990, indeed which had been encouraged by local governments to form, found themselves bound by decrees that subsequently came into force. Of the 100 companies targeted by the State Council decision, only 20 were permitted by the SCRES and the CSRC to be listed in 1993. At least for 1994, the others have lost the opportunity to even be considered, since in February of that year, the CSRC stopped accepting applications for listings filed by such companies.

5. The Leading Role of Public Ownership was Verified in the Corporatization Experiment. Public ownership is playing a leading role in the corporatization of SOEs. In 1991, while still a senior official at SCRES, Mr. Liu Hongru, who would serve both as a member of the State Council's Security Policy Committee (SPC) and from 1992 to March 1995 as Chair of the CSRC, confidently commented on SCRES' regulatory measures: "In all the provisions and measures we carried out regarding the shareholding experiment, the leading role of the public ownership is consistently stressed. So, undoubtedly, we can say, in the shareholding experiment, we firmly persist in the socialist direction."

The state of the shareholding experiment at the end of 1991 substantiate Liu's comments. There were 3,220 shareholding experimental enterprises in China, including both joint-stock companies and limited liability companies. Three-hundred and eighty are legal person shareholding companies (about 12% of the total). Two-thousand, seven-hundred and fifty-one are employee shareholding (86%). Eighty-nine are public offering (8%). The eighty-nine publicly offered companies had a total capital of RMB 5.810 billion, including 2.74 billion of State shares (47% of the total), 1.68 billion legal person shares invested by other enterprises, 830 million individual shares, and 560 million foreign capital shares. Clearly, even in the shareholding experimental enterprises that offered shares to the

40. See sources cited supra note 39.
41. Conversation with spokesperson of the CSRC on several policy questions concerning the current stock market, CSRC BULLETIN, supra note 22, 1994, no. 1, at 28.
general public, public (i.e., state) ownership continued to play a leading role.\footnote{Id. at 11.}

Transferring shares, however, is difficult. At the end of 1991, only 13 companies among the 3220 had legally transferable shares, and these had a face value of merely 200 million RMB. Shares may be transferred only on the Shanghai and Shenzhen Securities Exchanges. It should be noted that eliminating or limiting transferability of shares has created a dilemma: either continuing or ending this freeze permanently will produce a serious crisis in the markets. A further problem persists in the legality of publicly offered companies. Among the eighty-nine publicly offered companies, two-thirds have problems of legality. These companies are still seeking approval from the relevant authorities.

C. Expansion and Standardization of the Experiment

1. Background. During Deng Xiaoping's early 1992 tour of southern China, he spoke repeatedly of the need to accelerate reform. The expansion of the experiment in corporatization clearly echoed these remarks.\footnote{At the beginning of 1992, during Deng Xiaoping's progress through southern China, he publicly warned against the forces obstructing reform and called for expanding and accelerating the reforms. These remarks caused a dramatic shift in the stock markets of China. See Wu Xianman, Deng Xiaoping nanxunhou zhongguo gushide xin fazhan [The New Development of China's Stock Market After Deng Xiaoping's Southern Progress], ZHONGGUO ZHENGQUAN PINGGU [CHINA SECURITIES RATING], 1994, no. 2, at 12.} In January, SCRES presented a plan in its annual "Key Points of the Restructuring of Economic Systems." In the special economic zones in Guangdong, Fujian, and Hainan provinces experiments could be made in publicly offered shares not listed or traded on exchanges. The measures and amount of issuance were to be jointly examined and approved by the People's Bank and SCRES. In Shanghai and Shenzhen, the plan provided that the numbers of listed companies should be increased in a planned way. In other areas, the policy was to develop legal person shareholding limited liability companies, joint-stock companies, and enterprise groups. The scope of internal employee shareholding was to be expanded in a planned and incremental way.\footnote{Guojia tigaiwei guanyu 1992 nian jingji tizhi gaige yaodiande tongzhi [Notice of the State Commission on the Reform of the Economic System Concerning Important Points of Economic Reform in 1992], reprinted in COMPILATION OF NEW LAWS, supra note 18, 1992, no. 1, at 107.}
In April of 1992, SCRES and the Production Office under the State Council clarified the procedures for the examination and approval of the listing of shares. Outside of Shanghai and Shenzhen, the listing of any shares had to be examined and approved by the Working Meeting of the State Council on the Listing of Stocks.  

As the experiment expanded, the ministries and commissions began to promote a uniform and standardized corporation model. From May to December 1992, around ten ministries and commissions of the Central Government separately or jointly promulgated fourteen administrative rules formalizing the corporatization experiment. These rules covered joint-stock companies, limited liability companies, and the securities market within each governmental organ's jurisdiction. SCRES issued the two rules that drew the most attention: The Opinion on Standards for Limited Liability Companies and The Opinion on Standards for Joint-Stock Companies (Standards Opinion).

2. Unified Control of Ministry Rules

a. Authority and Applicable Scope of Ministry Rules. In China, binding documents issued by the ministries and commissions under the control of the State Council are called "ministry rules". As with local rules, the ministry rules must be based upon corresponding laws and administrative regulations. Departmental rules may not be used to fill in legal lacunae, except for the purpose of autonomously exercising their administrative functions within their delegated authority.

The scope of the departmental rules conforms with the jurisdictional scope of the particular ministry or commission formulating the departmental rule. If a ministry or commission is itself a vertical system (such as the People's Bank of China) and extends its power to

46. SHARE SYSTEM EXPERIMENT POLICIES, supra note 39, at 8.
47. The ministries and commissions included SCRES, the State Planning Commission, the Ministry of Finance, the Ministry of Labor, the Ministry of Personnel Administration, the Ministry of Material Supply, the State Land Administration, the State Bureau for the Administration of State Assets, the State Taxation Administration, and the State Scientific and Technological Commission.
48. Standards Opinion, supra note 3. As used throughout this Article, the abbreviation, "Standards Opinion," refers to only the Opinion on Standards for Companies Limited by Shares.
49. See XIANFA (1983) [Constitution], art. 90 (China); Zhonghua renmin gongheguo guowuyuan zuzhifa [Organic Law of the State Council of the People's Republic of China], art. 10; see also Zhonghua renmin gongheguo xingzheng fagui xuanbian, supra note 27, at 8, 58.
the local level by setting up branches, its departmental rules will be binding upon the whole system. If a ministry or a commission is not a vertical system of power with branches at local levels of government, it remains an open question whether this ministry or commission's rules are binding upon local governments. If in conflict with local regulations, ministry rules, as we have noted above, will be trumped.

b. Comparison Between Ministry Rules and Local Regulations. As argued earlier, the increasingly prominent role of central government organs in the corporatization enterprise led to stricter, more standardized rules. This point is particularly well illustrated by the way in which the Standards Opinion differs from local regulations of the 1980s. The Standards Opinion:

(1) Set qualification limitations on promoters of companies. Under the Opinion, individuals and private enterprises may not promote joint-stock companies.  
(2) Limits the quantity of individual shareholding. The shares held by individual investors may not exceed 0.5% of the outstanding shares of the company. 
(3) Requires a higher minimum capital requirement. The initial paid-in capital of a joint-stock company shall not be less than RMB 10 million. 
(4) Requires that, without exception, State shares shall be common shares. 
(5) Requires the promoter, before the company is established, make contact with the administrative department in charge of the line of business in which the company seeks to trade. 
(6) Allows that the procedures for approving the establishment of a company may involve the provincial government or the Central Government.

50. Standards Opinion, supra note 3, art. 10, ¶ 2, art. 24, ¶ 3, art. 12, ¶ 3, art. 24, ¶ 2, § 1, art. 13, ¶ 2, § 1.  
51. Id.  
52. Id.  
53. Id.  
54. Id. art. 13, ¶ 2. Gufenzhi qiye shidian banfa [Methods for Enterprise Experiments in the Share System], part 9 (stipulating that "[a]t the time a trial is approved, a controlling agency should be selected based on the operational scope of the trial enterprise.").  
55. Standards Opinion, supra note 3, art. 13, para. 4.
c. Ministry Rules and the Distribution of the Administrative Approval Powers. Examination and approval rights regarding the establishment of corporations are distributed among various central and local government organs. Though the language in the ministry rules concerning examination and approval rights are unambiguous, as we shall see the procedures for applying such approval are often vague.

The governmental bodies that may permit an enterprise to commence procedures to initiate or promote a company will only accept applications from companies that have received permission to apply from the administrative agency in charge of their trade or industry. This power may be called the permit to apply for initiation. This power generally belongs to the competent administrative departments in charge of the industry, unless the application involved a foreign invested enterprise is concerned, in which case, the power belongs to the Ministry of Foreign Economic Cooperation and Trade.

This request for permission to apply implies that certain of an individual's right in private and public law, have been absorbed by the administrative department in charge of the individual's industry or trade. Therefore, the individual may claim only those rights subject to the administrator’s consent. Thus, governmental organs which are obliged to protect the individual’s rights are responsible only to the competent administrative departments, not the individual possessing such rights.

SCRES, or provincial commissions for restructuring economic systems, hold the power to approve or refuse the application for

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56. An agency in charge of a trade or industry is a central or local government organ that within its authorized scope exercises governmental power in regard to all legal and natural persons in that trade or industry. Moreover, in matters outside its own jurisdiction that require approval by another government organ, it either permits or represents the legal and natural persons under its supervision in seeking approval from that other governmental organ.

57. Standards Opinion, supra note 3, para. 3.

58. In 1992, an ad hoc organization—the Office for the Joint Examination and Approval of Shareholding Experimental Units—was established in each province. The Provincial Commission for Restructuring Economic Systems is the core of the Office. See Fang Liufang, Approval Procedures for the Establishment of Companies in China, SOCIAL SCIENCE IN CHINA, 1993, no. 4, at 167-84. The benefit the examination and approval power provided to the officials of Commissions for Reform of the Economic System (CRES) is patent. In April 1993, the deputy director of the Shenyang Municipal CRES subscribed 74,000 yuan (face value) of a company before it was listed. After its listing, he sold 68,000 shares at 16 yuan a share, for a profit of 900,000 yuan. In 1994 he was indicted for accepted bribes. BAOKAN WENGAO
initiation (the most important permit needed for the establishment of a joint-stock company). Promoters of corporations may not apply directly to SCRES or a corresponding provincial commission for restructuring the economic system, even if the promoters have obtained consent of the competent administrative department in charge of the enterprise’s trade. The promoters must first submit an application to the local commission for restructuring economic systems. The provincial commission, before approving an application for initiation, often conducts an examination of the application in conjunction with other governmental organs such as the state assets bureaus, branches of the People’s Bank, and the Planning Commission.

Under the Standards Opinion, in addition to its right to permit initiation, SCRES’ permit rights include, but are not limited to: (1) transfer by directors and managers of shares in their names; (2) the acquisition by shareholders (other than the promoters) of more than 10% of the outstanding shares of the company; (3) the company’s redemption of its own shares; (4) the amendment of the company’s articles of association; and (5) the merger and break-up of companies. SCRES also has the power to instruct any company to correct any actions in violation of the Standards Opinion and to suggest that the State Administration for Industry and Commerce (SAIC) impose sanctions on offending companies.59

Other powers involved with the corporatization of SOEs are vested in various central government organs. The People’s Bank controls the permit power for the issuance of shares—whether or not an IPO—as well as the power to formulate and distribute issuance quotas. The State Bureau for the Administration of State Assets exercises the power to affirm assessments of state-owned property and to approve the transfer of state shares. It also participates in the examination of the application for initiation. Property powers are vested in the State Land Administration, which is responsible for investments involving the sale, transfer, or lease of the land use right.60


Where the initiation of a joint-stock company concerns a new construction project, or a SOE that formerly implemented the state's mandatory plan is to be reorganized into a joint-stock company, the State Planning Commission may possess the authority to issue the power of initiation permit. If the promoter is registered as a high-technology enterprise, the State Commission on Science and Technology will participate in the examination of the application for initiation. Only after promoters of corporations have obtained permits from other governmental organs will the SAIC handle the registration procedures.

In the current environment in which every agency urgently seeks to extend its bureaucratic power, this system of allocating powers to approve corporatization experiments encounters bureaucratic problems. It is almost impossible to accurately define the powers of a specific government agency since the power to issue a permit is defined by the government agency itself. Without subsequent recognition by the State Council, one agency's power does not have binding force over other governmental organs at the same level. Furthermore, governmental organs divide their permit authority into sub-permits so as to produce work for the organ's subordinate bureaus and departments. Governmental organs have also proven adept at creating permit procedures for newly developing areas not covered by existing permit powers. With the proliferation of new areas and the ever finer divisions within industries, conflicts among the licensing powers of different government organs appears to be a permanent fact of life. Thus, promoters of corporations must supplicate different government organs or apply to one government organ several times.

d. Retroactivity of Rules. Emerging companies in China need not only a "birth" permit, but also a permit for their continued existence. This is because the Standards Opinion and the administrative rules issued contemporaneously with the Standards Opinion all had retroactive effect. Whether a company registered before the rules

62. Guojia kexue jishu weiyuan hui [State Commission on Science and Technology], Guanyu zai guojia gaoxin jishu chanye kaifaqu chuangban gaoxin jishu youxian gongsi ruogan wentide guiding [State Commission on Science and Technology, Provisions on Several Questions Concerning Startups of Joint Stock Limited Liability High Technology Companies in State High Technology Industry Development Zones], reprinted in id., no. 4, at 301.
became effective could continue to exist after the rules entered into force depended upon whether the company's operations and structure matched the new rules. Thus, each new administrative rule is a threat to the continued existence of a company.

The experience of one company which was established in 1986 and had issued stock is illustrative. Between 1986 and 1994, the company faced four "checkups" and "reexaminations and reapprovals." The local government conducted "serious examination and checkup" to certify that the company was qualified to continue as a joint-stock company. During the 1988 to 1990 corporate "rectification and consolidation" (qingli zhengdun) process, the company was required to undergo further inspections by various governmental organs to re-register.

The company obtained the required permit to "continue as a shareholding experiment" (thus legalizing its continued existence), in May 1991, after surviving various examinations carried out separately or jointly by six central and local government organs. In gaining the legal imprimatur for its continued existence, the company went through several bureaucratic hoops. The company petitioned the Provincial Commission for Restructuring Economic Systems to affirm the registration it received five years before. After gaining the approval of the local Commission for Restructuring Economic Systems, the company was required to apply to SCRES for reaffirmation. It also had to submit an application to the provincial branch of the People's Bank, petitioning the Bank to affirm the company's share issuance completed five years before. After the provincial branch approval, the company was required to apply to the Headquarters of the People's Bank for reaffirmation. Furthermore, the company had to petition the local Bureau for the Administration of State Assets in order to affirm the transfer five years previously of state assets from the SOE to the joint-stock company. With the approval of the local Bureau for the Administration of State Assets, the company could then apply to the State Bureau for the Administration of State Assets and SCRES for their joint-affirmation of the company's legality.

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63. As demanded by Document No. 52, 1987 of the State Council.
64. See COLLECTION OF LAWS, SUPP. VOL., supra note 16, at 350.
66. See sources cited supra note 36.
The company faced another legal challenge when, in May 1992, five ministries and commissions under the Central Government jointly issued the "Measures for Experiment in Shareholding Enterprises," which demanded a "complete checkup of all the experimental shareholding enterprises according to the standardized requirements and re-application for examination and verification."\(^{67}\)

In order to list its shares in 1993, the company had to petition the State Council's Securities Policy Commission (SPC) to reaffirm the legality of its existence. Finally, in 1994, the CSRC (which is directly subordinate to the SPC) categorized these kinds of companies as "residual historical problems" and refused to accept their applications to list shares.\(^{68}\) If the rule of legal retroactivity controls, there is no way for anyone to judge whether or not a company that already lawfully exists may continue to exist lawfully. Nor is there anyway to judge either the validity of a government organ’s decision, or the length of its validity.

3. Reallocation of Permit Power and the Establishment of the China Securities Regulatory Commission.\(^{69}\) The months surrounding the release of the Standards Opinion witnessed the peak of the

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67. GUFENZHI QIYE ZUJIAN HE SHIDIAN ZHENGCE HUIBIAN, supra note 42.
68. Conversation with spokesperson of the CSRC on several policy questions concerning the current stock market, CSRC BULLETIN, supra note 22, at 28.
69. According to a December 17, 1992, notice issued by the State Council, the CSRC is not an administrative organ, but is an institution (shiyue danwei) belonging to the State Council's Securities Policy Committee. In 1994, the CSRC was listed as an institution belonging directly (zhishu) to the State Council. See CSRC BULLETIN, supra note 22, 1994, no. 1, at 1. This description specifically refers to the 5 organizations—the Academy of Sciences, the Academy of Social Sciences, the State Council Center for Research on Economic Technological and Social Development, the State Council Center for Research on Rural Development, and the New China News Agency—which all lie outside the jurisdictional authority of ministries and commissions, fall under the direct leadership of the State Council, and lack any administrative functions. See Guowuyuan, Guanyu guowuyuan jigou shezhide tongzhi tongzhi 1988 [State Council 1988 Notice Concerning the Establishment of State Council Organizations]. For an organization like the CSRC, which is under the jurisdiction of the State Council's Security Policy Committee and wields broad administrative powers, to be listed as "an institution directly belonging to the State Council," is an extraordinary precedent. The arrangement was made in order to allow the highest policy making levels to have a certain room for retreat: before sufficient experience has been obtained to create a stable management system, a relatively low level organization can be on the front lines exploring, while the Security Policy Committee can wait behind the scene until the time is ripe to concentrate power in its own hands.

In March 1995, the General Office of the State Council issued another notice formally fixing the CSRC internal structure and the limits of its authority. See CSRC BULLETIN, supra note 22, no. 4, at 1. The CSRC has been formally listed as an organization directly under the State Council.
People’s Bank’s power. In April 1992, the People’s Bank forced the Hainan Provincial Government to disestablish the Hainan Internal Stock Exchange Center. In May 1992, the Bank established an Office for Securities Administration and began to draft the Interim Regulation on the Management of the Issuance and Trading of Securities. Concurrently, SCRES was drafting a regulation of the same name. In June, 1992, the People’s Bank requested that other government organs conduct examinations and approvals of corporations in such a manner as not to exceed their authority and reiterated the bank’s exclusive control over the quotas for stock issues and the listing of shares.

Through the summer of 1992, the People’s Bank sought to protect its position as the most powerful government organ in charge of the corporatization experiment in China. In July 1992, the President of the People’s Bank convened the National Working Conference on the Management of Securities, including delegates from more than ten Central Government organs. This Working Conference, which supplanted the 1991 Working Conference on Securities Markets, established its permanent office within the People’s Bank and decided to organize the CSRC. Per the decision of the Conference, the CSRC was to have the character of a quasi-governmental organ (ban guanfang jigou). Vigorously guarding its turf, the Bank objected to establishing a committee above the CSRC, an idea then under discussion. The Bank concluded that, “under the current circumstances, it is unrealistic to set up a nation-wide unified

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70. The Hainan Internal Stock Exchange Center was organized by the Hainan Economic Reform Committee, the Legal System Bureau, and the provincial branch of the People’s Bank. It formally opened on March 26, 1992. Three companies’ common stock was traded, and 14 local securities dealers acted as the center’s members. In the roughly twenty days of the Center’s existence, the total value of trading was 130 million RMB, with the largest single day volume approximately 12 million RMB. Owing to opposition from the central office of the People’s Bank, the center was closed in the last week of April. The provincial government opened the center because at that time, Hainan already had five companies which had begun to issue stock to the public. These shares had no way of coming to the market on either the Shanghai or Shenzhen exchanges. Thus, if the stock was to circulate, there was no other choice but to open the center in Hainan. Interview with a leading official of the Hainan trading exchange, in Haikou, Hainan (May 1992).


72. Gupiao faxing shangshi bixu yang an chengxu shenpi [Issuing and Listing Stocks Must be Done According to Procedures of Examination and Approval], RENMIN RIBAO [PEOPLE’S DAILY], June 7, 1992, at 2.

73. This body succeeded the 1991 Working Conference on Securities Market.

74. RENMIN RIBAO [PEOPLE’S DAILY], July 4, 1992, at 1.
and centralized organization." The Bank felt that a national organization could be established when the securities market had matured. Clearly, a less powerful Working Conference better served the People's Bank's aim of maintaining its leadership role in developing the nascent securities markets.

The end of 1992, however, witnessed a diminution in the power of the People's Bank. On October 25, 1992, the State Council decided to disestablish the National Working Conference on the Management of Securities and organize the Securities Policy Committee (SPC) and the CSRC.

The duties of the SPC were defined in the December 17, 1992, Circular of the State Council, which delineated various ministries and commissions administrative authority over the securities markets. The SPC was charged with:

(1) Drafting laws and administrative regulations concerning the securities market;
(2) Researching and formulating guidelines, policies, and rules concerning the securities market;
(3) Enacting a comprehensive plan for the development of securities markets and making planning suggestions;
(4) Directing, coordinating, supervising and inspecting various departments involved with the securities market;
(5) Overseeing the CSRC.

The membership of the SPC is drawn from the People's Bank, SCRES, the State Planning Commission, the Ministry of Finance, the State Bureau for the Administration of State Assets, the SAIC, the State Tax Bureau, the Supreme People's Court, and the State Administration for Foreign Currency Control. Until now, the SPC has failed to become a permanent organization. Instead, it is a loose confederation of officials from Central Government ministries and commissions.

75. Id.
76. Zhengquan bangongshi fuzeren tan zhengquan guanli tizhi [Senior Official From the Securities Office Discusses the System of Securities Regulation], ZHENGQUAN TOUZI ZHOUKAN [SECURITIES AND INVESTING WEEKLY], 1992, no. 16, at 1.
77. Guowuyuan guanyu jin yibu jiaqiang zhengquan shichang hongguan guanlide tongzhi [Notice of the State Council Concerning Further Strengthening the Macro Regulation of the Securities Market], reprinted in COMPILATION OF NEW LAWS, supra note 18, 1992, no. 4, at 262.
According to the Circular establishing it, the CSRC—a non-official organization able to exercise governmental power only with the authorization of the SPC—does not itself possess the authority to issue administrative rules. Instead, the CSRC proposes and drafts "methods" concerning the management of the securities market. Such "methods" are made effective only after they are approved and promulgated by the SPC. However, the CSRC has broad supervisory and regulatory powers over the actual issue and exchange of securities. After May, 1993, the CSRC obtained the power to re-examine the issuance and listing of stocks—in effect, the power of ultimate approval.

Thereafter, other governmental organs no longer had the power to directly interfere with the securities market. However, the following governmental institutions do have roles to play in the securities market. The State Planning Commission is responsible for working out the volume of stocks and debentures to be publicly issued each year. The People's Bank regulates broker-dealers through permits to open and operate (although the CSRC maintains the right of supervision and control). Likewise, the Ministry of Finance is responsible for the administration of accountants and accounting firms, though accountants engaging in securities work are required to get an operation permit from the CSRC. The Shanghai and Shenzhen Securities Exchanges are governed by local people's governments, but are also subject to the CSRC's supervision.

The SCRES is responsible for the drafting of relevant laws and regulations for shareholding experiments as well as the organization and coordination of shareholding experimental enterprises. However, the powers to govern the stock exchange, which SCRES conferred upon itself in the Standards Opinion, are not recognized by the highest governmental authorities.

The December 17th Circular also substantially altered the permit system for the initiation of corporations specified in the Standards Opinion. The Circular specifies that the transformation into a joint-stock company of an enterprise directly subordinate to a ministry or commission of the Central Government is subject to the joint approval of the agency in charge of the enterprise's line of trade and the SCRES. Whether or not local governments' commissions on reform of the economic system may exercise the power of approval depends on whether the local government has granted them that authority. Even if they have received such authorization, it is not an
exclusive one and must be exercised jointly with the administrative agency in charge of the enterprise.

Two constitutional issues are raised by the Circular's regulations. First, may the State Council authorize the SPC to "draft" laws (faliü)? Second, may the SPC authorize the CSRC to exercise broad governmental power?

The constitution of the PRC invests the power to enact laws (faliü) exclusively with the National People's Congress (NPC) and its Standing Committee. The power to draft laws belongs to the Legislative Affairs Commission under the Standing Committee of the NPC. Except when delegated with such power from the legislature, the State Council may not exercise legislative power.

In April 1985, the NPC authorized the State Council to formulate "interim provisions and regulations" as part of "restructuring the economic system and opening up to the outside world." This authorization excluded the possibility that the State Council would draft laws. In 1992, the Standing Committee announced that it had placed the enactment of the Company and Securities Law on its agenda. The Legislative Affairs Commission and the Financial Committee—both subordinate to the Standing Committee—were drafting the Company and Securities Laws, respectively. Thus, it is problematic whether it is constitutional for the State Council to have authorized the SPC to "draft" laws governing the securities market.

The constitution of the PRC does not specify whether the State Council or its subordinate organs may authorize non-governmental organizations to exercise state powers. However, in China, the co-existence of governmental and non-governmental functions in a public entity was already widespread when the Constitution was enacted in 1982 and has not substantively changed since. Each public organization in China—whether a company, a school, or a association—is a subordinate unit of the competent administrative department supervising its affairs. Through their subordinate units, these supervising agencies extend governmental power into the daily life of

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78. XIANFA (1983) [Constitution], art. 58 (China).
every individual. Thus, the administrative departments and their subordinate units are mixed within one legal entity. Any effort to separate official from non-official organizations is meaningless. A public entity's exercise of governmental power in regard to its employees and branches is a de facto phenomenon. Unless there is evidence to the contrary, the situation should be presumed to be authorized by the government.

However, some specific powers of a governmental organ are not transferable. For example, a governmental organ at a certain level cannot authorize a non-governmental organ to issue directives to, or formulate written rules binding on, another governmental organ at the same level. The power of the SPC to coordinate the management of the securities market among the various government ministries and commissions cannot be delegated. In certain areas, where the authority of the SPC overlaps with the authority of other governmental organs, only documents jointly formulated and issued may have the binding force of administrative rules.

From January to March 1993, the CSRC jointly promulgated provisions on permits for engaging in the securities business by lawyers, accountants, asset estimate agencies, and auditors. Those ministries cooperating in jointly fashioning these rules were the Ministry of Justice, the Ministry of Finance, the State Bureau for the Administration of State Assets, and the State Auditing Office. The CSRC unilaterally exercised licensing power over the stock underwriting business, stipulating that the CSRC must reaffirm the People's Bank' issuance of a permit to underwrite.

80. These regulations are divided as follows: (1) Sifabu, zhengjianhui, guanyu congshi zhengquan fälü yewu lushi ji lushi shiwusuozige queren de zanxing guiding [Temporary Provisions Concerning the Confirmation of the Qualifications of law firms and lawyers engaged in securities law], issued by the Ministry of Justice and China Securities Regulatory Commission, 1993; (2) Cai zhenghengbu, zhengjianhui, guanyu congshi zhengquan yewude kualijishiwusuozhuce kuaijishi zige queren de guiding [Provisions Concerning the Confirmation of the registration and qualifications of Accounting firms and accountants engaged in securities industry work], issued by the Ministry of Finance and the China Securities Regulatory Commission, 1993; (3) Guojia zichan guanli ju, zhengjianhui, guanyu congshi zhengquan shiwude zichan pinggu jigoujigou zige querenyouguan wentide tongzhi [Notice Concerning Problems in Confirming the Qualifications of Property Appraisers and Property Appraisal Organizations that are Engaged in Securities Work], issued by the State Asset Management Bureau and the Securities Regulatory Commission, 1993; and (4) Shenjishu, zhengjianhui guanyu congshi zhengquan yewude shenji shiwusuozige querenyouguan wentide tongzhi [Notice Concerning Problems in Confirming the Qualifications of Auditing Firms Engaged in Securities Work], issued by the Audit Office, the Securities Regulatory Commission, 1993. CSRC BULLETIN, supra note 22, 1993, vol. 2, at 289-97.

81. Zhengjianhui [Securities Regulatory Commission], guanyu zai gupliao gongzhuxiong qianghua zhengquan chengxia oilishu he zhuanyexing zhongjie jiguouzuoyongde tongzhi [Notice
Ministries and commissions made great concessions to the CSRC, because of its gatekeeper role in the securities industry. With the exception of companies in Shanghai and Shenzhen, all other companies seeking to make public offerings and to list their shares must obtain final approval from the CSRC. And, if they want to attract clients, lawyers, accountants, assessors, and auditors need their qualifications recognized by the CSRC which may refuse to accept documents prepared by unauthorized professionals.

Under the current legal framework, whether professionals need to acquire a second permit in order to engage in the securities business, and wherefrom the permit shall be issued, ought to be determined independently either by the administrative department in charge of the trade or the trade association. However, the licensing provisions described above have created a precedent: if necessary, a governmental organ may formulate administrative rules jointly with a non-governmental organization to govern matters within the scope of its authority. In essence, this is a transfer of administrative rule formulation power by a governmental organ to a non-governmental organization.

Yet one cannot find in either China's current needs or in its legal system a justification for such a power transfer. When a governmental organ makes essentially a "blank check" grant of authority to a non-governmental organization, and permits the non-governmental organization to exercise this power broadly in matters of public interest, the governmental organ is relinquishing power it should exercise itself. This poses questions about the necessity for the governmental organ in the first place.

This analysis applies to the governmental organs that have granted the CSRC its authority. The CSRC exercises broad governmental powers, yet it is not bound by administrative or judicial review. A decision made by an agency reviewing a complaint against the consequences of its own prior grant of authority may be treated skeptically. However, a party who believes that a CSRC decision has violated its rights may only either seek administrative review by the SPC, or bring suit against the SPC under the administrative litigation law. An ultra vires action by the CSRC may victimize the party


82. Article 11, § 2, of the Xingzheng fuyi tiaoli [Administrative Reconsideration Regulations] states: "Applications for reconsideration of specific administrative acts of departments under the State Council shall come under the jurisdiction of the department which
affected and the SPC. However, under the Rules on Administrative Review and the Administrative Litigation Law, the CSRC, as a quasi-governmental body, cannot be subject to administrative review or be made a defendant in an administrative proceeding. This kind of delegation of power exempts the CSRC from any possible liability.


a. Origin of the Quota System. The Central Government is especially concerned with two factors in creating joint-stock companies. First is preserving public ownership. Second is placing the issuance of shares—the product of a market economy—under the strict control of a state plan.

Before 1991, it was unnecessary to establish a complex planning and control system for publicly issued shares, because the total shares publicly issued in Shanghai and Shenzhen was worth no more than RMB 200 million. However, in the last quarter of 1991, in what can be considered the first stock issue quota, the Working Conference on Securities Market of the State Council examined and approved the public offering of a total of 130 million shares by nine Shanghai companies. At this time, because the public offering experiment was limited to Shanghai and Shenzhen, the government was not faced with the problem of allocating share issuance quotas for the whole country.

The expansion of the public offering experiment engendered intra-governmental rivalries. In April 1992, SCRES decided to extend the corporatization experiment to Guangdong, Fujian, and Hainan. However, it did not make clear whether the application for public offering of shares had to be reaffirmed by the Main Office of the People's Bank after approval by the provincial branches of the People's Bank. From April to June 1992, a number of joint-stock companies in the cities of Anshan, Xiamen, and Chongqing issued public offerings after they had obtained approval from their local governments and local branches of the People's Bank. However,
The General office of the State Council issued a notice specifically criticizing this sort of local authorization.

Contemporaneously, the Main Branch of the People’s Bank released the quotas for public offerings and the procedures to apply for a quota. These guidelines provided that:

(1) The provincial branches of the People’s Bank shall, after consultation with provincial government organs, conceive and then submit for final approval to the Main Branch, annual plans for issuing shares and descriptions of those entities applying to issue shares;
(2) Based on these reports the Main Branch of the People’s Bank shall allocate an annual quota to each province for issuing shares;
(3) The provincial branches of the People’s Bank shall, within the quota allocated to the province, determine the size of each applicant’s issue;
(4) The provincial branches of the People’s Bank shall submit each applicant’s plans of issuance to the Main Branch of the People’s Bank for approval.

When an enterprise was not issuing shares to the public but only issuing its internal shares to its employees or other legal persons, the same set of procedures was to be followed, but with one exception. The plan for issuance had to be approved only by the provincial branches of the People’s Bank. This matches the method adopted by the People’s Bank to control state loans, one marked by centralized control of the totality of loans and levelled management of loan quotas. The People’s Bank still uses this method to control debenture issuance.

In May 1992, before the December 17 Circular restructured its role in the markets, the Main Office of the People’s Bank announced that the totality of shares issued might over fulfill the previously set 1 billion ceiling of issuable shares. The actual issuance quotas were

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85. See Gupiao faxing shangshi bixu yange an chengzu shenpi, supra note 72.
86. Guojia jiwei [State Planning Commission], renmin yinhang [People’s Bank], Guanyu faxing qiye zhaiquan shixing e’du shenbao shenpi banfade tongzhi [Notice Concerning Methods of Quota Reporting and Approval for Issuing Enterprise Bonds], COLLECTED SECURITIES LAWS, supra note 16, at 129.
87. In 1992 more than 1 billion shares were issued. ZHENGQUAN TOUZI ZHOUKAN [SECURITIES INVESTOR WEEKLY], 1992, no. 10, at 1.
about 1.5 billion. Because in 1992 Shenzhen and Shanghai alone issued to individual investors shares with total face values of 500 million and 400 million RMB, respectively, the quotas acquired by other provinces and cities were quite small. Even if they received the quotas, the other provinces and cities, specifically Guangdong, Fujian, and Hainan, could not implement the quotas until the relevant plans for share issuance were approved by the central government.

b. Quotas Allocated in 1993. The total amount of shares allocated for issuance throughout China in 1993 was 5 billion. This figure was set jointly by the SPC and the State Planning Commission and submitted to the State Council for final approval. The SPC and the State Planning Commission then allocated the issuance quotas to ministries and commissions with directly subordinate enterprises, to provinces, to autonomous regions, and to municipalities directly under the Central Government, thereby completing the first distribution. After acquiring their respective quotas, the recipients allocated the quotas to issuing companies.

The 1993 distribution of issuing quotas resulted in three, large-scale state, ministry-affiliated enterprises—Ma Steel (Magang), Shanghai Petrochemical, and Guangzhou Shipyard, acquiring issuing quotas for 1.35 billion shares, 27% of the national total. Quotas allocated to companies ranged from 10 million to 680 million (Magang). Quotas obtained by provinces, autonomous regions, and the municipalities directly under the Central Government varied from Xinjiang Province’s 50 million to 500 million for Shanghai, which, as a municipality directly under the Central Government, has the same status as a province.

Not all of the companies that received quotas were permitted to issue shares in 1993. Those companies located in places other than Shanghai or Shenzhen that had previously offered shares could use their 1993 quota only to offset earlier issuings, not to make new ones. For example, in June 1992 the Xiamen Oceanic Fishery Developing Co. Ltd., with the approval of the municipal branch of the People’s Bank, made a public offering of 10 million shares. The SPC

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88. In 1992, 53 Shanghai companies issued individual shares with a face value of 463,382,000 yuan. Among these shares, those from 9 companies should be considered part of the 1991 quota, so the 1992 quota was roughly 400 million RMB. See Shanghai guptao nian faxing liang [Yearly Amount of Shares Issued in Shanghai], SHANGHAI ZHENGQUAN [SHANGHAI SECURITIES], 1992, no. 37. In 1992, the total face value of shares which received permission to be listed was 1.5 billion RMB, more than 50% higher than the subscribed quota.
confirmed the legality of the issuance in May 1993, but conditioned its approval on the Xiamen municipal government's agreement that the 1993 quota would apply to shares issued in 1992. Had Xiamen not agreed, Oceanic Fishery could not have applied to list its stock on either the Shanghai or Shenzhen Securities Exchanges.

Thus, sometimes the issuance quotas were actually listing quotas. In 1993, around twenty companies successfully obtained issuance quotas but failed to issue shares. The total amount of shares actually issued in 1993 was around 4 billion, 1 billion short of the quota. This gap was compounded by the addition of still another requirement: the 1993 consignment of Treasury Bills from the Ministry of Finance had to be sold before a public offering could be made under a provinces', autonomous regions', or municipality's quota. By 1993, the issuance quota had become a fixed system and was inscribed in the Interim Regulations on the Regulation of Stock Issuing and Trading, which took effect in May 1993.

C. Contradiction Between the Issuance Quota System and the Application Procedures.

Comparing the procedures on the application for issuing stock and the de facto practices formed by quota control will help us to judge the answers to the following questions: Have generalized norms been established under the statutes? Are the allocation and reallocation of issuance quotas compatible with the procedures on application or approval? What parts of the currently valid law have become and integral part of the current norms and what parts exist only on paper? Which of the currently effective regulations has become an integral part of the practical legal framework?

Under articles 12, 13 and 20 of the Interim Regulations, applications for the public offering of shares are made in the following manner. First, before an application for public offering is made to a governmental organ of the local or Central Government, the application must meet certain requirements:

1. The applicant must be a joint-stock company, or have obtained permission to initiate a joint-stock company and registered the promotion with the SAIC;


(2) the applicant must have already retained experts to conduct financial auditing, prepare an assessment of company assets, and provide legal advice; the applicant must also have an auditing report, property assessment report, as well as a "document of confirmation" from the State Bureau for Administration of State Assets regarding the reports and legal opinions from lawyers; 

(3) the applicant must have an underwriting contract specifying the category and volume of the shares to be issued, their face value, their offering price, and the starting and ending dates of the offering. The underwriting period may not exceed ninety days. Furthermore, the applicant or its underwriters must produce a prospectus.

(4) the applicant must have acquired a permit for fixed assets investment.

Second, the governmental organ of the local government or the Central Government will, after receiving the issuance quotas, conduct an examination of the applicant. If the government determines that the applicant is properly qualified, it will agree to assign the applicant an issuance quota and approve its application for offering.

Third, the CSRC will carry out a re-examination of the decision of the governmental organ (either the local or central government) approving the application for offering. If the applicant passes the re-examination, it may apply to be listed on a securities exchange. After the exchange has approved the listing of the applicant's shares, the applicant may make the public offering.

However, getting to steps two and three is highly problematical, because, based on the rules and regulations in effect, no applicant can satisfy the four conditions in the first step.

If the applicant is an existing joint-stock company, it can issue new shares only after it has been established for twelve months. The issuance of new shares entails amending the company's articles

91. When preparing these documents, both the applicant and the experts must possess extraordinary foresight. Before the quotas of public offerings are granted, they must be sure that the employee shares issued months or years before do not exceed 10% of the issuance quota (the maximum number of shares that may be issued to employees), that the sum of shares issued and the new shares issued will not be less than 50 million shares (the minimum paid-in capital for listed joint-stock companies), that the subscription by the promoters may not be less than 30 million shares, and that all the shares previously issued by the company would not be more than three times the issuance quota.

92. Standards Opinion, supra note 3, art. 36.
of association, a process subject to the approval of the SCRES.\textsuperscript{93} SCRES' approval of amended articles of association could be construed as an ultra vires assignment of an issuance quota by SCRES, since the approval would permit the company to issue new shares. Rejection by the SCRES voids the underwriting contract.

This regulation has often been violated. I have read all the prospectuses of the forty-eight joint-stock companies in which a SOE has been the sole promoter (during the period of June 1992 to December 1993). The records show that, at the establishment of these companies, there has been only one shareholder—the State. The interval between the companies' establishments and their public offering is an average of twenty-three days. Thus, these forty-eight joint-stock companies, without exception, violated the provision that SOEs shall be transformed into joint-stock companies by raising initial capital through public offerings and shall offer additional new shares only twelve months after the establishment of the company.

If the applicant is the promoter of a joint-stock company and has registered the preparatory plan for establishing the company, the SCRES must have already approved the initiation application, which would have included the total volume of shares to be issued.\textsuperscript{94} This process means that after approval the issuance quota has been assigned and need not be applied for again.

Before the assignment of the issuance quotas, the applicant has no justification for conducting an appraisal of its property. Only after the administrative department in charge of the trade of the enterprise has applied to and received permission from the State Bureau for Administration of State Property, may the enterprise retain an appraisal organization.\textsuperscript{95} Because of the utter unpredictability of obtaining an issuing quota, applications for property appraisals made by enterprises before the quotas are issued will never be accepted.

The procedure for issuing shares includes many uncertainties. For example, before the assignment of an issuance quota, in order to produce a legal opinion on a matter that has not, and may never,
happen, the lawyer must make a choice between facts and fabrication, between professional ethics and money. Furthermore, the applicant and underwriters conclude an underwriting agreement and produce a prospectus before they know if they can get a quota, and if so, how large a quota. Other than manufacturing an invalid contract and a prospectus full of false and misleading information, the only other purpose of this exercise is to polish the parties' story-telling technique.

It is an even more difficult thing for the applicant to acquire permission for fixed asset investment before it has raised enough funds to begin operations. For example, a real estate company in Shanghai applied to construct a building. The process involved 28 governmental organs giving 98 official seals. Among these governmental organs, 18 would stamp more than two official seals, the most egregious of which attached 12 official seals. It will take a company at least one and perhaps as many as three to five years to complete this sort of complicated procedure.\(^9\)

Under the current system of issuing quotas, the problem is not how to apply for the public offering but how to apply for the assignment of a quota. In the case of applying for a quota, an applicant is unable to start its application until two conditions have been met. First, the issuance quota must be publicly allocated to the local government and the organs of the Central Government. Second, the governmental organs responsible for the reallocation of the quotas must publicly announce the qualifications for an application. These two conditions have never been satisfied, because the allocation and reallocation of issue quotas are processed in a surreptitious way. Enterprises submit their applications and produce their requisite legal and official documents, approval documents of government organs, and underwriting agreements before the company has an idea whether its locality could be assigned any quota. Unknown as well are the qualifications required for an application, and the starting time and deadline for the application. The applicant may, in defiance of the Interim Regulation, prepare the required documents for their application after the governmental organs have assigned the company an issuance quota. In my view, most companies will choose to defy the interim regulations and prepare applications after the assignment of quotas. Thus, the basic fact is that since at the time they allocate

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96. See *WENHUIBAO*, Sept. 8, 1991, at 3. In 1994, the State Planning Commission changed the project approval rules. A company may first be established and then the project reported.
the issuance quotas government organs have already selected the companies that will issue, the application system is moot. The quotas have rendered the statutory procedures meaningless.

Initial approval of the application for an issuing quota does not guarantee that the company will be permitted to make public offerings. The application must still be re-examined by the CSRC. A CSRC document provides:

> the application materials shall, after the examination, verification and approval of the local governments, be submitted to the Public Offering Division of the CSRC directly by the local government or underwriters authorized by the local government. . . . The CSRC will neither receive inquiries or materials directly from the enterprise nor have any direct contact with enterprises.97

Usually, it is the government body that has approved the issuing application that sends a letter to the CSRC affirming the applicant’s submission of its materials. Therefore, the applicant has no rights in this review process, and cannot present any additional information or explanation to the examiner. The CSRC reviews acts as a check on the legality of the local government and Central government decisions to approve the issuance applications.

The Interim Regulations’ provisions concerning application to list shares are indeed singular. First, they require the applicant and the securities exchanges to implement two contradictory directives. Article 12 provides that between the time its application to list has been reexamined and before it has issued shares, the applicant must further apply to a securities exchange to have its shares listed. Only after the exchange has accepted the listing may the shares be issued. This means that the CSRC conditions its approval for issuance on whether the securities exchanges have approved the listing of stock. Yet, on the other hand, under article 30 the first condition to be satisfied by a company applying to have its shares listed is that “its shares must have been issued to the public.” And article 81 defines “public issue” as “the making of an invitation to offer for an issuer’s shares, the making of an offer for an issuer’s shares or the sale of an issuer’s shares by the issuer to the public, other than the issuer, through a securities trading firm.”

Second, these conflicting provisions create a dilemma for the securities exchanges. On one hand, the exchange is required to

promise to accept a listing of stock when the offering of that stock has not started. The offering may fail or be suspended and cancelled; for example, some of the applicants have not yet established their company and there exists a risk that the company is never created, or the shareholders of an established company have not approved the public offering. On the other hand, the exchange must conduct examinations as to the listing applications according to the specified requirements in order to fulfill its obligations to public investors, yet these listing requirements cannot be determined before the public offering is made.

Third, the procedures and requirements for listing as provided in the Interim Regulations are completely incompatible with the procedures and requirements in articles 29 through 39 of the Professional Experimental Rules of the Shanghai Securities Exchange. These contradictions and conflicts can only lead to confusion for the applicants. Many questions arise as to the effect for each set of regulations. Which provisions should be binding on the applicant? Shall the listing procedures and requirements be stipulated by law or independently by the securities exchanges themselves? Is the application, and the acceptance of application, to list a contractual relationship for the company and exchange, or is it an executive relationship between the applicant and law enforcement organizations? In case of dispute, should contract law or the Administrative Litigation Law govern?

The Interim Regulations effectively grant the CSRC the power to examine the listing application without bearing any responsibility. Moreover, if the applicant fails to pass this reexamination, the governmental organ that earlier assigned the quota and approved the issuance application may withdraw the quota from the applicant.

5. Issuance Quotas and Transaction Costs.

a. Issuance Quotas and the Subscription Fee. Prior to 1992 and the new central government laws, Shanghai and Shenzhen issued shares by lottery. To enter the lottery, a subscriber would fill out a numbered lottery form obtained from the underwriter and pay RMB 400 in earnest money. The underwriter then provided an identically numbered subscription order receipt, which served as the lottery number. The unlucky got their earnest money back.

98. Collected Securities Laws, supra note 16.
In 1992, Shanghai and Shenzen publicly issued share subscription certificates and share subscription lottery forms, respectively (practices the SPC extended nationwide the following January). In January of 1992, the Shanghai municipal government sold 2.087 million share subscription certificates which were valid for the whole year and cost RMB 30 each. There was no maximum limit on an individual purchase and the sale netted a total income of approximately RMB 62.24 million. In 1992, Shanghai held four lotteries, none of which had a preset chance of success, and which, together, resulted in individual winners subscribing to roughly 400 million shares. 99

In August 1992, the Shenzen municipal government sold 5 million share subscription lottery forms, each of which was priced at RMB 100. It also sold 500 thousand share subscription lottery forms individually priced at RMB 1000. The income from the subscription sales totaled RMB 1 billion, equivalent to two times the face value of all the shares issued in Shenzen that year. Official corruption during the sale of the forms led to street demonstrations and bloody conflicts. 100

By 1993, the central government also adopted two other means by which one was selected to purchase stock. One method was unlimited subscription application forms. The second method was to connect subscriptions to savings accounts in banks. Of the 100 companies that issued shares in 1993, 98 used the former method. 101

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100. See ZHENGQUAN SHICHANG ZHOUKAN [SECURITIES MARKET WEEKLY], 1992, no. 6, at 3; ZHENGQUAN SHICHANG ZHOUKAN, 1992, no. 7 at 3.
101. See Zhengquan weiyuanhui Guanyu 1993 nian gupiao fashou yu rengou banfa yijian, supra note 89.
Table 1 shows that to buy one common share with a face value of RMB 1 in 1993, investors needed to pay RMB 3 to buy a subscription form. The subscription costs depended on the prefixed chance of winning and on the number of shares a subscription form entitled a purchaser to buy. Thus, among the 100 companies issuing shares in 1993, the chance of buying Xiamen Engineering Machinery Co., Ltd., shares was the lowest (only 0.00248%) and the cost of subscribing for one share with face value of RMB 1 was RMB 16. By contrast, the 4.485% chance of buying one share of Magang with face value of RMB 1 was the best, and the subscription forms commanded a commensurately lower price of RMB 0.4.\textsuperscript{102}

Lottery subscription is, in fact, a gambling contract with unpredictable risks for the participants. The gamblers’ opportunities to win decrease with an increase in the number of participants. In contrast, the banks have guaranteed profits which continue to increase as more individuals join the lottery.

The lottery also warps the ability of a purchaser to evaluate stocks and make an informed purchase. Potential subscribers have no information as to which stocks will be offered or in what quantity. Furthermore, when more of the shares of several different companies

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\textsuperscript{102} ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], Jan. 6, 1994, at 1.
are joined together for a lottery subscription, subscribers lose their right to choose a company in which to invest, and the role of securities investment in optimizing resource allocation is lost. Additionally, the application forms mix together high quality stock shares with junk stocks which end up being distributed per capita. The result is a system of stock purchasing which is not based upon the nature of the business, the company performance, general financial conditions, or policies that influence the investor's investment decisions. These decisions are instead made for them by the lottery, an uncontrollable, unpredictable force. It is therefore not the law of the market which controls capital distribution but a random gamble.

An additional problem with the lottery subscription is that it forces the subscriber to bear all of the risks which should be borne by the underwriters and issuer companies. If a subscriber is lucky enough to be chosen to purchase, he or she will be unlikely to pass on the opportunity, even when the stock offered is of questionable value. This is especially so, because the investor has paid several times the price of shares just to obtain this subscription opportunity. Since the purchase is almost certain to be made, the underwriters and issuer are not subject to any risk that an offer will not be successful.

The lottery system also artificially constricts the supply of stocks. The shortage effect that this creates drives the stock prices even higher, as was demonstrated in 1993 when the RMB 1 trillion in savings that had been excluded from purchasing the RMB 5 billion of initial offerings flooded into the narrow trading markets. Thus people are still willing to pay the high prices for the subscription opportunity in the issuance market, because the shortage effect makes the value of subscription opportunities exceed the property right included per share. The value in the subscription opportunities lies in the possibility of resale of the shares at much higher prices in the trading market. The unending upward spiral in stock prices stimulated by the high costs of subscription cannot be sustained in the long-term and must inevitably collapse.

Finally, the lottery system wastes too much paper. For example, Guangzhou City printed 300 million application forms, and only 120 million of them were sold. The extra forms were destroyed. Another example, 300 million forms were printed for the issuance of shares of the Tsingtao Brewery Co., Ltd., 280 million were sold, but only 180 thousand were lucky ones, thus reducing 298.2 million application
forms to worthless pieces of paper. According to estimates by securities market experts, the RMB 12.2 billion paid for this sort of lottery ticket is about 3 times the total face value of shares issued to the public in 1993.

b. Issuance Quota and the Underwriting Fee. Underwriting of shares would appear to be superfluous in a lottery subscription system. Direct issue of shares by the company to the lottery winners would seem a less wasteful choice. However, in both the Interim Regulation and the local rules, underwriting of shares is mandatory. This requirement forces companies to pay commissions for underwriting services, regardless of whether they were needed.

### TABLE 2: EXPENSE OF UNDERWRITING OF SHARES OF 11 LISTED COMPANIES IN 1993*

<table>
<thead>
<tr>
<th>Rank</th>
<th>Issuer's Name</th>
<th>Shares issued to the public (in million shares)</th>
<th>Price per share of 1 yuan par value (in yuan)</th>
<th>Commissions (in million yuan)</th>
<th>Ratio of commission to total par value of public issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Magang Steel</td>
<td>687.81</td>
<td>3.45</td>
<td>59.83</td>
<td>8.69%</td>
</tr>
<tr>
<td>2</td>
<td>Huaxin Cement</td>
<td>40</td>
<td>3.8</td>
<td>5.66</td>
<td>14.15%</td>
</tr>
<tr>
<td>3</td>
<td>Lizhu</td>
<td>13</td>
<td>6.38</td>
<td>1.88</td>
<td>14.47%</td>
</tr>
<tr>
<td>4</td>
<td>Mindong Electrical Machinery</td>
<td>33.54</td>
<td>1.68</td>
<td>0.84</td>
<td>2.5%</td>
</tr>
<tr>
<td>5</td>
<td>Meiling Refrigerator</td>
<td>30</td>
<td>4.8</td>
<td>4.5</td>
<td>15.0%</td>
</tr>
<tr>
<td>6</td>
<td>Qingdao Haier Refrigerator</td>
<td>50</td>
<td>7.38</td>
<td>4.4</td>
<td>8.8%</td>
</tr>
<tr>
<td>7</td>
<td>Changchun Motor City</td>
<td>20</td>
<td>4.2</td>
<td>6</td>
<td>30.0%</td>
</tr>
<tr>
<td>8</td>
<td>Wuhan</td>
<td>230</td>
<td>2.5</td>
<td>6.9</td>
<td>3.0%</td>
</tr>
<tr>
<td>9</td>
<td>Guangzhou Shipyard</td>
<td>126.49</td>
<td>5.23</td>
<td>16.44</td>
<td>12.9%</td>
</tr>
<tr>
<td>10</td>
<td>Tsingtao Brewery</td>
<td>100</td>
<td>6.38</td>
<td>13</td>
<td>13.0%</td>
</tr>
<tr>
<td>11</td>
<td>Shanghai Petrochemical</td>
<td>550</td>
<td>3.0</td>
<td>30</td>
<td>5.4%</td>
</tr>
</tbody>
</table>

*Sources of Information: (1) Prospectus, Shanghai Securities, Nov. 4, 1993, at p.4; (2) Underwriting agreement, Files of CSRC; (3) Id.; (4) Id.; (5) Id.; (6) Id.; (7) ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], Dec. 1, 1993 (Listing report); (8) Underwriting agreement, Files of CSRC; (9) ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], Oct. 27, 1993, at 10; (10) ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], Aug. 25, 1993, at 4; (11) Prospectus, p.7.


104. ZHENGQUAN SHICHANG ZHOUKAN [SECGURITIES MARKET WEEKLY], 1993, no. 43, at 6.
Underwriting fees are not the only fees an issuer pays to securities firms. The issuing company also pays an agent network fee, compensation for underwriting management, expenses for public relations and advertising, and costs for the production of a shareholder name list. For example, as Table 2 shows, the Wanneng Company paid 13.225 billion to the underwriters, which included not only the 6.90 million in underwriter's fees, but also the aforementioned list of additional expenses. The shares offered to the public by the underwriters were only 63 million instead of 230 million, because 160 million legal person shares and 7 million employee shares did not have to be sold through the underwriters. Therefore, the ratio of the face value of the shares actually issued to the underwriting commission was: $\frac{1322.5}{6300} = 21\%$.

In 1993, the CSRC issued a rule which permitted securities houses to charge 1% to 2.5% of the amount underwritten as their underwriting fee for both best effort (daixiao) and firm commitment underwriting (baoxiao). This essentially increases the underwriters' profits. The underwriters also are allowed to set their fee at the price offered rather than at the face value price, which is usually significantly lower. Underwriters have also calculated their fees by including shares they have not underwritten, such as those issued to employees, thus increasing their profits even further.

After the ratio of the offering price to the underwriting fee is set, the most widely used method to increase the underwriting fee is to increase the number of shares underwritten. Certain shares, such as those subscribed by affiliated companies, investment organizations and employees, do not require the assistance of an underwriter to issue, and their offering may have been initiated or even completed before the participation of underwriters. However, underwriters usually include these shares in their calculations of shares underwritten. As Table 2 shows, Shanghai Petrochemical made a public offering of shares with the face value of RMB 550 million, 300 million shares of which were legal person shares and employee shares. However, the underwriting fees up to RMB 30 million shows that the legal person shares and employee shares were regarded as part of the shares underwritten.


106. The underwriting agreement between the company and the Shanghai Global Securities Company (Shanghai wanguo zhengquan gongsi) provided that 400 million shares were
These fees to the underwriters are only part of the issuing costs. At a minimum, pre-offer costs include property appraisal (RMB 200 thousand), as well as lawyers fees and accountants fees (each, RMB 100 thousand to RMB 500 thousand). Necessary post-issue costs include at least a listing recommendation fee RMB 200 thousand to RMB 500 thousand paid to a securities broker that is a member of one of the exchanges, stock trust and registration fee (RMB 500 thousand), and a listing fee (RMB 10 thousand). Additionally, every issuing company will pay at least 1 million for printing relevant documents, for travel expenses, and for publication of its prospectors and listing announcement. The fewer the shares issued, the higher the offering costs are.

Issuing companies pay a large sum of money to issue their stocks. A company issuing stocks with a face value of 20 million pays as much as 6 million in underwriting fees alone. Table 2, for example, shows that Changchun Auto City paid RMB 6 million in underwriting fees for its RMB 20 million issue of stock. For another example, the 1992 Annual Report of the Shanghai Erfangji Co., Ltd., reveals that the company paid RMB 23.57 million for the issuing expenses and new share listing fees required in order to issue its 3.82 million A shares and 1.25 million B shares (each with a face value of RMB 10). The price equals 46.8% of the total face value of the shares issued and 16.5% of the after-tax profit of the company that year. One cannot help but wonder about the reasonableness of such payments.

Articles 40, 41 and 48 of the Accounting System for Shareholding Experimental Enterprises promulgated by the Ministry of Finance in 1992 govern the accounting procedures for share issuance. The articles stipulate the following three ways of accounting treatment for expenses incurred in the corporatization process.107

1. The expenses used in the corporatization shall be listed separately in the column of other assets as "establishment costs" (kaiban fei), which shall be amortized (tanxiao) over five years.
2. If the shares are issued at face value price, the offering expenses shall be included in the column of other assets as undertaken in firm commitment underwriting and 150 million in best effort underwriting.

"costs to be amortized for a long time," and the amortization period shall not be less than one year.

(3) If the shares are issued at premium price, the premium incomes shall be used to offset the offering expenses and the amount left shall be placed into the reserve fund.

Problems arise with the third method of accounting. If a company is established after its offering of shares and those shares are offered at a premium price, should the offering expenses be listed in the establishment cost or be offset by the premium income? If the latter, then the offering expenses will be kept in separate accounts. But how then could these expenses be reflected in the company's financial statement? The General Rules of Financial Affairs of Enterprise promulgated by the Ministry of Finance provide that the establishment cost shall be listed in the column of successive extension as a separate item.108

Such methods of accounting do not treat expenses incurred for an offering as long term investments, and thus distort the financial health of a company and fail to allow for depreciation.

The practice of most companies is to deduct the lump-sum offering expenses from the premium income generated by the issue and convert the remainder into a capital reserve fund. Because the promoters (and, under most circumstances, also the institutional investors) purchased the shares at the face value price while the outside investors purchased at the offering price (premium price), the payment of huge expenses for the issuance and listing of shares by the company will result in the dilution of the outside investors' interests.

c. Offering Price of Shares.

i. Determination of Offering Prices. After 1988, as joint-stock companies in Shanghai—both existing companies issuing additional shares and new ones making initial public offerings—routinely issued shares at prices over the face value, the size of premiums increased. In April 1988, the Shanghai Dianzhenkong Company, Ltd., issued its new shares at an offering price of RMB 113 against a face value of RMB 100. In October 1990, the offering price for shares of the Shanghai Yanzhong Industrial Company, Ltd., was RMB 40 against a face value of RMB 10. And in August 1991, the

Shanghai Xingye Real Estate Company made a public offering of its shares at RMB 60 offering price against a face value of RMB 10. Hualian Shopping Center Company Limited, sold shares at the highest premium to date, when in June 1992 it set an offering price of RMB 9.2 for its shares against a face value of RMB 1. In 1992, all of the shares offered in Shanghai and Shenzen were offered at premium prices on average five times the face value of the shares. This astounding increase in prices has not been justified based on financial grounds. Nor has there been an attempt to rationalize or standardize premium pricing practices.

However, after personal investigation consisting of discussions with government officials and company managers, I concluded that the offering prices are fixed in the following manner.\textsuperscript{109}

First, the competent government organizations\textsuperscript{110} will, on the basis of the average price/earnings (P/E) ratio of listed commercial enterprises, determine an artificial ratio for the stocks that are to be issued. For example, if the average P/E ratio is 30, then the issuing company's P/E ratio might be set at 20-25.

Second, the company itself calculates its average after-tax profit per one hundred yuan net assets for five years: that is, the actual after-tax profits of the two years prior to the issue and the predicted after-tax profits for the three years after the issue. Thus, if the face value of the shares that are to be issued is RMB 100, then the offering price equals the average after-tax profits per RMB 100 of net asset value for five years, multiplied by the P/E ratio.

\textit{ii. Dilution of New Shares.} In Shanghai, the 53 companies that made public offerings in 1992 fell into one of three categories: (1) those that were established before the issuance of shares, (2) those that were established during the issuance, and (3) those that were established after the issuance. In the companies that were established during or after the issuance (categories 2 & 3), there were two types of subscription prices: the promoters purchased the shares at the face value price, while other shareholders purchased the shares at a price 2 to 9 times the face value. In companies established

\textsuperscript{109} Shanghai hualian shangsha gufen youxian gongsi [Shanghai Hualian Shopping Center Co., Ltd.], Gupiao shangshi baogaoshu [Announcement of Stock Listing], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES DAILY], July 27, 1992, at 11.

\textsuperscript{110} The organizations involved are: (1) the financial management section of the branches of the People's Bank; (2) the share system experimental enterprises, at the core of which is the commission for restructuring the economic system; and (3) the offices for security management.
before the issuance, there was a similar practice. New shares were issued to outside shareholders at a price 2 to 9 times the face value while old shares were offered at face value. When new shares are subscribed at higher prices than the face value, the value of the new shares is reduced by the presence of older shares which had been offered at lower prices. Therefore, the rights and interests of the outside shareholders are actually diluted. This situation did not change in 1993 when the national situation concerning issue prices was essentially the same it had been in Shanghai the previous year.

The case of Shanghai Hualian Shopping Center Company Ltd. illustrates the changes in shareholder interests after the issuance of new shares. Within a short period of 15 days, the interests of the old stock shareholders grew from 100.7 million to 231.9 million, an increase of 130%.' At the same time, the value of the shares held by individual and institutional shareholders was diluted by 31%, and the value of a share was reduced from RMB 9.28 to RMB 6.35. Individual and institutional shareholders total investment of 131.85 million [(9.82-6.35) * 4500] evaporated without ever allowing shareholders to realize their interest. At the same time, their rights and interests of RMB 6.35 per share were also mixed in with corporate assets such as creditorship, inventory, and asset assessment and appraisal appreciation, all of which are difficult to convert into cash.

Raising the premium price also enables companies to evade the restrictive effect of the issuance quota which does not govern premiums. A company approved for an offering of 20 shares would raise only RMB 200 if it had offered the shares at the face value of RMB 10. By increasing the price to RMB 15, it raises RMB 300, the sum it would have raised if it had been approved for 30 shares. For example, Shanghai Hualian actually used 45 million issuance quotas to raise RMB 417.6 million in capital. Despite the fact that the shareholders know their rights will be diluted, the outsider shareholder is still willing to subscribe the new shares. Such behavior illustrates once again the distorting effects of the issuance quotas.

In addition, the high price of offerings has increased the capital reserve of companies to one to four times of their share capital.

111. Shanghai hualian shangsha gufen youxian gongsi [Shanghai Hualian Shopping Center Co., Ltd.], Gupiao shangshi baogaoshi [Announcement of Stock Listing], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES DAILY], July 27, 1992, at 11.
112. Id.
According to the accounting rules applicable to joint-stock companies, the capital reserve may be used only to increase the share capital or make up losses. But increasing share capital through issuance of new shares is limited by provisions stating that two consecutive offerings cannot be made within 12 months of each other and must be examined and approved by level upon level of competent administrative departments. So, if there is no loss or only a small loss, the capital reserve, instead of being used for re-investment, is deposited in interest earning accounts or used to buy debentures. In 1993, the mid-term financial statements of listed companies showed that interest from bank accounts and debentures constituted a substantial part of joint-stock companies’s profits. Clearly, joint-stock companies have not yet become an optimum medium for the allocation of resources.\textsuperscript{113}

d. Assessing the Extent to which the Quota System Controls the Amount of Issuance. In 1992, the total number of shares offered greatly exceeded the total cap. The total issuance quotas for the whole country was RMB 1 billion, but just 100 companies in Jiangsu, Shangdong, Shanxi provinces, Beijing, Tianjing and Shenzen by themselves issued RMB 8.98 billion worth of shares to the public. Among these shares, 22 enterprises of Tianjin publicly offered RMB 4.04 billion stock, four times the issuance quota for the whole country.\textsuperscript{114} The issuance quotas for Shanghai in 1992 were 400 million, yet in 53 enterprises in Shanghai issued four lots of legal person and individual shares with a total face value of RMB 2 billion. Using an average of the issuing price equalling 5 times the face value, we can calculate RMB 10 billion of capital was raised.\textsuperscript{115}

In 1993, the national issuance quota was RMB 5 billion, but the companies being listed raised 7 billion by requiring existing shareholders to purchase untransferable stock warrants and new shares.\textsuperscript{116} Through 1993, the employee shares issued by the unlisted companies amounted to RMB 25.3 billion.\textsuperscript{117} Finally, a quasi-private company

\textsuperscript{113} Bannian yingyun, yixi yiyou [Half a Year of Good Operation], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], Sept. 12, 1993, at 2.

\textsuperscript{114} 92 zijin da fenliu, zhengquan shichang zhan jiduo [The Great Capital Flow, Securities Markets Tie up Too Much], ZHENGQUAN SHICHANG ZHOUKAN [SECURITIES MARKET WEEKLY], 1993, no. 2, at 15.

\textsuperscript{115} Id.

\textsuperscript{116} Jiansu kuorong, baohu gushi [Slow the Expansion, Preserve the Securities Market], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], Feb. 1, 1994, at 4.

\textsuperscript{117} ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], Oct. 17, 1993, at 1.
in Beijing raised RMB 1 billion capital, which equalled the national issuance quota of 1992.\textsuperscript{118} This de facto disregard of the issuance quota further underscores the need for its abolishment.

e. The Role of Lawyers in the Issuance Application. The CSRC mandates that lawyers provide a legal profile of applicant companies. The lawyers shall examine the applicant’s shareholding structure, the purpose of the fund raising, the articles of association, the organizational structure, the applicable tax rate, the legality of the business, management and the possession of the property, . . . the legality of the public offering and share listing. . . . [and] the lawyers shall present a written legal opinion on these matters to the CSRC.\textsuperscript{119}

In fulfilling this duty, a lawyer is faced with conflicting interests. On the one hand she has been retained at great cost by the client specifically to prepare a legal opinion on the client’s application, and professional ethics demand that the client’s wishes be satisfied. Thus the legal analysis may not be wholly objective. On the other hand, the requirements of the CSRC, however, instruct the lawyer to produce a letter of opinion about the legality of the listing; if she believes it to be unlawful, her opinion should say so. The government sees the lawyers as “economic police,” but they are police who prior to conducting their public business have been paid handsomely by the “suspects.”\textsuperscript{120}

The conflicts between the issuance quota and the application procedures (noted above), leave little room in the public offering process for lawyers to perform their services. Prior to the allocation of issuance quotas, when the companies do not know whether they

\textsuperscript{118} Shiyi yuan pianjude pochan [The 1 Billion Yuan Fraudulent Bankruptcy], RENMIN RIBAO [PEOPLE’S DAILY], Aug. 24, 1993, at 2.

\textsuperscript{119} Zhengquanxu falibao fuleren qiangdiao: zhengquan congye lushi yao qinmian jinze [Senior Official of the State Council Securities Policy Committee’s Law Office Insists: Lawyers Engaged in Securities Work Must be Diligent and Fulfil Their Responsibilities], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], July 28, 1993, at 1.

\textsuperscript{120} The remuneration for these two to three page written legal opinions range from 100 thousand to 500 thousand yuan. Some commentators wonder if the amount of legal work and the trustworthiness of the opinions is worth so much money. “If the Securities Policy Committee had not forcibly demanded that lawyers participate, enterprises would have been unwilling to waste so much money.” Zhengquan lushide qianzi zhi duoshao qian [How Much is a Securities Lawyer’s Signature Worth?], ZHENGQUAN SHIKAN ZHOUKAN [SECURITIES MARKET WEEKLY], 1994, no. 43, at 29.
will even acquire a quota, companies retain lawyers. After the assignment of issuance, the government organizations responsible for the distribution of the quota conduct substantive examinations of the issuers, but the lawyers have no authority to examine the legality of the decisions of the government body, nor are they hired for this purpose. In answer to part of this problem, the CSRC invented a professional permit which transfers government powers to lawyers, accountants, and other professionals to share some of the CSRC's examination duties. While this allows professionals to use the government powers to engage in profit seeking activities, it also, however, forces the applicants to choose professionals who operate within the parameters determined by the CSRC.

The specific permit system setup by the CSRC means that a lawyer must have a permit to practice law in the securities field. This has created a precedent whereby other administrative organs may also require similar permits to practice law in the areas under their control. To push the argument further along this line, would it be unreasonable for courts to require permits for lawyers practicing before them? Moreover, the permit system means that the lawyer has lost her independence and becomes merely an affiliate of an administrative organization. Additionally, the permit system will not solve the conflict of interest problems. Will clients trust lawyers who have to obtain permits from the CSRC to bring administrative suits against the CSRC? Nor will permits solve the problem of lawyers who solicit and accept commissions from clients on issues about which they have no specialized knowledge. Only the double pressure of market competition and malpractice damages will cause avaricious lawyers to stop accepting commissions they are incapable of accomplishing. Yet under the present structure, there are no market forces. The Interim Regulation and the permit system both force the applicant to retain lawyers. The lawyer is then required to render opinions about complex financial transactions, much of which is speculative due to the nature of the application process. Finally, the required administrative procedures that interfere with the contractual freedom of the parties create job opportunities for lawyers within the scope determined by the CSRC.
III. CLASSIFICATION CRITERIA OF STOCKS AND THE MARKET ACCESSIBILITY OF DIFFERENT KINDS OF STOCKS

A. Unification of Classification Criteria

One of the characteristics of the shareholding experiment formed by the Standards Opinion was the recognition of a customary uniform set of classifications for company shares: state shares, legal person shares, individual shares, and foreign capital shares. While this classification structure had been observed locally prior to the new law, there was some lack of uniformity in interpreting what each category actually meant.

The development of the classification system began in the mid-1980s. The Shanghai branch of the People's Bank issued a resolution to classify the shares offered to outsiders in two categories: collective shares and individual shares. There was no mention of state shares. The meaning of individual shares is self-evident: they were offered to individual members of the public. Collective shares, regardless of whether an enterprise were a state-owned or collectively-owned enterprise, referred to shares subscribed by an enterprise with its retained capital. This resolution must have been implemented after unpublicized revisions, because the earliest seven joint-stock companies all issued unit shares (danwei gufen), which, despite the different term, was the same as collective shares. Three of these seven companies issued State shares as well. In other provisions of the Shanghai Municipal Government, stocks were classified as government shares, unit shares, and individual shares.

In Shenzhen, local government rules in the 1980s did not require that shares be classified according to ownership. If a SOE was the promoter, the shares it subscribed were taken over by the Shenzen Municipal Investment Management Company, a beneficiary shareholder on behalf of the local government. If more than 25% of a company's shares were held by a foreign business, it was governed by

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121. Zhongguo renmin yinhang Shanghai shi fenhang guanyu faxing gupiaode zanxing guanli banfa [Interim methods for regulating stock issues, Shanghai Branch of the People's Bank of China], 1984, reprinted in Stock Economics, supra note 6, at 381.

122. Shanghai shi gufenzhi qiye zanxing banfa [Interim methods for share system enterprises in Shanghai], reprinted in Stock Economics supra note 6, at 250.
a special provision, promulgated in 1986, by the Guangdong Provin-
cial Government.\footnote{Guangdong sheng jingji tequ shewai gongsi tiaoli [Guangdong Province special economic zone regulations for companies with foreign elements], (1986), reprinted in STOCK ECONOMICS, supra note 6, at 360.}

In Fujian Province the provincial government required shares to be classified according to ownership. Shares formed by state-owned assets were called “state-owned assets shares,” shares purchased by enterprises other than the promoters were called “outsider enterprise shares,” shares held by the promoters with their own capital were called “this enterprise assets shares,” and shares subscribed by an individual investor were called “individual assets shares.”\footnote{See SECURITIES LAWS, supra note 14, at 108.}

Beginning in 1989, and then especially between 1991 and 1993, the categories became increasingly unified. First, starting in 1989, SCRES consistently divided joint-stock companies into three types toward which it adopted differential policies: legal person shareholding, employee shareholding, and public shareholding. Then, after 1991, the Shanghai and Shenzhen exchanges demanded that all listed companies divide their shares into State shares, legal person shares, foreign capital shares, and individual shares. It is important to note here that like so many other elements in the securities markets, these categories were in fact handed down from above—more a product of the administration discretion of the People’s Bank, which was then in charge of the exchanges, than a decision by the exchanges. The bank’s influence on this matter was felt in other ways as well. According to a document released by the Bank two weeks before the establishment of the Shanghai exchange, applications for listing and trading of joint-stock companies in Shanghai and Shenzhen had to be examined by the local branches of the Bank and finally approved by its main branch.\footnote{See Zhongguo renmin yinhang guanyu yan’ge kongzhi gupiao faxing he zhuanrangde tongzhi [Bank of China Notice Concerning Strict Control of Share Issues and Transfers], reprinted in COLLECTION OF LAWS, SUPP. VOL., supra note 16, at 164.} Clearly, whatever forms the Bank confirmed would be imitated by later applicants.

Probably one of the main reasons for administrative organs to have established classification standards is the disparity in the transferability of different types of shares. State shares and legal person shares are theoretically nontransferable, foreign shares may only be traded in a special, closed market, and individual shares may be transferred only between Chinese citizens.
The final step in the unification of classification criteria was the replacement of local rules and regulations with national ones. After May 1992, the Standards Opinion divided companies into directed offering (diangxiang muji) and public offering (shehui muji), depending on the scope of their initial share offering. In a directed offering (which might also be translated as fixed channel offering) companies' promoters subscribe a portion of the shares, and offer the remainder to other legal persons and employees of the company. Public offering refers to companies which make their initial offering open to all investors. When the Standards Opinion further classified the shares themselves into state shares, legal person shares, foreign capital shares, and individual shares, the precedent established by the Shanghai exchange became the national rule.

B. Ideological Background of the Criteria for the Classification of Shares

The use of the classification system promotes the principle of public ownership in that it shows whether or not a company has met the ideological requirement of maintaining the leading role of the public economy by having state and public organizations hold the majority of shares. On this point, the suggestion of influential, Beijing University economics professor Li Yining is representative:

if we provide the shares held by individuals shall not exceed a certain proportion in the total capital of the enterprises and the proportion of individual shares in the total capital of the enterprises shall be under that of the public ownership shares, that enterprise is still a joint-stock enterprise with the public ownership playing a leading role.126

Mr. Li Yining's proposals were embodied in the regulations, administrative rules and securities trading rules later formulated by the government. In the Measures for the Experiment in Shareholding Units promulgated by the State Council in April 1992, the shares held by the State and the public organizations were called "publicly owned assets shares," and the other shares were called "non-publicly owned assets shares." Furthermore, in the Standards Opinion and Interim Regulations on Share Issuing and Trading, promulgated shortly

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126. Li Yining, Guoyou qiye zai gongyouzhi jichushang shixian gufenzhide tujing [The Path for State Owned Enterprises to Realize the Share System on the Basis of Public Ownership], GAIGE [REFORM], 1991, no. 1, at 158.
thereafter, the maximum individual shares was stipulated as .5% of the total outstanding shares of the company, and individuals and private enterprises were not permitted to be promoters.\textsuperscript{127} Gradually, majority shareholding by state and public organizations became an implicit precondition for listing. Until August 1993, out of all the 15.47 billion (face value) shares listed on the Shanghai Exchange by 70 companies, 68% were State shares, 12% were legal person shares, 10% were transferable individual shares, 1.2% were untransferable employee shares, and 8% were B shares.\textsuperscript{128}

C. Shares Classified According to the Identity of the Shareholders

1. \textit{State Shares}. As more SOEs are corporatized, the State has a correspondingly greater interest in owning more shares of the new joint-stock companies. While the State is willing to give up exclusive ownership of the firm, it is not willing to lose all power to direct and influence the activities of the firm. Majority ownership is one method by which such influence can be maintained while also presenting the opportunity to raise capital from the sale of other shares.

State shares are those issued and held by the State. If a SOE is the only promoter, it transfers all its rights and obligations to the joint-stock company and then it terminates once the joint-stock company is established. The shares subscribed by a SOE as promoter must be held by a government organization or by a controlling company authorized by the government.\textsuperscript{129}

Therefore, not all shares constituted by state-owned assets are state shares, but instead, the State shares are a special phenomenon

\textsuperscript{127} Standards Opinion, \textit{supra} note 3, art. 24.

\textsuperscript{128} 1993 \textit{nian Shanghai zhengjiaosuo shangshi gongsi zhongqi baogao gailan} [\textit{Overview of the 1993 Midterm Report on Companies Listed on the Shanghai Stock Exchange}], \textit{ZHONGGUO ZHENGQUAN BAO} [\textit{China Securities Daily}], Sept. 5, 1993, at 2; \textit{ZHONGGUO ZHENGQUAN BAO}, Sept. 8, 1993, at 3. As of November 1, 1994, the face value of the issued shares of the 170 companies listed on the Shanghai exchange was 45,594,460,000 yuan. The percentages of this face value by share category was: individual shares, 17%; state shares, 50%; promoter shares, 7%; legal persona shares, 9%; employee shares, 1%; B shares, 6%; H shares, 9%; foreign invested enterprise legal person shares, 1%. \textit{Shanghai zhengjiaosuo shangshi gongsi guben jiegou} [\textit{The Share Capital Structure of Companies Listed on the Shanghai Exchange}], \textit{ZHENGQUAN SHIKAN ZHOUKAN} [\textit{Securities Market Weekly}], 1994, no. 48, at 24-6.

occurring with the disappearance of a SOE (the promoter) in the process of the corporatization. However, if several SOEs jointly promote a joint-stock company and continue to exist after the establishment of the new joint-stock company, or if at the time they subscribe shares of a company the SOEs are not the sponsors, the shares held by the SOEs are called "legal person shares." This is the case even though these shares, like those formed during the transformation of SOEs into joint-stock companies, originated from state-owned assets. The difference lies in the fact that the legal persons forming the new company have not been extinguished but retain their separate identities.

That administrative rules from different government organizations have different definitions of the State shares exacerbates the problems of definition, for the content and extension of State shares will be substantially different as each different set of rules is applied.

According to the Standards Opinion, state shares are the shares formed by authorized government departments and organizations investment of state-owned assets into companies. On the other hand, according to the provisions of the State Bureau for the Administration of State Assets, state shares shall include:

(1) The shares converted from the net assets of SOEs which have been transformed into joint stack companies.

(2) Shares initially issued by companies and purchased by the governmental departments investing on behalf of the State.

(3) Shares initially issued by companies and purchased by the investment companies, assets management companies, and economic entity companies authorized to make investment on behalf of the State. The extension of this provision is obviously broader than the former one.\textsuperscript{130}

\textsuperscript{130} The State Asset Bureau's provisional regulations were superseded on November 3, 1994, by the "Interim measures for administering the rights of state shares in joint stock limited liability companies" (Gufen youxian gongsi guoyou guquan guanli banfa), promulgated jointly by the State Asset Bureau and SCRES. \textit{See CHINA SECURITY DAILY}, Nov. 5, 1994, at 2. Based on the new regulations, state shares (guojia gu) may be obtained by transfer of state assets under the following circumstances: (1) a state enterprise has been absorbed and merged into a joint-stock company; (2) when a joint-stock company's accumulated capital exceeds the net book asset value of a state enterprise by 50%; (3) a state enterprise's autonomous operating capital has been completely or largely transferred to a joint-stock company; (4) they are the initial shares offered by a company subscribed to by a state investment organization. State shares may be held only by a state authorized investment organization. Before the law made
We can reasonably conclude that the current criteria for distinguishing state shares are a mixture of the capital origin and the identity of the shareholders. However, these criteria only solved one question: who has the right to possess the shares of a company when it becomes established and the promoter terminates?

2. Legal Person Shares. Legal person shares are those owned by a legal entity, such as another company. However, these can also be owned by the State, in the sense that if the State is not the entity making the initial public offer, but rather is a purchaser, the shares are owned by the State. Because the State is not the promoter, the shares are called legal entity shares. This is the most complex of the four classes of shares. Based on the source of the capital, legal person shares can be subdivided into state-owned legal person shares, collective enterprise legal person shares, private enterprise legal person shares, foreign invested enterprise legal person shares, and institutional legal person shares.

a. State-Owned Legal Person Shares. With the exception of state shares, all shares having their origins in state-owned assets and held by state-owned organizations are state-owned legal person shares. State shares and state-owned legal person shares differ only in the status of the share holder: the holder of state shares must be a government organization or a company with governmental functions; the holder of state-owned legal person shares may not be a governmental organ. For example, as the listing announcements of the 10 companies in Table 3-1 reveal, it is fairly common for financial

this stipulation, state shares were held by various levels of bureaus of state asset administration or their deputed investment organizations. A state enterprise that has turned all its assets over to a joint-stock company must be dissolved and can no longer, as before, hold shares to preserve the empty shell.

There is some doubt as to whether these new rules can be implemented. This uncertainty arises not simply because one ministry's or commission's rules have binding effect over other ministries, commissions and local governments, but also because the efficacy of any new division of administrative jurisdiction is uncertain. At present, ownership of state assets is divided among the different levels of the central and local governments. This situation has been maintained for a long time and was further consolidated following the recent division of tax revenues between the central and local governments. Under these conditions the administrative authority over state assets is exercised in all cases by central and local government “agencies in charge of the trade” (hangye zhuguan bumen). If the State Asset Bureau's new regulations are put into effect, the reorganization of a state enterprise into a joint-stock company would signify that control had been transferred from the agency in charge to the State Asset Bureau, an arrangement the agencies in charge will not lightly accept.

131. See infra p. 218.
organizations (e.g., trust and investment companies and securities companies) to hold the legal person shares of listed companies. Indeed, they often hold the next largest number of shares after the state shares of the promoters.

b. Collective Enterprise Legal Person Shares. Collective enterprise in China comprises three types: enterprises owned by the local government; enterprises whose assets come from the State, but which, for policy reasons, are not classified as state owned; and enterprises funded by individuals, but which attach themselves (guakao) to a supervisory administrative department in order to avoid discrimination or obtain favorable treatment otherwise available only to public enterprises, such as tax benefits or licenses for a particular trade sector. The first two types of collective enterprises are not substantially different from state-owned ones.

Although it is unusual for collective enterprises to subscribe to shares of other companies of companies outside their own domicile, they often possess a large number of shares in local small-scale companies. Moreover, when collective enterprises act as the promoter of a company, they often continue to exist after that company's establishment. Indeed, the sole purpose of this continued existence is to be an empty shell with legal personality in order to hold shares. Otherwise a government organ will take over the shares subscribed by the promoter. The greater the ambiguity concerning the final ownership of a collective enterprise's property, the fiercer the desire of the collective enterprise as promoter to hold shares under its own name.

132. "Attached" (guakao) enterprises are commonly called "wear the red hat" (dai hongmao) private enterprises. Reports from several local surveys reveal that the number of "attached" enterprises is one to two times greater than the number of registered private enterprises. In 1994, there were 420 thousand registered private enterprises.

133. Before 1994, in Beijing's Zhongguancun New Technology Development Zone, privately invested enterprises were required to register as "collective enterprises without a supervisory agency" (wu zhuguan jiti qiye). Within a certain period of time, private investors could obtain a certain rate of profit commensurate with the amount of their invested capital. Other than this, they could assert no property right in regard to the enterprise. At the time such enterprises reorganized into joint-stock companies, the central issue was who owned the shares based on the property put up as the enterprise's investment? Legally, an individual may not be the beneficial owner of transferred collective property. Yet in these collective enterprises, without a supervisory agency, there existed no government organ qualified to hold the shares, prompting some of the already reorganized enterprises to retain an "empty shell" (kongqiao) to hold the shares.
c. Private Enterprise Legal Person Shares. These are limited liability companies with legal person status whose capital comes entirely from private individuals. Private enterprises could exist legally only after the Constitution was amended in 1988 to allow private enterprise. Prior to the Company Law on July 1, 1994, private enterprises were prohibited from being promoters of joint-stock companies. Therefore, private enterprises usually purchased the shares of companies after the establishment of the companies. However, legal prohibitions could not deter these strong private enterprises from adopting flexible methods to promote companies. For example, first, together with a collective or state-owned enterprise, a private enterprise would organize a jointly operated enterprise. Then, by attaching itself (guakao) to the administrative agency in charge of the industry, it would establish one or several collective enterprises under its own control. Finally, using the name of this enterprise, it would promote a joint-stock company. Two companies listed on the Shenzhen exchange, Hainan minyuan gufen gonsi and Xin nengyuan gufen gonsi, were both essentially established through this route. In this sort of company, a significant portion of the legal person shares are in fact controlled by a private enterprise.

d. Foreign Invested Enterprise Legal Person Shares. From the mid 1980s overseas investors starting joint-stock companies or purchasing shares were subjected to almost no limitations by local regulations in Guangdong province or the Shenzhen Special Economic Zone. As the discussion in Section 4 of Yuanye Ltd. shows, this Hong Kong company not only promoted a Shenzhen joint-stock company but also acquired all the shares held by other shareholders and for a short while became the sole shareholder of the joint-stock company. Moreover, as SCRES and the Bank of China discovered in a May 1990 study of about 20 Shenzhen joint-stock companies, 27% of their shares were held by foreign-invested enterprises and overseas investors.

In 1992 the Standards Opinion prohibited overseas investors from holding A shares, but permitted sino-foreign equity joint ventures and sino-foreign contractual joint ventures to promote joint-stock companies, so long as they constituted no more than one third of all promoters. Thus, according to this provision, an overseas investor may not buy or sell A shares under its own name. But, if the overseas investor establishes a sino-foreign equity or cooperative joint venture in China, it is then permitted to promote a joint-stock
company or purchase A shares, so long as the holder of the A shares is an economic entity with legal personality under Chinese law and not the foreign investor, itself.

The relevant legal question that readily arouses debate is this: if a sino-foreign equity joint venture dissolves after promoting a joint-stock company, and through the division of the surplus assets acquires A shares, is this acquisition legal? In localities such as Guangdong's special economic zones where local regulations permit overseas companies to become promoters of companies, the legality of this action is without doubt. The force of local regulations supersedes the Standards Opinion, for while the former may be used as the basis for a legal decision, the latter may not. Even if local rules and regulations had no explicit provisions concerning this matter, if prior to the Standards Opinion and its coordinate rules taking effect, the local government permitted overseas investors to hold A shares, this shareholding remains legal. For, no prohibition can pursue behavior that was not proscribed before the prohibition took effect. However, at the moment the Standards Opinion took effect and thereafter, even if local regulations clearly permitted it, overseas investors could not legally hold A shares, regardless of whether or not they had obtained permission from the local government. This was the case because, a regulation of the State Planning Commission had established a rule: after a company promoted by an overseas invested enterprise was terminated, any shares that the overseas investor obtained through division of the surplus property had to be converted into B shares. However, once the Company Law took effect on July 1, 1994, the Standards Opinion was voided, and the Company Law has no prohibitions on foreign investors holding A shares.

e. Institutional Legal Person Shares. Shares subscribed in the name of trade unions, the Communist Youth League, or the Women's Federation with funds raised from individuals are called institutional legal person shares. Under the name of institutional legal person shares, companies not permitted to make public offerings could issue their shares to individuals other than their employees, and individuals who could not hold a company's internal shares could subscribe to shares under the name of a legal person.

f. Problems with Legal Person Shares. Constant policy changes have caused legal person shares to become an inextricable knot. From 1992 through the first half of 1993, legal person shares became a speculative hot spot. There are several reasons for this.

First, legal person shares were encouraged because they were regarded as a barrier against privatization (siyouhua). Under the aegis of this sort of thought, legal person shares circulated for a while in the market. In the beginning of 1992, SCRES proposed an experimental program in the "internal circulation of legal person shares" (farengu neibu liutong). In special situations, trading of legal person shares could be conducted between organizations. In July of that year, SCRES gave a special permit for the National Automatic Securities Quotation System (STAQ), which became the sole center for trading in legal person shares. By the end of the year, three companies listed on the STAQ legal person shares with a face value of RMB 197.27 million. The shares were all underwritten by securities firms belonging to STAQ.

Thus, in May 1993, another trading center devoted to legal person shares was opened with the backing of the People's Bank of China—China Securities Trading System Limited (NETS). The involvement of SCRES and the People's Bank of China in the trading market for legal person shares made investors optimistic about the future of these shares. Companies which, owing to the limitations of the issuance quotas, could not make public offerings, and thus had no hope of being one of the companies listed on either the Shanghai or Shenzhen exchanges, were attracted to STAQ/NETS in the hope that they could obtain permission to list and trade legal person shares.

Second, initially, institutional investors had little interest in the legal person shares of listed companies. But in 1992, institutional investors seemed to obtain a commitment from the local authorities in Shanghai and Shenzhen that it would not be long before legal person shares would be traded on the market. A precedent in the Shanghai exchange gave these investors reason to rely on this promise. In 1991 when the first group of 8 companies listed their shares, individual and legal personal shares totalled 70 million and 15.4 million shares, respectively. After the company shares were listed, the exchange surreptitiously permitted some companies legal person shares to be circulated. This is what caused institutional investors to believe that shortly after the listing of companies' individual shares, legal person shares would be allowed to circulate.
Statistics on 1992 Shanghai issues indicate several things about legal person shares. They do not seem to have been subject to the issuance quota, issuing companies thus happily increased the number of legal person shares, and, inevitably, legal person shares became an increasingly important element in securities trading. Of the RMB 2 billion (face value) in shares issued in 1992 by 53 Shanghai companies, there were approximately 460 million worth of individual shares and 1.54 billion of legal person shares. The shares were issued in four batches, and with each batch there was a sharp increase in the percentage of legal person shares. In the first group of 9 companies, the ratio of legal person shares issued to individual shares was 1:2.3; in the second group of 34, 1.3:1; in the third group of 5, 1.9:1; and finally in the fourth group of 7 companies, 4.5:1. For organizations subscribing to shares, the costs were significantly lower than for individuals because organizations did not have to first buy lottery tickets at 2 to 6 times the face value of shares. Therefore, many employees of powerful organizations bought legal person shares in the name of their employer. If an organization was a government organ prohibited by law from shareholding, its officials use the name of trade unions, the Youth League or other groups to accomplish the same goal. Clearly the former coldness toward legal person shares had been replaced by enthusiasm. Of course, misappropriation of public funds, insider trading, and bribery were a disastrous, hard-to-contain concomitant.

Third, at the time China's non-banking financial organizations, which for the most part were the brokerage houses belonging to STAQ and NETS, acted as the underwriters and listing advisers, their purchase of legal person shares was limited only by the amount of their own capital. Moreover, since brokerages' trading in individual shares was completely legalized after September 1993, illegal trading in individual shares was a short-term speculative play which did not need to tie up capital for a long time. Thus, the non-banking financial organizations put large amounts of capital into the market in legal person shares.

Still, for a number of reasons, the market in legal person shares never became the gold mine some people imagined. The Shanghai and Shenzhen exchanges constantly adopted measures to prevent STAQ and NETS from siphoning off the capital in their exchanges. Companies which had already listed on the Shanghai and Shenzhen exchanges were not permitted to allow their legal person shares to circulate on either STAQ or NETS, and companies which had already
listed their legal person shares on STAQ or NETS had no hope of listing their individual shares on the exchanges. Indeed, in June 1993, the Shenzhen Municipal government issued an order to this effect. Without specific permission, no Shenzhen company "could on its own authority prepare to list on the Beijing legal person share market [i.e., STAQ or NETS]"\textsuperscript{135} and no local securities company could "act in Shenzhen as the transaction agent for Beijing legal person shares."\textsuperscript{136}

Other factors also served to cool interest in legal person shares. Beginning in 1993, when the CSRC took over SCRES' and the People's Bank's authority over securities issues and exchanges, questions arose about whether or not the SCRES supported STAQ and the Bank supported NETS could accept applications to list without the approval of the CSRC. Moreover, when non-banking financial institutions disrupted financial order by borrowing heavily from their parent institutions—the banks—to purchase legal person shares, the central government ordered all specialized banks to recall for a certain period all loans to non-banking financial institutions. The result was a reduction of capital flowing into the trading markets. Concurrently, the listing of large quantities of individual shares on the Shanghai and Shenzhen exchanges diluted the market capital. If additional legal person shares had been permitted to circulate, it would have led to a further drop in share prices.

In June 1993, the CSRC notified STAQ and NETS to stop accepting applications to list legal person shares, and in February 1994 reaffirmed the halt in listing of legal person shares.

3. Individual Shares. Individual shares are the shares held by Chinese citizens. Individual shares offered to a company's employees are called "internal employee shares" (\textit{neibu zhigong gu}), while shares offered to the general public are called "public individual shares" (\textit{shuihu geren gu}).

Internal employee shares were once the key shareholding experiment advocated by the government. Shortly before the release of the Standards Opinion, a government policy document still recommended that "the emphasis ought to be on the establishment and experiment of the first and second types of shareholding

\textsuperscript{135} ZHENQUAN SHICHANG ZHOUKAN [SECURITIES MARKET WEEKLY], 1993, no. 27, at 23.
\textsuperscript{136} Id.
enterprises,” namely legal person shareholding and employee shareholding joint-stock companies. But shortly thereafter, employee shareholding was severely restricted. In August 1992, the head of the People’s Bank of China, which at that time was in charge of the securities markets, announced a temporary suspension in the development of employee shareholding joint-stock companies. In April 1993, SCRES and the CSRC issued a notice “resolutely halting the non-standard [i.e., vis-à-vis the Standards Opinion] issuance of internal employee shares.” Finally, in July 1993 SCRES issued special provisions on the management of internal employee shares.

The Standards Opinion provided that the number of shares offered to employees through directed offerings (dingxiang muji) may not exceed 20% of the company’s total number of shares. If it has already exceeded that amount, it could obtain permission to issue and sell to the public 10% of its total shares, but could not set aside any of these shares for sale solely to employees. In a number of ways this is a muddled provision. If shares are issued before a company is established, how is the promoter to distinguish who are employees of the company? How can the company predict how many shares it will be allowed to sell to the public and determine whether or not to use the opportunity to ration shares for sale to its employees (peishou gufen)?

In 1993, a new administrative regulation was issued that reduced the percentage of employee shares to 2.5%, though no revisions were made to the Standards Opinion. Once again, one can see the ad-hoc administrative influence on the development of securities markets in China.

4. Foreign Capital Shares. Foreign capital shares include B shares and H shares. B shares are shares of Chinese companies that are denominated in Chinese currency, issued and listed within China, purchased by foreign investors with foreign currency, and traded only among foreign investors. H shares are shares of Chinese companies that are directly issued and listed in Hong Kong. Between 1991 and

138. RENMIN RIBAO [PEOPLE’S DAILY], April 8, 1993, at 4.
139. Dingxiang muji gufen youxian gongsi zhigong chigu guanli guiding [Regulatory Provisions for Directed Offering to Workers and Staff of Joint-Stock Companies], RENMIN RIBAO [PEOPLE’S DAILY], July 30, 1993, at 3.
1993, 19 companies, each in Shanghai and Shenzhen, offered shares with a face of value of RMB 2.45 billion. In 1993 six companies issued H shares.

D Market Accessibility of Various Classes of Shares

1. Transferable Individual Shares and the Unreliable Index of Share Prices. To avoid the privatization of shares held by state and public organs, Peking University economics professor Li Yining once proposed the separate trading of three classes of shares and three separate securities markets.\(^{140}\) If a company's shares were all state shares, trading of its shares would be limited to state investment organizations. If a company's shares comprised state shares and public organization shares, trading could occur among state investment organizations, among public organizations, and between the two types of shareholders. If a company's shares comprised state shares, public organization shares, and individual shares, the trading of its shares should be confined to the respective categories of shareholders.\(^{141}\) At least superficially, Li's proposal became the reality of China's securities markets. Trading of individual shares is confined to individuals, trading of foreign capital shares occurs only among foreign investors, and the trading of a small quantity of legal person shares occurs only among public organizations. From the establishment of the Shanghai and Shenzhen markets to the time I completed this Article, the only transferable listed company shares are individual shares.

The Shanghai Securities Exchange Annual Statistical Report (Shanghai Exchange Annual Report) for the years 1990 through 1992 publish only the total number of individual shares at the time of a company's listing and not the number of additional shares issued after listing. The total number of transferable individual shares in a given month or given year have never been disclosed. Employing other means to make the calculation presents three difficulties. First, the Shanghai exchange grants a number of local companies the special privilege of transferring a portion of legal person shares into individual shares. The amount transferred has never been disclosed

\(^{140}\) Li Yining, Guoyou qiye zai gongyouzhi jichushang shixian gufenchide tujing [The Path for State Owned Enterprises to Realize the Share System on the Basis of Public Ownership], GAIGE [REFORM], 1991, no. 1, at 158.

\(^{141}\) Id.
and the privileged local companies are unwilling to make a public disclosure. As of February 1994, the Shanghai exchange had permitted the transfer of 14 companies' legal person shares. Second, the listed companies repeatedly issue new (rationed) shares to shareholders. Most of the new shares are subscribed by individual shareholders, with legal person shareholders buying a minority. The 1990-92 Annual Reports do not reveal the change in the total number of individual shares after the assignment of these new shares. Third, through a private placement, the state shareholder of companies listed in 1993 transferred a large quantity of shares to individual and legal person shareholders. Unless these listed companies reveal the information in their 1993 end-of-the-year reports, we cannot know how much this transfer increased the number of individual shares.

The issue of hidden shares is not an arcane legal problem. It has a direct and immediate effect on investors, because the number of shares influences market valuation. The formula for calculating the Shanghai Stock Exchange A share price index for a given day (Shanghai Share Index) is:

\[
\text{Index} = \frac{TCMV}{TBMV} \times 100
\]

where: TCMV=total current market value of listed shares  
TBMV=total base market value of listed shares

The market value of a share is simply calculated by multiplying the stock's closing price by the number of shares issued for that stock. The total market value (TMV) is therefore the sum of the market value of all listed shares, or:

\[
TMV = \sum (CP \times NS)
\]

where: CP=given stock's closing price  
NS=number of shares issued for given stock

142. There is some evidence to suggest that the first thirteen Shanghai companies to list on the Shanghai exchange by November 1992 had surreptitiously put 30 million yuan worth of state and legal person shares into circulation. The way in which the Shanghai exchange gave local companies special privileges and concealed the news from the mass of investors received criticism from the news media. See Ping Wei, Hushi liutong panzi jiuji duoda [In Fact How Large is the Circulation in Shanghai?], ZHENGQUAN SHICHANG ZHOUKAN [SECURITIES MARKET WEEKLY], 1992, no. 18, at 18.
The distinguishing feature of the Shanghai Share Index is this: all of the shares of a listed company are treated as transferable shares and calculated into the "listed total," then on the basis of a given days' closing quote for every listed company's transferable shares the market value of all a company's stock is calculated, and finally one calculates the market value of all the shares of listed companies.

Unquestionably, this method of calculating the stock price index misleads investors. First, it conceals the fact that most of a listed company's shares are non-transferable, exaggerates several fold the true scale of the market, induces entry of capital that ought not be circulating in the stock market and which only aggravates the speculative trading. Second, it greatly diminishes the volume of trade and the rate of turnover, concealing the seriousness of short term speculation, and making it difficult for even knowledgeable investors to make reasonable predictions of risk. Third, given that a large portion of listed shares are frozen, the number of shares needed to manipulate the market is much smaller than usual, and the danger of market manipulation through continuous buying and selling of a stock is much greater.

If the Shanghai exchange included only transferable shares in the listed volume, the changes in the index caused by manipulation would be far clearer. Knowledgeable investors would be reminded to make careful judgments and would not be defrauded by manipulative behavior. Fourth, the index's TMV assumes that all listed shares may be transferred at market price. Thus, when a listed company's state shareholder transfers state shares to an individual shareholder there exists no reason to require a premium to divest the state share of its privilege. Yet, in 1993 the Shanghai Exchange stipulated that when state shareholders transfer shares to individual shareholders the share price ought to "divest the privilege." Shifts in prices caused by this practice are hard for investors to predict.

2. Circulation Across Boundaries by Different Categories of Shares. Circulation among state, legal person, and individual shares has not truly been obstructed. During the 1980s, the Shanghai and Shenzhen rules regulating securities neither prohibited organizations from over the counter transactions nor restricted the transfer of organization held shares to only other organizations. There seems to be no insurmountable obstacle to exchange of individual and legal person shares.

In the first year after the establishment of the securities exchanges, only individual shares could be listed, and only individual
shareholders could trade on the exchanges or open trading accounts with securities companies. However, buying and selling by the securities companies themselves has never been explicitly prohibited. Only organizations other than brokerage houses were superficially excluded from securities trading markets. But despite the theoretical legal risk, this exclusion could not prevent organizations from opening stock trading accounts in individual’s names in order to trade.

In June 1991, in an effort to attract more capital to the market and halt an uninterrupted fall in prices, the Shenzhen branch of the People’s Bank took the lead in eliminating controls on organizations entering the market. It permitted enterprises and other institutions (shiye danwei) to use their own funds to buy individual shares of listed companies. Clearly, then, transactions in the names of securities firms were also legal.

On October 16, 1992, the Shanghai Exchange formally announced that member brokerages could engage in trading activities, but limited them to trading in companies with more than 1 million transferable shares and required them to hold purchased shares for seven business days before selling them.143

On September 4, 1993, the Shanghai Exchange and the Shanghai Central Securities Registration and Accounting Company (Shanghai zhengquan zhongyang dengji jiesuan gongsi) jointly issued a notice announcing that “except for those prohibited by the state from participating in stock trading, all institutional investors may from this date initiate procedures for opening a trading account and begin investing in the securities market.”144

Thereafter, the individual share market was completely opened to institutional investing. The shares purchased by a legal person in the primary market are called legal person shares, and the shares it purchases in the secondary market are called individual shares. When a listed company announces the number of individual shares, the figure includes individual shares held by legal persons but not shares transferred by legal persons to individuals. If the category of shares can be transferred only among shareholders of the corresponding class, the separation between different classes of shares can perhaps still be maintained. But if shareholders of different classes may

143. SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES DAILY], Sept. 19, 1992, at 1.
144. Jigou rushi damen yi bikai [The Door to Organizations Entering the Market is Well-Opened], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES DAILY], Sept. 4, 1993, at 1.
possess the same kind of shares, the policy of separating classes will lose all meaning.

IV. STOCK OWNERSHIP AND CORPORATE CONTROL

I open this section with three tables illustrating the relationship in ten listed companies between stock ownership and corporate control. Table 3-1 is a general overview; table 3-2 covers stock ownership; table 3-3 treats the relation between shareholders, directors, and legal person representatives. Throughout this section, I will draw extensively on these tables.
### TABLE 3-1: GENERAL INFORMATION OF TEN LISTED COMPANIES

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company Name*</th>
<th>Sector</th>
<th>Promotor**</th>
<th>Date of registration</th>
<th>Date of 1st public issue</th>
<th>Date of shares listed</th>
<th>Total Par value of outstanding shares (in million yuan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>SP</td>
<td>Industry</td>
<td>SPC (SOE)</td>
<td>June 29, 1993</td>
<td>A shares: August 1993</td>
<td>Nov. 8, 1993</td>
<td>6,230</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>H shares: July 1993</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>H shares: June 1993</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>ZJG</td>
<td>Industry</td>
<td>JCF (SOE)</td>
<td>March 1993</td>
<td>not disclosed</td>
<td>July 1993</td>
<td>70.54</td>
</tr>
</tbody>
</table>

*The full name of ten listed companies:
1. SP: Shanghai Petrochemical Co. Ltd.
2. KEM: Kiamen Engendering & Machinery Co. Ltd.
3. GSI: Guangzhou Shipyard International Co. Ltd.
4. TB: Tsingtao Brewery Co. Ltd.
5. XHTI: Xinjiang Hongyuan Trust & Investment Co. Ltd.
6. QHR: Qingdao Haier Refrigerator Co. Ltd.
7. NH: North-east Hualian Co. Ltd.
8. NMT: Ningbo Machinery & Tube Co. Ltd.
9. ZJG: Zhejiang Jianfeng Group Co. Ltd.
10. SHSS: Shanghai Huchang Special Steel Co. Ltd.

**The full name of the main promoters of ten listed companies:
1. SPC: Shanghai Petrochemical Complex
2. KEMF: Kiamen Engineering Machinery Factory
3. GSF: Guangzhou Shipyard Factory
4. TBF: Tsingtao Brewery Factory
5. XHTI: Xinjiang Hongyuan Investment Company
6. QHRC: Qingdao Haier Refrigerator Complex
7. HMGP: Hunjiang Municipal Grocery Plaza
8. NMC: Ningbo Machinery Complex
9. JCF: Jinhua Cement Factory
10. No.5 SSF: Shanghai No.5 Steel Factory

In this table the main promoters are entities which are dissolved after they have promoted and have registered the company.
**TABLE 3-2: STOCK OWNERSHIP IN TEN LISTED COMPANIES**

<table>
<thead>
<tr>
<th>Name</th>
<th>Holding size** per group (%)</th>
<th>Holder number per group</th>
<th>Largest holding size per group (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SHS</td>
<td>LHS</td>
<td>IHS</td>
</tr>
<tr>
<td>SP</td>
<td>64.2</td>
<td>2.4</td>
<td>6.4</td>
</tr>
<tr>
<td>KEM</td>
<td>74.5</td>
<td>/</td>
<td>25.5</td>
</tr>
<tr>
<td>GSI</td>
<td>42.6</td>
<td>/</td>
<td>25.5</td>
</tr>
<tr>
<td>TB</td>
<td>44.4</td>
<td>5.93</td>
<td>11.1</td>
</tr>
<tr>
<td>XHTI</td>
<td>28.6</td>
<td>42.8</td>
<td>28.5</td>
</tr>
<tr>
<td>QHR</td>
<td>65.2</td>
<td>/</td>
<td>34.8</td>
</tr>
<tr>
<td>NH</td>
<td>26.1</td>
<td>25.8</td>
<td>53.0</td>
</tr>
<tr>
<td>NMT</td>
<td>21.3</td>
<td>53.0</td>
<td>25.6</td>
</tr>
<tr>
<td>ZIG</td>
<td>61.0</td>
<td>18.3</td>
<td>20.6</td>
</tr>
<tr>
<td>SHSS</td>
<td>48.8</td>
<td>42.4</td>
<td>8.75</td>
</tr>
</tbody>
</table>

*The holders of SHS or promotor held shares in ten companies are as follows:
1. SP: China National Petrochemical Holding Co.Ltd.
2. KEM: Kiamen Municipal Bureau of Finance
3. GSI: China National Shipyard Industrial Co.Ltd.
4. TB: Qingdao Municipal Bureau of State Assets Management
5. XHTI: China Construct Bank Xinjiang Branch
6. QHR: Haer Group Company
7. NH: Jilin Provincial Bureau of State Assets Management, Hunjiang Municipal Bureau of State Assets Management
8. NMT: Ningbo Municipal Bureau of State Assets Management
9. ZIG: Jinghua Municipal Bureau of State Assets Management
10. SHSS: Shanghai Municipal Bureau of State Assets Management

** SHS: state held shares
LHS: legal entity held shares
IHS: main land Chinese individual held shares
FHS: foreign investor held shares
### TABLE 3-3: RELATION BETWEEN HOLDERS, DIRECTORS AND LEGAL REPRESENTATIVES IN TEN LISTED COMPANIES

<table>
<thead>
<tr>
<th>Name</th>
<th>Date Created</th>
<th>Directors Number</th>
<th>Number of Directors Relative to the State or Holder Groups*</th>
<th>Number of Directors Hold Concurrent Corporate Officials</th>
<th>Post of Legal Representatives***</th>
</tr>
</thead>
<tbody>
<tr>
<td>SP</td>
<td>June, 1993</td>
<td>15</td>
<td>SH (14)</td>
<td>SH (12)</td>
<td>Board President &amp; General Manager</td>
</tr>
<tr>
<td>KEM</td>
<td>December, 1993</td>
<td>7</td>
<td>SH (7)</td>
<td>SH (7)</td>
<td>General Manager</td>
</tr>
<tr>
<td>GSI</td>
<td>May, 1993</td>
<td>19</td>
<td>SH (17)</td>
<td>SH (16)</td>
<td>Board President &amp; General Manager</td>
</tr>
<tr>
<td>TB</td>
<td>June, 1993</td>
<td>9</td>
<td>SH (1)</td>
<td>SH (7)</td>
<td>Board President &amp; General Manager</td>
</tr>
<tr>
<td>XHTI</td>
<td>December, 1993</td>
<td>10</td>
<td>SH (7)</td>
<td>SH (7)</td>
<td>Bank Official</td>
</tr>
<tr>
<td>QHR</td>
<td>April, 1989</td>
<td>7</td>
<td>SH (7)</td>
<td>SH (6)</td>
<td>Board President</td>
</tr>
<tr>
<td>NH</td>
<td>September, 1989</td>
<td>17</td>
<td>SH (12)</td>
<td>SH (12)</td>
<td>Board President</td>
</tr>
<tr>
<td>NMT</td>
<td>March, 1993</td>
<td>11</td>
<td>SH (6)</td>
<td>SH (6)</td>
<td>Board President &amp; General Manager</td>
</tr>
<tr>
<td>ZJG</td>
<td>March, 1993</td>
<td>13</td>
<td>SH (6)</td>
<td>SH (6)</td>
<td>Board President &amp; General Manager</td>
</tr>
<tr>
<td>SHSS</td>
<td>December, 1992</td>
<td>19</td>
<td>SH (13)</td>
<td>SH (12)</td>
<td>Board President</td>
</tr>
</tbody>
</table>

* LEH: legal entity holder  
IH: individual holder  
SH: state holder  
PH: promoter holder  
FIH: foreign investor holder.

** Directors related to the legal entity holders are those whose professional experience is not linked to the main promoter and they are nominated as directors neither because they are holders nor because of their posts in government institutions.

*** The relation between legal representatives and promoters or state holders are as follows:  
1. SP: General Manager or SP  
2. KEM: Chairman of Worker Union in KEMF  
3. GSI: General Director of GSF  
4. TB: Senior Engineer of TBF  
5. XHTI: Bank Official  
6. QHR: General Manager of both holding company and promoter  
7. NH: Former Vice-director of Provincial Economic Structure Reform Committee  
8. NMT: General Director of NMC  
9. ZJG: General Director of JCF and representative of state holder  
10. Director of No.5 SSF which is the promoter of company and holds 26.18% outstanding shares.

Sources of information for Tables 3-(1-3):  
A. Three Approaches to Restructuring SOEs as Public Corporations

Three methods exist by which a SOE may be transformed into a corporate entity. These methods are designated as the "merger method" (jianbing tujing), "splitting method" (xinshe tujing), and the "mixture method" (hunhe tujing), and are distinguishable by the type of initial offering used in the corporatization.

1. **Merger Method.** Under the merger method, a prospective joint-stock company makes an initial offering to a single subscriber, usually a state enterprise. Once the subscriber purchases the shares and transfers its own assets to the new company, the subscriber's legal status terminates and the new company is established. When these transactions are completed, the new joint-stock company assumes completely the subscriber's rights and obligations vis-à-vis third parties.

   Most state enterprises use the merger method to become joint-stock companies. The transaction between the state enterprise subscriber and its other "self"—the joint-stock company—involves the transferring of debts and exchanging of shares and property ownership. At the instant the process is completed, the state enterprise ends, and the joint-stock company emerges. At its establishment, the joint-stock company has only one shareholder. This shareholder nominates all of the members of the first board of this newly formed corporation. Board chairmen are elected by the directors under the direction of the shareholder. Of the companies listed in Table 3, Guangzhou Shipyard, Shanghai Petrochemical, Tsingtao Beer, Dongbei Hualian, Ningbo Machine Tools, and Siamen Engineering Machinery used the merger method to establish joint-stock companies.

   Within a month of their formation, each of these six companies made additional share offerings to the public. For the promoter or controlling shareholder, this method of merger and sequential share offering provides obvious benefits. First, the initial subscriber has total control over the election of directors and all introductory matters involved in corporatization. Although on average the size of the six companies' new offerings were 44% of the initial one, there was no additional selection of directors. Thus, during the three years between the first and second meetings of the boards of directors, since outsider shareholders could not exercise their right either to nominate or elect directors, promoters acted alone. From calling the opening meeting, through reviewing the appropriateness of promoting fees and the legality of the way stock was issued, to the selection of directors
and the application for registration, the outside public shareholders had no choice but to accept these \textit{faits accompli}.

Second, by making two offerings within a short period of time, the promoter could avoid the legal constraint imposed by the Standards Opinion's rule that "similar classes of shares offered at the same time must be issued at the same price."\textsuperscript{145} Despite the short time interval between the offerings, the price of the second offering was as much as 2 to 3.4 times the first and generated substantial paid-in surplus as a windfall for the original shareholder.\textsuperscript{146}

2. \textit{Splitting Method.} In this method, a certain percentage of a company's initial public offering is subscribed to by two or more promoters, with the rest of the shares issued to the public. The promoters do not lose their identity upon the formation of the joint-stock company. The chief promoter is split into two parts: the SOE which retains its existence after transferring all or most of its assets into the joint-stock company, and the newly established joint-stock company in which the SOE is the majority shareholder. Of the companies listed in Table III, only Shanghai Huchang Special Steel used this method to establish itself. Shanghai Huchang was initiated by Shanghai Number Five Steel Factory (Shanghai Steel) together with six state enterprises and financial institutions. Shanghai Steel used the capitalized value of a building in construction as consideration to buy 75\% of the shares.\textsuperscript{147} The other six promoters used cash as consideration to obtain 2.6\% of Huchang's shares. The remaining 22.4\% of the shares were issued to the employees of the state enterprise, the general public, and various organizations.

The splitting method of corporatization differs from the merger method in several respects. First, the initial offerings of the two methods involves different players with very different results. In the

\textsuperscript{145} Standards Opinion, supra note 3, art. 27.

\textsuperscript{146} In June 1992, when Shanghai's Hualian Company issued additional news shares, the net value of the old shares was 2.75 RMB per share. The new shares were issued at a per share price of 9.28 RMB. The ratio between the net value of the old share and the issuing price of the new was 1:3.4.

The disclosures in the Huachang notice of offering demonstrate that there were three subscription prices for the initial shares issued at face value of 10 RMB per share. The state shareholders and the five Shanghai Steel factories were priced at 14.5 RMB. The six sponsors other than the 5 steel factories paid 26 RMB per share. Organizations other than the founding sponsors and individuals each had to pay 28 RMB per share.

\textsuperscript{147} Of this Shanghai Steel actually holds only 26.18\%. The other 48.82\% is controlled by the Shanghai State Asset Bureau.
splitting method, shares are issued to the promoters and the general public in the initial offering, instead of holding a second offering just for the public. Also, with this method, the establishment of the joint-stock company does not terminate the promoters' or enterprises' entity or any rights and obligations of these enterprises. The promoters issue the stock under the name of the joint-stock company. These promoters are jointly and severally liable for their promoting activities and assume the risk of failure in the initial stock offering. Under the merger method, the original subscriber is relieved of liability, since the joint-stock company assumes the responsibility. Under the splitting method, the promoter remains liable, even after the company is formed, for fraud and misrepresentations during the share offering.

Finally, under the splitting method, the public shareholders have greater control over the initial formation of the corporation. The promoters are obliged to notify the new shareholders about the inaugural meeting of the corporation. The promoters and the public shareholders are able to participate in the selection of the first board of directors. Thus, the promoters do not have the same opportunity to concentrate their power that they do in the merger method.

3. **Mixture Method.** Under this method of corporatization, two or more promoters subscribe a set amount of shares in the new company during the initial offering. Other subscribers are then allowed to purchase shares in a subsequent offering to the public. At least one promoter has his legal status terminated after the offering. This promoter also transfers his rights and obligations to the joint-stock company upon establishment.

Of Table 3’s companies, Qingdao Haier, Xinjiang Hongyuan, and Zhejiang Jianfeng, were established using the mixture method. The promoters of these companies used all of their net assets as consideration for the shares, which were then merged into the newly formed joint-stock company. In this respect the mixture method is similar to the merger method. Otherwise, it is more like the splitting method.

4. **Critique of the Merger and Splitting Methods.** Unlike the mixture method, both the merger and “splitting” methods have several aspects which cannot survive scrutiny under the Standards
Opinion. Under the Standards Opinion, when a state enterprise is the sole promoter of a company, it must establish the company by making a public offering (muji) and must have at least two shareholders upon establishment. However, under the merger method, only one shareholder exists upon formation. Thus, the legitimacy of the corporation's legal status under the merger method can be easily challenged.

Setting aside this obvious problem, the company formed under the merger method faces yet another legal dilemma. The Standards Opinion mandates a twelve month period between any two share offerings. The splitting method does not violate these provisions, since it offers shares to the promoters and to the public during the initial offering. However, under the merger method, there are separate offerings to the state enterprise and to the public. The second and third offerings to the public occur within one month of the establishment of the joint-stock company, clearly violating the twelve month waiting period mandated by the laws.

The splitting method is not free from defects either. Under the Standards Opinion, a class of shares being offered at the same time must be offered to all buyers at the same price. However, in the initial offering under the splitting method, the company offers shares at lower prices to the promoters than the prices offered to the other subscribers. Thus, both methods of corporatization have certain aspects which are prohibited by the terms of the Standards Opinion.

B. Control of the Majority Shareholder

Some Chinese corporations have a majority shareholder who owns more than 50% of the common stock. Whether under the former regime of the Standards Opinion or the new one of the Company Law, this shareholder has the right to elect more than 50% of the directors, to appoint all managers, and to dismiss all of the directors and managers. Thus, the majority shareholder in Chinese corporations has the ability to control the management of the corporation.

149. Standards Opinion, supra note 3, art. 9, ¶ 2.
150. Id. art. 36.
151. Id. art. 27.
152. These actions require, though, majority votes at the meetings of the shareholders and directors, respectively. Id. art. 43, ¶ 1, item 6, art. 47; Gongsifa [Company Law], art. 106, art. 2, art. 117.
Four companies listed in Table 3, specifically Shanghai Petrochemical, Xiamen Machine Tool, Zhejiang Jianfeng, and Qingdao Haier, have one shareholder who holds more than 50% of outstanding shares. The state is the controlling shareholder in all of these companies, except Qingdao Haier. These four companies have forty-two directors combined. Of these forty-two directors, thirty-two of are former managers or party officials at the sole or most important promoter, while two others are representatives of relevant government agencies. Twenty-six directors who hold concurrent managerial or senior positions were formerly managers at the promoting companies.

1. *Shanghai Petrochemical Case Study.* Among the four companies mentioned above, Shanghai Petrochemical was the largest company to be listed in China in 1993. It also represents a typical example of a corporation formed by the merger method. Shanghai Petrochemical has fifteen directors divided into two groups called executive directors and non-executive directors. The non-executive directors comprise the highest positions in the company, such as the general manager and the vice general manager. They also hold such other important positions as managers, heads of party committees or chairmen of trade unions in subsidiary companies. Three other directors are presidents of promoters, outside legal counsel, and professors. Except for the promoter, no other shareholders have seats on the board of directors.

Candidates for director positions can be nominated by any shareholder who owns more than 5% of the shares. These directors can only be elected or dismissed by a majority of the votes cast at the shareholder meeting. Board chairmen are elected or dismissed by a two-thirds majority of the directors’ votes. The vice-chairmen are then elected by the chairmen, subject to the approval of a majority of the directors.

Since Sinopec (China Petrochemical), the state shareholder, owns a majority of the shares in Shanghai Petrochemical, this majority shareholder can control more than 60% of the board. Without the majority shareholder’s approval, no other candidates can be elected as directors. Similarly, without its consent, no director can be dismissed.

The remaining shares of Shanghai Petrochemical are held by a variety of shareholders. About 316,200 individuals hold approximately 400 million shares. Their holdings amount to approximately 6.4% of the 6 billion outstanding shares. Thus, the average number of
shares held per individual is 1265 with each share having a face value of RMB 1. Actually, the shares are not equally distributed among these shareholders, since one individual holds 210 thousand shares, accounting for 2% of all the outstanding shares. This is a large portion of the 6.4% held by the other individuals collectively. The prospectus did not disclose the number of legal person shareholders, but altogether they hold about 2.4% of the total shares, with a face value of RMB 1.5 billion. The top ten legal person shareholders hold a combined 27 million shares, with the maximum amount held by a single legal person being 12 million shares.

Foreign investors hold about 27% of the total outstanding shares in the form of 1.68 billion Hong Kong listed H shares. This number of shares is distributed among the 6057 total foreign shareholders, with the average amount of shares held by each foreign investor being 277,000 shares. The top ten foreign shareholders hold approximately 1.141 billion shares, while the top foreign holder owns 0.67 billion shares, representing 10.86% of the total outstanding shares.

These disparate categories of shareholders' ability to influence corporate affairs varies widely. Ownership by individuals of A shares is most dispersed, so no single shareholder is qualified to attend a shareholders meeting. Even if all these individual shareholders assigned their voting rights to a single representative, they could still nominate only one director. The legal person shareholders hold insufficient A shares to nominate even a single candidate for director. By contrast, H shares are the most concentrated, and the single largest shareholder can nominate two directors. Also, collectively, the foreign shareholders can nominate five candidates for director. Thus, foreign shareholders will always have representation on Shanghai Petrochemical's board of directors.

In 1993, the CSRC, the Hong Kong Stock Exchange (HKSE), and the SCRES signed a memorandum which gave shareholders of H shares immunity, allowing them to purchase more than 10% of the total outstanding shares without obtaining the approval of the Chinese government. Thus, no legal obstacle to concentration of H shares exists. Although in the short-run Sinopec's control of Shanghai Petrochemical seems impervious to an H share challenge, the H share's potential impact cannot be neglected.

2. Zhejiang Jianfeng Case Study. The other companies listed in Table 3 have some similarities and some differences when compared to Shanghai Petrochemical. While Xiamen Engineering and Qingdao Haier have majority shareholder characteristics similar
to those of Shanghai Petrochemical, Zhejiang Jianfeng differs in several aspects. Compared to the power held by the Shanghai Petrochemical majority shareholder, Zhejiang Jianfeng has a much less centralized control structure. In Zhejiang Jianfeng, there were seven promoters, chief among them Jinhua Municipal Concrete Factory, a state enterprise. The other six were township and village enterprises, with five having their initial investment divided into state shares and legal person shares. Although the chief promoter was merged into Zhejiang Jianfeng and state shares constitute 60% of the total shares outstanding, the assets represented by those shares came from six enterprises. Thus, the control of the majority shareholders is not as exclusive as in Shanghai Petrochemical.

To illustrate, of the thirteen directors in Zhejiang Jianfeng, six of them were nominated by legal person shareholders other than the primary promoter, and one is a government official. Managers at the leading promoter occupy six seats on the board, and occupy such important positions as the director, vice directors, general manager, and vice general manager. In this company, the majority shareholders and the minority shareholders both control the same number of seats on the board. Due to this board composition, the one vote of the government official becomes crucial in the event of an impasse.

C. Control of the Minority Shareholders. In other companies, the state shareholders have a minority holding rather than the controlling interest of those companies discussed above. In Table 3-2, Guangzhou, Shanghai Huchang, Ningbo, Dongbei Hualian, Xinjiang Hongyuan, and Tsingtao Beer lack a state shareholder with a majority interest. Among these companies, the highest percentage of state shares is 48% of total outstanding shares, and the lowest percentage is 21%. The average state holding among all these companies is about 29.5%. However, the state still owns the largest block of shares with the remaining shares dispersed among the shareholders. The next largest holding constitutes approximately 27% of the state's shares. Thus, even though it is not a majority shareholder, the state can still control as a minority shareholder through its power to appoint or remove at least half the directors and managers on its own.

1. Dongbei Hualian Case Study. Among the above-mentioned companies, Dongbei Hualian has the second-lowest percentage of state shares, at 21.1%. The 14.77 million shares owned by the state are held by two government agencies. The Jilin Province State Assets Administration Bureau (SAAB) holds 13 million shares while the
Huijiang Municipal SAAB holds 1.77 million shares. In addition to these state-owned shares, 18.03 million shares, or 25.8% of the total shares, are held by twenty-one institutions. Each institution thus averages 85,000 shares, with the maximum holding among these investors being only 2.8% of the total. Individual shareholders hold the remaining 37 million shares. These shares, totalling 53% of the total shares, are held by 9817 individual shareholders. Thus, each individual shareholder only holds a small amount of shares and can exert little control over the corporation.

The formation of Dongbei Hualian illustrates the control which can be exerted by the sole promoter even where the state is not a majority shareholder. In December, 1988, the sole promoter, Huijiang department store, established Dongbei Hualian using the merger method. In 1992, the local government reinvested RMB 13 million to the corporation. Among the twelve directors who were also managers of the newly formed company, eleven of them were from the promoter or its subsidiary. The general manager and three assistant general managers were all members of the Board. Thus, unless ownership of other types of shares (e.g., individual and legal person) becomes more concentrated while, in the course of transfer, ownership of state shares becomes more dispersed, if the leading promoter of the joint-stock company is a state enterprise, regardless of whether state shares constitute a majority or minority, the leading promoter will ineluctably retain its control of the corporation.

2. Guangzhou Case Study. Guangzhou is one of the ten largest companies listed on the Shanghai Stock Exchange (SHSE). Guangzhou was established under the merger method, with Guangzhou Shipyard as its sole promoter. The total face value of the shares is RMB 494.67 million. Individuals own 25.55 percent of the total shares, distributed among 24,043 individuals. The average amount held by an individual is 5260 shares, or .1% of the total outstanding shares. The maximum holding of an individual is 2.3 million shares, or .4% of the total shares. Also, in the form of H shares 1129 foreign shareholders own 31.8% of the total shares. The maximum H shares held per person is 55.8 million shares, or 11.89% of total shares, and

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153. Tsingtao Beer actually has the highest percentage of state shares among the companies with minority state ownership in Table 3. However, since the company did not disclose crucial information in its prospectus, we cannot analyze the degree of centralization or dispersion of share holding. Thus, Guangzhou, which is very similar to Tsingtao in its percentage of state share holding, was chosen as the subject of this case study.
27.9% of the state shares, but the average H share owner holds only 139,406 shares. Agents of these foreign investors occupy two of the nineteen seats on the board of directors with the remainder filled by managers from the promoter, Guangzhou Shipyard.

D. Legal Person Representative

In a Chinese enterprise which has legal person status, the legal person representative is the most powerful figure. Many examples exist which illustrate the power the representative has over company affairs. For example, a contract between two enterprises can only take effect upon signing by both legal person representatives. However, the legal person representative may confer this power to others in writing. Also, any shares transferred without the signature of the legal person representative cannot be used as a share certificate. A bank will not accept a company’s check without the representative’s signature and will not write a note for the company without written authorization of the representative. Also, the representative is the only person who may represent the company to the public, unless the articles of association provide otherwise. The legal person representative may not claim the defense that his activities were ultra vires, since all of his actions on behalf of the company are authorized and legal. Thus, the representative is the embodiment of the company. The corporate managers may speak on behalf of the company only with the authorization of the legal person representative.

Unless otherwise provided in the articles of association, the board chairman is the legal person representative of the company. The positions held by the legal person representatives of the ten companies listed in Table 3 are fairly typical. In eight of the companies, representatives are from the highest managerial level of the leading promoter, while Hongyuan and Dongbei Hualian have government officials as legal person representatives. Five of the ten representatives act both as the board chairman and the general manager. One of them is also the representative of the shareholders.

Because the representatives hold dual positions in representation and share holding, they obtain unlimited control over the dismissal of managers in the company. Thus, there is no need for the representa-

154. Standards Opinion, supra note 3, art. 59. According to article 113 of the Company Law, the representative of a joint-stock company legal person can only be the chair of the board of directors. Company articles of association leave no room for flexibility. Gongsifa, art. 113.
tive to be the manager of the subsidiary company. However, the legal representative must transfer a certain amount of power to the managing staff in order to guarantee their cooperation. The legal person representative system is therefore helpful in building the corporate managers’ authority and in improving management’s efficiency in operation. However, this system may present problems of granting too much power in the representative without any system of checks and balances to control his behavior. Without such checks, there is no way to ensure that the representative will exercise his authority in the best interests of the shareholders or to ensure that he handles corporate matters as diligently as he handles his own personal matters.

E. Administration of State Shares

1. Control of State Shares. The administration of the state shares is distributed among the ministries and commissions of the State Council, as well as to the local government agencies. State shares subscribed as a promoter by enterprises directly attached to the ministries and commissions belong to the appropriate ministry or commission or a national company under their aegis, which has a governmental function. Shanghai shihua and Guangzhou are examples of companies which fit this description. On the other hand, as in the cases of Tsingtao Beer and Ningbo Zhongyuan, state shares subscribed for by local state enterprises in the name of a promoter belong to a relevant agency designated by the local government.

In locations where a SAAB exists, the local government’s SAAB is the shareholder of the state shares. However, where none exists or where it is part of the Bureau of Finance, then the Bureau of Finance is the holder of the state shares. One exception does exist to these general rules, as seen by the case of the Shenzhen Municipal Government. In 1988, this government set up a state-run investment management company to participate on behalf of state shareholders in the management of the company. Thus, the investment company actually functioned as a management company and as the SAAB.155

Another situation arises where a state enterprise is a subsidiary of another state enterprise. Even though the legal status of the subsidiary terminates upon the formation of the joint-stock company, the shares subscribed for it by the promoter will be held by the parent

155. GUIDE TO THE STOCK SYSTEM, supra note 6, at 156.
rather than the SAAB as in the previous examples. For instance, Guangzhou Baiyun and four other factories are wholly-owned subsidiaries of Baiyun Enterprises Group, which in turn ultimately belongs to a state holding company, Guangzhou municipal Nong Gong Shang general company. In 1992, the five factories acted as promoters in setting up Guangzhou Baiyun as a joint-stock company, thus terminating their legal status upon the establishment of the company. The shares subscribed for by these five factories are all held by the Baiyun Enterprise Group, as delegated by the state holding company.

2. Voting Rights. The ultimate shareholding company usually adopts one of several methods to exercise its voting rights as a state shareholder. It may delegate the voting right to the board chairman, who was previously the general manager of the state enterprise. The company of Zhejiang Jianfeng is an example of a company which adopted this method. The board chairman and state share representative is the president of Jinhua Shuini, which was the leading promoter of the joint-stock company.\textsuperscript{156}

Other methods exist by which the holding company may exercise its voting rights. It may delegate the voting right to the managing staff in the former state enterprise, with the votes distributed according to the ranks of the managers' titles.\textsuperscript{157} Also, the company may delegate the voting right to its own official who is the director of the company. Also, the SAAB may set up an assets operation management company to be the parent holding company of the joint-stock company. The SAAB, however, often faces resistance from other government organizations in its exercise of the administration of state shares. One solution to this problem is to allow the government agencies claiming a right to administration of the shares to send their own representatives to the board.

When government agencies cannot reach an agreement as to who can designate a representative as a director, the post of director is left vacant. This situation occurred in Shanghai Number 2 textile, which

\textsuperscript{156} Also, in 1992, Zhangjian SAAB authorized the board chairman of Guangdong Huawei, who is the ex-president of Huawei Bingye, the leading promoter, to hold 28,800,000 shares on behalf of the state. In another example, the board chairman and ex-general manager of Manan Shan steel company, which was the leading promoter, is now the state share representative of Magang. The company's prospectus, reprinted in SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES DAILY], Nov. 11, 1993, at 5.

\textsuperscript{157} See Guojiagu rengehua pozai meijie [The Urgency of Converting State Shares into Individual Shares], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Sept. 15, 1993, at 1.
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was established as a joint-stock company in 1991, but had no director nominated by institutions holding state shares until 1993.

When state enterprises are restructured as joint-stock companies and SAABs hold state shares, the power of the government agencies who used to supervise the former state enterprise is significantly weakened. At the same time, the newly established SAAB also does not have enough power to command the joint-stock companies. Thus, in the midst of power redistribution the joint-stock company apparently enjoys even greater autonomy than the state enterprise had. A survey of seventeen listed companies conducted in 1993 by the Shanghai municipal government revealed that the fourteen possible operational autonomies allowed in joint-stock companies had been granted to most of the companies surveyed. The percentage of implementation of these autonomies in joint-stock companies was 20% higher than the percentage in state enterprises. However, this trend will possibly be reversed with the rise in SAAB power. In 1993, for example, Shanghai and Zhejiang founded SAABs with broadened powers. China's economic reform makes clear that the expansion of state agencies' power inevitably restricts the autonomy of the individual, company, and community.

3. Effects of Distribution of Control. Although distributing the power to administer state assets among government agencies may not bring about revolutionary change, it at least forces the government agencies holding state shares and administering state assets to play three conflicting roles. First, as a government agency, it has the obligation to give equal treatment to the competing enterprises within its jurisdiction and to avoid getting involved in their competition. Second, the diversification of the state investment and high percentage of state shareholding may force the representative of the government agency to act as director in two competing companies. As director, he is entrusted with the duties of disclosing his interests in other companies to the board and to the shareholders, maintaining the confidentiality of commercial secrets, and avoiding competition with the company. However, as a director in competing companies, he may have a duty to one company which forces him to violate his duty to another company.

Third, the administration of the state assets presents complications of legal relationships as well. The beneficiary of the state shares is the state. However, whether this state is represented by central or local government must be determined by looking to precedents and to the separation of administrative power. If the share beneficiary is separated from the holder, then the former is no longer a shareholder in the legal sense. In this case, the state shareholder is not the state itself, but rather the government or a holding company with a governmental function. The state representative becomes the trustee, responsible for the protection of the state’s interests, as well as those of the minority shareholders. Thus, he cannot bring benefits to the state at the expense of the minority shareholders' interests. In the end, the dispute over who represents the state and holds shares is resolved by fait accompli, rather than by statute.

F. Transferring State Shares

1. Transfer of Harbin Pharmaceutical’s State Shares  In 1993, three companies listed on the SHSE transferred a large amount of their state shares to the companies’ individual shareholders. Among these companies, Hayiyao (Harbin Pharmaceutical) was the most outstanding case.

   On June 6, 1993, Harbin Pharmaceutical was listed on the Shanghai Stock Exchange. At that time, the face value of the total shares is RMB 252.64 million, with 74% being state shares and the remaining 26% owned by individuals. The state shareholder was the promoter’s controlling company, called Harbin Pharmaceutical Group.

   On July 17, 1993, Harbin Pharmaceutical’s board announced that it was calling a special meeting of the shareholders to approve transfer of 52 million state shares (face value of RMB 1) to individual shareholders at a price of RMB 4.06 per share. The board provided that any one individual holding more than ten individual shares could subscribe for up to eight state shares, with the subscription right being non-transferrable. The subscription period lasted from July 29 to August 6. One day before the news was disclosed to the general public, Harbin Pharmaceutical’s closing price was RMB 16.75 per share.159 On July 26, 1993, the CSRC notified the Harbin municipal

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government and SHSE in writing that it wanted Harbin Pharmaceutical to terminate the transfer of state shares. The Commission gave two reasons for the termination. First, the transfer of state shares should have been approved by the SAAB rather than the special shareholder meeting held by Harbin Pharmaceutical. Second, article 47 of the Stock Regulative Ordinance requires any legal person shareholder who holds more than 5% of the total outstanding shares of a listed company to report to the issuing company, the CSRC, and the SHSE in writing whenever its holdings increase or decrease by more than 2% of the total outstanding shares. This report must be made within three working days of the time the change occurs. The Commission contends that Harbin Pharmaceutical violated this provision by not writing this report within the time specified.

The Harbin municipal government and its SAAB responded to the CSRC’s demand by stating their case in the media. First, the State Council had affirmed “united leadership and multi-level administration” in the administration of state assets. Within the scope of the authority granted them, local governments could transfer state assets. Second, they asserted that the Heilongjiang provincial government had sent written authorization for the Harbin municipal government to transfer or auction state assets within its jurisdiction. Harbin Pharmaceutical’s state shares are from the local state enterprises’ investments. These shares fall within the state assets under the administration of Harbin’s SAAB. Third, the state shareholder, Harbin Pharmaceutical Group Company, obtained approval from the Harbin SAAB before it made the transferring decision. Fourth, in all fairness to the public, the transfer could not be halted because once news of the transfer had been disclosed, heavy trading of Harbin Pharmaceutical’s shares had affected investors. Fifth, failure to notify the CSRC in writing had been an oversight for which the city was willing to take responsibility. To make amends, Harbin’s mayor would personally go to Beijing to report to the CSRC.

For its part, the SHSE issued a statement that was an indirect criticism of the CSRC: “[a]ny policy decision by the concerned

161. *Id.
authorities ought to take into account its impact on the market."

Eventually, Harbin Pharmaceutical completed the transfer of state shares pursuant to its original plan.

2. Legal Issues Arising from the Transfer of Harbin Pharmaceutical's State Shares

The legal issues involved in the transfer of Harbin Pharmaceutical state shares extend beyond the disputes between the CSRC and Harbin municipal government. Did the state shareholder have the right to transfer the shares under its own name? Why did the state shareholder rush to sell its shares at prices far below the market price on the Xth trading day after the shares were listed? Was damage to the state interest caused by the transfer in this case? Was the offer from the state shareholders to individual shareholders subject to the constraints of article 47 of the Regulations on Issuing Shares? Finally, did the CSRC have the power to demand that the Harbin municipal government change its decisions?

a. Transfer Rights. Harbin Pharmaceutical group company, the promoter and holding company, is Harbin Pharmaceutical's state shareholder. The beneficiary of the state shares is Harbin municipal government. The beneficiary's agent is Harbin SAAB, which delegated its power to act in the best interest of the beneficiary to Harbin Pharmaceutical group company. Thus, whether the transfer of state shares by Harbin Pharmaceutical is subject to the approval of the municipal SAAB depends on whether the latter's authorization included the right to make the transfer. This question touches on the relationship between the municipal SAAB and the Haiyiyao group and is regulated by contract law. In deciding these issues, a court can judicially intervene upon the request of one party, unless the administrative regulations specially provide otherwise or an administrative organization has been granted the authority to act on its own initiative. The Methods for Administering State Property in Share System Experimental Enterprises (Gufen shidian qiye guoyouchan guanli banfa) enacted by the state SAAB in 1992 says nothing either about limiting the SAAB's right to transfer shares or about all transfers requiring approval by the national SAAB. Neither the authorization by the Security Policy Commission to the CSRC nor the Regulations on Issuing Shares grants CSRC the power to prohibit the

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162. Hayiyao guoyougu zhuanrang zaicheng jiaodian [Harbin Pharmaceutical's Transfer of State Shares Again Becomes a Focus of Attention], ZHENGQUAN SHICHANG ZHOUKAN [SECURITIES MARKET WEEKLY], 1993, no. 31, at 3.
transfer of state assets or to exercise supervision regarding the validity of such transfers. Thus, whether the CSRC’s intervention exceeded its jurisdiction should be decided by administrative or judicial review.

b. Share Offering. In January 1992, 65 million individual shares of Harbin Pharmaceutical were offered to the public with a face value of one yuan per share. The municipal government granted a 65 million share issuance quota in 1993 solely to make Harbin Pharmaceutical’s 65 million individual shares issued in 1992 eligible for listing and trading. Thus, Harbin Pharmaceutical cannot rely on this quota to support any further issuance of shares, since it was only a “listing quota” rather than an “issuance quota”. Compared with other companies which were granted an “issuance quota” in 1993, Harbin Pharmaceutical paid an incredibly high price for the listing of its shares. Generally, the other companies offered their individual shares at prices three to eight times the face value. This means that a company getting a quota to issue each share with a face value of one yuan could raise three to eight yuan per share. Harbin Pharmaceutical, however, offered all of its 65 million individual shares at face value. Aside from this loss, Harbin Pharmaceutical now also needs at least 4 or 5 million yuan for the expenses of asset estimation, audit of financial condition, legal services, trust of shares and listing advertisements. So, Harbin Pharmaceutical will surely be faced with a serious shortage of cash flow after the listing of its shares.

c. Harm to State Interest. Because of the issuance and listing quotas, a company may transfer only one-fourth of its shares issued within the previous year and may not issue new shares. In an attempt to inject circulating funds into its subsidiary, the controlling company was forced to transfer its shares at a low price. Such was the background for Haiyiyao’s actions. If Harbin Pharmaceutical caused damages to the state-owned assets, the question arises whether this harm should be attributable to the transferor, or to the quota control system which exerted such financial pressure on the transferor.

In the five days immediately preceding Harbin Pharmaceutical Group’s decision to transfer its state shares, the average closing price was RMB 16.52 per share. However, the 52 million state shares were sold at a much lower price of RMB 4.06. In a fully opened stock market, this type of behavior would be out of the ordinary. However, the Shanghai Securities Exchange is not such an opened market.

The market price of the Harbin Pharmaceutical shares only reflected the true value of the one-fourth of the total shares which
were transferrable, since all state shares were frozen at this time. Had the state shares been transferrable, the Harbin Pharmaceutical shares might have had a much higher price. Thus, the RMB 16.52 price was an incorrect price resulting from the classification of shares and the discretion of the stock trading market. Critics have argued that the state shares should be transferred at the market price to avoid the transferring of the state shares at low prices and thereby draining the state-owned assets. However, these critics overlook the fact that these non-transferrable state shares have neither a market nor a market price. Valuing the state shares at the individual shares' market price allows the state shares to unjustly obtain the favorable high price without bearing any of the inherent market risks. Thus, Harbin Pharmaceutical rightly did not attempt to transfer its state shares at market prices, and thus did not disadvantage the individual shareholders in the process.

A shareholder may transfer its shares at any price and for any purpose except to manipulate the market. This decision depends solely on the shareholder's business judgment and may not be interfered with by any other person. The price available to the shareholder is not necessarily equal to the market price. When all shareholders attempt to sell their shares at this price, the competition may drive the price down so that no one actually concludes a transaction at this predetermined market price. Therefore, under such circumstances, a transfer below the market price is a rational and predictable choice for the shareholder.

When first listed, the per share net value of the Harbin Pharmaceutical shares was only RMB 2.28. Within less than a month of the listing, Harbin Pharmaceutical transferred 52 million of its state shares at a price of RMB 4.06 per share. This transaction made RMB 92.56 million in profits for Harbin Pharmaceutical in addition to recouping its capital outlay. This investment recovery rate of 178% suggests the unreasonableness of characterizing this transaction as detrimental to the interest of the State.

d. Application of Article 47. Article 47 of the Regulations on Issuing Shares contains a clause which applies specifically to the acquisition of corporations. Harbin Pharmaceutical's transfer of shares may not fall under this provision though, since it may not be a "corporate acquisition." In Harbin Pharmaceutical's transfer of its state shares, a majority shareholder transferred its shares to thousands of minority shareholders, each of which could buy the transferred shares in their ownership proportions. Thus, this transaction was a
dispersion of the shareholdership, which is the direct opposite of the corporate acquisition. Furthermore, when the Harbin Pharmaceutical Group offered to transfer its state shares to the individual shareholders, no increase or decrease of shareholdership amounting to 2% of the total shares issued had occurred as required in the statute. So, even if the "corporate acquisition" clause was applicable to the case at bar, Harbin Pharmaceutical did not have to make a report since the 2% threshold was not reached.

G. CSRC as a Competent Authority in the Business Sector

At the time of the Harbin Pharmaceutical transfer, the newly established CSRC was eager to establish in several spheres its examining and approving authority, because, generally, this sort of authority was formed on the basis of customary practice. Thus, the CSRC disapproved of Harbin Pharmaceutical's transfer of state shares precisely in order to establish the CSRC's approval authority over such matters. Regardless of whether the CSRC had a proper justification for this action, a non-governmental organization has no legal grounds on which to order a local government to alter its decision.

Harbin Pharmaceutical did not invent the transfer of state shares; it simply followed the precedent set by two companies on the Shanghai exchange. The first case occurred in April 1993, when the Shanghai Lujianzhui Co. (LJZ) transferred its 30 million state shares to its individual shareholders at a price of RMB 2.9 (the face value was RMB 1). For each individual share held, the holder was permitted to buy two state shares. Before the transfer, the total share capital of the company was RMB 715 million, with 93% state shares, 5% legal person shares, and 2% individual shares. According to the listing requirements of the SHSE, the "shares publicly offered" could not be less than 10% of the actual paid-in share capital. Thus, even if all the legal person shares and individual shares of LJZ were treated as "shares publicly offered", the company would still have only 7% publicly offered and would not meet the 10% requirement of the SHSE. The state shareholder declared that it transferred the state shares just to enable the company to meet the listing requirement.

Another case is important for its precedential value to Harbin Pharmaceutical. Just one week before Harbin Pharmaceutical transferred its state shares, Shenneng Co. Ltd, one of the biggest listed companies in Shanghai, transferred 60 million of its state shares
to its individual shareholders. The holder of each individual share was allowed to purchase two state shares at RMB 3.5 per share, well below the pre-transfer market price of RMB 15 per share.

Clearly, Harbin Pharmaceutical was inspired by the fact that these two Shanghai companies’ suffered neither interference from the CSRC nor any form of censure.\(^{163}\)

V. THE ROLE OF LITIGATION IN THE DEVELOPMENT OF CHINESE CORPORATE LAW

A. The Case of People’s Bank v. Yuanye and Runtao

In 1990, Yuanye Industrial was created from the Shenzhen Municipal Yuanye Textile Corporation, Ltd. (Yuanye Textile), which had been established in 1987 according to the Interim Provisions of the Shenzhen Special Economic Zone on Experimentation of the Shareholding System in SOEs.\(^ {164}\) The story of Yuanye Textiles acquisition by a privately held Hong Kong company, Runtao, its accumulation of debt and the subsequent litigation with its creditors illustrates how law becomes reality through litigation and how administrative influence and concerns impinge on that process.

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163. In its defense, the Harbin municipal government referred to these Shanghai precedents, but the CSRC maintained that Shanghai and Shenzhen were shareholding experimental areas. Thus, it argued, the Central Government specially permitted these two areas to carry out bold experiments which other areas were not privileged to perform. On October 25, 1993, the CSRC made the following decision regarding Harbin Pharmaceutical: at the time the state shares were transferred, the company did not fulfill its duty to report to the CSRC; however, afterward it recognized its mistake, and therefore will receive only a warning. See CSRC BULLETIN, supra note 22, 1993, no. 1, at 117.

164. See GUIDE TO THE STOCK SYSTEM, supra note 6, at 132.
TABLE 4: CHANGE OF STOCK OWNERSHIP IN YUANYE INDUSTRIAL CO. LTD. (1987-1993)

<table>
<thead>
<tr>
<th>Date</th>
<th>Par value of outstanding shares (in thousand yuan)</th>
<th>Holder's name**</th>
<th>Shares held by each holder (in thousand yuan)</th>
<th>Size of holding(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>State owned enterprises</td>
<td>Foreign Investors</td>
</tr>
<tr>
<td>June 1987</td>
<td>1,500</td>
<td>XY</td>
<td>450</td>
<td>60</td>
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<td></td>
<td></td>
<td>SH</td>
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<td></td>
<td></td>
<td>KS</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>PJD</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>LKM</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Feb. 1988-</td>
<td>1,500</td>
<td>XY</td>
<td>900</td>
<td>60</td>
</tr>
<tr>
<td>July 1988</td>
<td></td>
<td>Tanco</td>
<td>300</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>PJD</td>
<td>150</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>LKM</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Aug. 27, 1988</td>
<td>4,200</td>
<td>XY</td>
<td>900</td>
<td>21.5</td>
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<tr>
<td></td>
<td></td>
<td>Tanco</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>PJD</td>
<td>150</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>LKM</td>
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<td></td>
</tr>
<tr>
<td>Oct. 4-</td>
<td>20,000</td>
<td>XY</td>
<td>900</td>
<td>4.5</td>
</tr>
<tr>
<td>Dec. 22, 1988</td>
<td></td>
<td>Tanco</td>
<td>16,600</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>LKM</td>
<td>900</td>
<td></td>
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<tr>
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<td></td>
<td>LZ</td>
<td>800</td>
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<tr>
<td></td>
<td></td>
<td>XJS</td>
<td>800</td>
<td></td>
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<tr>
<td>Aug. 23, 1989</td>
<td>20,000</td>
<td>Tanco</td>
<td>19,100</td>
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<tr>
<td></td>
<td></td>
<td>CF</td>
<td>900</td>
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</tr>
<tr>
<td>1990</td>
<td>90,000</td>
<td>Tanco</td>
<td>56,600</td>
<td></td>
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<td></td>
<td></td>
<td>II</td>
<td>24,500</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>CF</td>
<td>6,900</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>KTY</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>ZC</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Aug. 1993</td>
<td>90,000</td>
<td>HKCI</td>
<td>34,411,500</td>
<td>12.5</td>
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<td></td>
<td></td>
<td>SCCD</td>
<td>11,250,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>II</td>
<td>44,338,500</td>
<td></td>
</tr>
</tbody>
</table>

**The full name of holders:
1. XY: Xinye Clothes Co. Ltd., a state owned enterprise
2. SH: Shenhai Clothes Co. Ltd., a state owned enterprise
3. KS: Kaisheng Co. Ltd., a Hong Kong company
4. PJD: Peng Jianzhong, the manager of SH, the majority holder of Tanco and the board president of Yuanye from 1988 to 1993
5. LKM: Li Kuimou, the brother-in-law of PJD
6. Tanco: Tanco Industrial Holding Co. Ltd., a Hong Kong company
7. LZ, XJS: Li Zhi, Xu Jingchu, individual holders
8. CF: Champaign Fashion Co. Ltd., the subsidiary of Tanco
9. II: individual holders, both employees of Champaign and the public
10. KTY: Kangya Textile Co. Ltd., a company held shares for the benificial of Tanco
11. ZC: Zhejiang Colthes Co. Ltd., a company held shares for the benificial of Tanco
12. HKCI: Hong Kong Chian Investement Co. Ltd., a Hong Kong company taking over most of Tanco’s shares in August 1993
13. SCCD: Shenzhen City Construct Development Co. Ltd., a state owned company taking over part of Tanco’s shares in August 1993

Significant facts relating to law suits:
1. In June 1987, Kaisheng, a HK Co., subscribed shares but did not contribute subscription money.

2. In February 1988, Tanco Industrial Holding Co. Ltd, a company registered in Hong Kong, replaced Kaisen as the holder of Champaign and subscribed an additional issue of common stock at 2.7 million yuan par value, but did not contribute subscription money.

3. In 1988, Shenhai transferred all of its stock to Xinye and withdrew from Champaign.

4. In August 1988, Nine hundred thousand shares of common stock held by Xinye were converted into preferred stock at a fixed annual premium of 350,000 yuan. Tanco paid all of its 3 million yuan subscription money.

5. After evaluation, the net assets of Champaign increased from 4.2 million to 31.73 million yuan in October 1988. After paying a premium of 350,000 yuan to the preferred stockholders, the increased book value was distributed among three common stock holders according to the size of their common stock holdings at 91%, 4.5% and 4.5% respectively.

   The increased ownership of Tanco amounted to 24.67 million yuan. Tanco reinvested 13.6 million yuan into Champaign and the other 13.93 million yuan was designated as Champaign’s debt to Tanco.

6. Mr. Peng transferred all of his shares to the other three individual holders.

7. In March 1989, three individual holders transferred all of their shares to Tanco and Tanco was the only holder of Champaign. It held 56.6 million yuan par value of shares under its own name. The others were held under the names of the other three companies.

8. In February 1990, Champaign issued 24.5 million yuan par value common stock to the public.

9. In August 1993, the restructuring group of Champaign made the decision to deprive Tanco of all of its stock ownership. The municipal government approved the decision.

* Sources for the chart: 1) Yvantı fafl guwen tan Yuanye ande fiaolong guma [Yuan ye's legal adviser tells the story of the Yuan ye case], Zhengquan shichang zhoukan [Securities Market Weekly], 1992, no. 13, at 9-14; 2) Yuanye di'er an shenli [Hearing the second Yuan ye case], Zhengquan shichang zhoukan [Securities Market Weekly], 1992, no. 16, at 6; 3) Shenzhen yuanye gonsi an kailing chui bolan [Opening of yuan ye case causes waves], Zhengquan shichang zhoukan [Securities Market Weekly], 1992, no. 15, at 5; 4) 'Yuan ye' youyou [Dragging out 'Yuan ye'], Shoudu jingji xinxing bao [Capital Economic Information Daily], Dec. 20, 1994, at 1; 5) During the course of writing this essay, Yuan ye's legal adviser, Professor Xu Bing of the Legal Research Institute of China's Academy of Social Sciences, provided me a copy of the decision from the Shenzhen Intermediate People's court and assisted me in proofing the chart.

1. Background and Procedural History.

A number of entities held shares of Yuan ye Industrial's predecessor, Yuan ye Textile. Sixty percent of the common shares of Yuan ye Textile were held by two SOEs, 20% by foreign enterprises, and 20% by two individuals. In the second half of 1988, the composition of the holders and the shares of Yuan ye Textile changed dramatically. Runtao Corp., a private, Hong Kong registered company whose majority shareholder was one Peng Jiandong, had obtained 83% of the common shares of Yuan ye Textile. Peng became the company's Chairman of the Board, while the common stock held by the two SOEs were converted into preferred stock. Overall, capital shares in Yuan ye Textile were increased in value from the RMB 1.5 million yuan to 20 million.
In 1990, Yuanye Textile changed its name to the Yuanye Industrial Corporation Ltd. (Yuanye Industrial) and in February of that year, made its first public offering of 2.45 million shares at a face value of RMB 10 each. By December of 1990, Yuanye Industrial had been approved for and was listed on the Shenzhen Securities Exchange.

In 1990 and 1991, Yuanye Industrial borrowed RMB 400 million in working capital from several local banks. Runtao guaranteed the loans with the common shares of Yuanye Industrial which it held. In April of 1992, however, Yuanye defaulted on a 250 million loan, prompting the Shenzhen Branch of the People's Bank, the administrative organ in charge of listed companies, and of Yuanye Industrial's creditors, to investigate Yuanye's financial condition. On June 20, 1992, the Shenzhen Branch declared that Runtao's ownership of the Yuanye Industrial shares were illegal and ordered creditors that they could not transfer the Yuanye Industrial shares they held as security. However, the Shenzhen Branch did advise China Industrial and Commercial Bank and several other creditor banks to file suit against both companies.

2. Judicial Treatment. On June 23, 1992, several of Yuanye's creditors did file suit in the Intermediate People's Court of Shenzhen City (the trial court) to procure repayment of the loans. In their complaint, the banks requested that the trial court declare Yuanye and Runtao jointly and severally liable for repayment of the principal amount of the loans, the interest due, and for fines related to nonpayment. More significantly, the creditor banks asked that the trial court declare void the agreement that Yuanye shares (allegedly held illegally by Runtao) would be collateral, so that Runtao would have to satisfy a judgement out of its own coffers.

In December of 1992, the trial court rendered a judgment in favor of the creditor banks and held that both companies were jointly and severally liable for the debt. The court also declared the agreement as to the shares void. In reaching its decision, the trial

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165. Between 1990 and 1991 real estate investment in Shenzhen was at a high tide. After Yuanye Industrial was established, it immediately invested in the Xingjian office building and apartments. The construction costs caused Yuanye to face a serious capital shortage. Yuanye Industrial applied to issue additional shares but was refused by the Shenzhen branch of the People's Bank.

166. See the Civil Judgement No. Zhongfajing II 054 of the Middle-level People's Court of the Shenzhen City.
court held that because Runtao's ownership of Yuanye shares was illegal, the loan agreement was void. However, the court held that Runtao was still liable for Yuanye's debt. As to the issue of the ownership of shares, the court reasoned that Runtao had not made a lawful investment in Yuanye, and therefore had no transferable interest in the company. Dissatisfied with the judgment, Runtao appealed to the High People's Court of the Guangdong Province (the appellate court).

On review, the appellate court in May 1993 reversed the findings of the trial court and upheld the loan agreement and Runtao's ownership of Yuanye's stock. In reaching the decision that the terms of the loan agreement should be upheld, the appellate court began its analysis by looking at the nature of the agreement. The court held that the underlying loan contract was a bilateral, private agreement between Yuanye and the banks, and given that it did not contravene public interest or the interests of the third parties, was a legally binding instrument.

With respect to the issue of Runtao's ownership of the stock and their use as collateral for the loan, the appellate court held that the Yuanye shares pledged to the banks had been acquired with the approval with the local people's government (that is, the Shenzhen Municipal Government) and its competent department in charge of securities. In light of such approval, the stock ownership was legal and could be used as collateral for the mortgage.

As to whether the interests of Yuanye Industrial or its stockholders had been adversely affected by Runtao's actions during the process of its acquisition of Yuanye stock, the appellate court made no findings. Instead, it stated that it would not consider the issue since the creditor banks lacked standing to bring such a suit. The court went on to state that only Yuanye and its stockholders could bring such a suit and that the appellees, the creditor banks, were not directly interested in the question of the legality of Runtao's possession of Yuanye stock. The appellate court stated further that the authenticity of Runtao's investment or the legality of its shareholding were questions irrelevant to the case at bar, and should be handled by the administrative authorities according to statutory procedure.

While the appellate court ostensibly reversed the lower court's decision in the body of the opinion, its final judgment failed to reflect a reversal. In its final judgment, the appellate court gave Yuanye 30 days within which to pay off its debts. However, if Yuanye was
unable to make repayment, the appellate court held that Runtao would be liable for the remainder, which had to be paid off with property other than the stocks pledged.\textsuperscript{167} Despite its reasoning to the contrary, in its actual instructions the appellate court appears to have upheld the trial court.

3. \textit{Critique of Judicial Treatment.} In order to adequately assess judicial treatment of this case, one must first consider whether the court system was the proper forum for resolution of this conflict. Yuanye was an extremely expensive case to litigate. According to Yuanye's legal counsel, the fees indirectly or directly paid by the plaintiffs and the defendants amounted to over RMB 10 million. This expense was incurred despite the fact that the defendant, Runtao, never denied its liability. Further, the final judgment was to some degree, rendered ineffective by the eventual reorganization of Yuanye. Given the expense, inadequacy of the judicial answer, and availability of other methods of resolution, one must conclude that the courts were not the appropriate body for answering the questions raised by this litigation. In fact it is surprising that the courts accepted this case for consideration at all.

After the People's Bank declared Runtao's possession of Yuanye shares illegal and prohibited the transfer of those shares, the relevant question which should have been pursued by the plaintiff banks was whether the mortgagee should be responsible for the debt with property other than the shares, not whether the stock guarantee was valid. However, the plaintiff banks chose to pursue the issue of whether the shares legally held could be pledged, an issue already decided by the administrative authorities and irrelevant to the central issue of liability.

The banks could have chosen a more economical and convenient way to protect their rights as creditors. For example, they might have transferred the stock pledged to them. If the proceeds from the sale of the collateral stock did not satisfy the liability, the banks could have petitioned the people's court to declare Yuanye Industrial bankrupt under article 199 of the Civil Procedure Law. Admittedly, an involuntary declaration of bankruptcy would adversely affect the value of Yuanye stock and thereby hurt its investors.

Instead of allowing the creditors' banks to pursue such a remedy, the People's Bank intervened in the situation. The People's Bank adopted a number of restrictive measures, such as prohibiting the further transfer of stock, suspending the listing of Yuanye Industrial, and preventing the creditors from filing a petition for a declaration of bankruptcy, to maintain the financial stability of Yuanye. While the Bank's actions were beneficial to other investors, its actions pressured the plaintiff/creditors (units directly under its administrative jurisdiction) to file a different action which ultimately failed to result in an acceptable solution to the problem.

The People's Bank clearly realized the effect of its actions in encouraging the creditors to take the action to court. It knew that its administrative act depriving Runtao of its stock ownership would be subject to judicial review and would thus force the court to decide the validity of ownership. Forcing judicial determination of the issue would relieve the Bank having to directly confront Yuanye in an administrative hearing. Contrary to the Bank's expectations, however, the appellate court held that an administrative and not judicial hearing was the appropriate method to resolve the stock ownership issue. It further held that the stock pledge contract was valid. This decision came after the litigants and the courts had expended considerable time and resources in deciding what should have been obvious and rendered moot the Bank's goal.

4. Additional Issues raised by Yuanye. Despite the courts not being the appropriate body for consideration of the legality of Runtao's ownership of Yuanye stock, the case did raise a number of interesting questions which were neither put forward by the parties nor addressed by the court. These unraised issues provide an excellent framework for analyzing the new Company Law, and as such, warrant investigation.

**QUESTION ONE:** May administrative authorities interfere with and declare void a private contract between two parties in the absence of a petition for intervention by either party?

It is a generally accepted that an administrative agency, as a government body, may take reasonable adverse actions against a private party when it acts pursuant to the law and in the public's interest. Because the purpose of such intervention is to protect the public's interest, the agency is not constrained by the potential effect on the party or whether there has been a petition for such action.
This is not to suggest that the agency is free to do as it pleases; it is subject to due process constraints, administrative reconsideration, and judicial review.

However, when an administrative authority intervenes on its own initiative in private civil affairs, the presumptive lawfulness of its actions are not so clear. The actions of an agency in private affairs not only violates the principal of self-determination in civil law, but also creates a situation in which government action is being used against one private party to the benefit of another private party, rather than for the general public good.

The People's Bank's declaration that Runtao's ownership of Yuanye stock was illegal exemplifies the danger of such intervention in civil affairs. This administrative act was obviously intended to favor the state shareholders. If Runtao's ownership was illegal, the state, as the shareholder with the next largest amount of stock, would take over Yuanye. This transfer would have occurred despite the fact the state itself made no such petition for transfer of control.

To some extent, the appellate court precluded such a result. In the opinion of the appellate court, unless Yuanye Industrial and its shareholders challenged the legality of Runtao's ownership, the court would not consider the issue. However and somewhat surprisingly, the court also held that the issue could be considered by the appropriate administrative agency under statutory procedure. The decision by the court that the agency could consider the issue is inappropriate. If the interested parties are the only ones with standing to bring such an action before a court, then they should also be the only parties able to bring such an action before an administrative agency.

QUESTION TWO: Should a third party guarantor of a loan be forced to satisfy its liability with property other than what was pledged, if for reasons not attributable to the guarantor, the pledge fails?

Despite upholding the validity of the pledge of stock as collateral, the appellate court required Runtao to repay the mortgage with other property. Unfortunately, the appellate court failed to provide any explanation for this decision.

The appellate court's judgement fails to address the obvious distinction between acting as a third party pledger of property and acting as a guarantor of a loan. The former is only liable for the loan
to the extent of what he pledged, while the latter may be liable to the extent of all of his property. When the People's Bank declared the pledged property (the stock shares) illegally possessed, the relevant question was whether Runtao, as the pledger, was liable for anything.

Both courts held that Runtao was liable for Yuanye's debts with property other than the pledged stock. However, they reached this decision on separate grounds. The trial court reasoned that Runtao was liable because its mistake had made the pledge contract invalid, and it had been the pledger. The appellate court reversed on the issue of the pledge contract, but without explanation, still held Runtao liable for the loan. Under either analysis, forcing Runtao to satisfy Yuanye's debt with property other than the stock unjustly makes Runtao bear Yuanye's liability without a showing that it created or benefited from the debt and in absence of a legal responsibility to do so.

The issue of whether Runtao used its controlling shareholding position to the detriment of Yuanye and its other shareholders was not addressed by the courts. However, from the court record, it is reasonable to infer that it did abuse its position. In any event, before such abuse is proven or even alleged by the shareholders, the courts should not have found Runtao liable for the loan in light of the invalidity of the pledge right. Further, if the appellate court felt so compelled to make an implicit finding of fault, it should explain why.

Litigation is an opportunity for a court to answer important social issues, demonstrate the application of the law, and define appropriate behavior. A judgment must be evaluated not only with regard to whether the outcome is just, but also as to whether the reasoning behind the outcome was properly based and adequately expressed. In Yuanye, neither of these criteria was met.


1. Background and Complaints. In January of 1993, Yuanye Industrial convened a special meeting of the Board of Directors. In that meeting, the Board decided to apply to the Shenzhen Municipal People's Government for restructuring of the company.168

168. The legal basis for Yuanye Industrial's reorganization (zhongzheng) is chapter 4 of the 1986 "Guangdong Province Special Economic Zone Regulations for companies with foreign elements" (Guangdongsheng jingjitequ shewai gongsi tiaoli). See STOCK ECONOMICS, supra note
In March of 1993, the Shenzhen municipal government issued Document No. 117. Document No. 117 established a board to organize and implement the reorganization of Yuanye. The Leading Group for Reorganization included directors of Yuanye, shareholder representatives, lawyers, accountants and auditors. Municipal government officials were appointed to supervise the group’s work.\(^6\)

In evaluating the prospects for reorganization of Yuanye, the group entered into negotiations with the China Investment Company of Hong Kong and its head, Zheng Lieli, to transfer controlling interest in the company. Though incorporated in Hong Kong, all of the China Investment Corp.’s capital comes from the mainland. This sparked considerable tension between officials in Hong Kong and China.

In June of 1993, the Hong Kong Supreme Court issued an injunction prohibiting China Investment Corp., Zheng Lieli, and his representatives, from directly or indirectly transferring shares of Runtao or Yuanye and from exerting influence on either company to make a new public offering.\(^7\) On August 19, 1993, the Shenzhen municipal government responded with Document No. 335, which permitted China Investment Corp. to acquire Runtao’s shares in Yuanye.\(^1\)

6 (now superseded by the Guangdong Provincial Company Regulations (Guangdong sheng gongsi tiaoli), which took effect on August 1, 1993). Regarding reorganization, the former regulations provide that “in order to escape financial difficulties that have repeatedly brought it to the brink of bankruptcy and in order to recover production operations, a special economic zone company with foreign elements may undergo reorganization.” The members of the reorganization small group are to be determined by either a meeting of the shareholders or by a meeting of the board of directors. The government may assign a “supervisor” (jianduren) to oversee the reorganization. The small group takes over all powers of the board of directors.

Professor Xu Bing (Yuanye Industrial’s legal adviser) believed that Yuanye had, at that time, the capacity to clear its debts and was not facing the risk of bankruptcy. Reorganization was thus not required. Even if reorganization were necessary, according to the regulations the small group had no authority to make decisions concerning questions of shareholders’ rights. When the majority shareholder has been deprived of the right to participate, no valid shareholder decisions can be produced. Therefore, the application for “reorganization” did not represent the true intent of Yuanye Industrial. See Yuanye gongsi zifa gudong dahuai yinqi zhengyi [Spontaneous Yuanye shareholders meeting arouses argument], ZHENGQUAN SHICHANG ZHOUKAN [SECURITIES MARKET WEEKLY], 1993, no. 35, at 12.

169. ZHENGQUAN SHICHANG ZHOUKAN [SECURITIES MARKET WEEKLY], 1993, no. 13, at 20.

170. RENMIN RIBAO [PEOPLE’S DAILY], Aug. 31, 1993, at 7

171. After the final judgment, Runtao invited two influential men to serve as chairman of the board and general manager, and commissioned them with full power to represent the company in negotiations with the Shenzhen municipal government. It further transferred to the
Document No. 335 was followed in September of 1993 with a decision by the Reorganization Group to deprive Runtao of almost all of its shares. The Reorganization Group justified its decision to deprive Runtao of its shares on a number of grounds: (1) The group alleged that the RMB 2.7 million worth of Yuanye shares which Runtao purchased in May of 1988 were "not approved and registered with the relevant department of the Shenzhen Municipal People's Government" and as such were an "unlawful investment" that should be revoked; (2) The group also claimed that additional shares Runtao acquired by using its profits from the 2.7 million RMB of shares "jeopardized the interest of the state capital, encroached upon the state-owned assets and were thus illegal proceeds." As such, these shares should become state shares; (3) The group also found that Yuanye had converted a fabricated capital appreciation into the shares that had been issued to Runtao; (4) the group held that in November of 1989, Runtao's holding of shares under four other names was deceptive and that the shares should be transferred to the Shenzhen Urban Construction Development Company; (5) finally, the group determined that the remaining shares of Runtao be taken over by the China Investment Corp., Ltd. After the restructuring, the public held 49.27% of Yuanye Industrial's shares, China Investment held 38.23%, and Shenzhen Urban Construction Development Co., held 12.5%. At a general meeting in September of 1993, the shareholders of Yuanye affirmed these decisions of the Reorganization Group.

In response to these events, Runtao instituted a legal proceeding against the Shenzhen Municipal Government in the Intermediate People's Court of Shenzhen City. In its complaint, Runtao alleged that the administration authorities had exceeded their power by reviewing the lawfulness of actions between private parties, specifically, the transfer of shares.

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new general manager 9.18% of the Yuanye stock it held. Using the name of Runtao, the new chairman, took all of the remaining Yuanye shares held by Runtao and transferred it to China Investment Company, Ltd., a private company he established in Hong Kong. Runtao then sought an injunction from the Hong Kong high court to enjoin this action.


173. *Id.*

174. *Id.*

175. In November 1993, the former chair of the Yuanye board of directors and now holder of Australian citizenship, Peng Jiandong, was arrested in Macao and brought back to the
2. The Legal Issues Raised. While Runtao has yet to be addressed by the courts, it does raise a number of significant legal issues. Apparently, the city of Shenzhen approached the appellate court prior to its creation of the reorganization group seeking counsel as to whether such actions were within the scope of its powers. This collusion between the court and the city raises serious questions as to the impartiality, fairness and equity in allowing the appellate court to hear this case.

Prior to the appellate court’s decision in Yuanye, the Shenzhen municipal government approached the court about the legality of actions it was contemplating. The Mayor of Shenzhen, Li Youwei told the press in April of 1993:

[After the trial of first instance by the Shenzhen Intermediate Court, we asked the Higher People’s Court of Guangdong Province for instruction on the problem of adopting administrative measures to restructure the Yuanye company and we got an affirmative answer. And on March 30, we for a second time, exchanged opinions with the leadership of the Higher People’s Court of Guangdong Province. In their opinion, the determination of shareholdership had always been decided administratively by the governmental organs. The solution of these problems used to be regarded as administrative acts, so it is logical and reasonable to solve them through administrative measures.]

The accuracy of Mayor Li’s comments to the press was borne out in August when the Higher People’s Court’s issued a decision that touched on a matter not raised by the parties and that exceeded the scope of civil litigation: the authenticity of Runtao’s investment and the legality of its shareholding ought to be settled by the relevant administrative authorities.

The contact between the mayor and the court is clearly questionable. It runs counter to rule of law to allow an administrative agency to consult a court which has jurisdiction over the disputes between the administrative organ and a certain party prior to the agency taking adverse actions against that party. This type of “advice seeking” is an invitation to the court to participate in the administrative decision-

mainland. The Shenzhen municipal procurator accused Peng of “serious crimes of bribery and embezzlement of public funds” (fan you yanzhongde tanwu zui he nayong gongkuan zui). ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], July 28, 1994, at 1.

176. ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], April 4, 1993, at 1.
making process. Such participation renders judicial review useless. The primary purpose of judicial review is to provide an independent review of an agency's decision making process; if the court participates in the decision making process, it will be reviewing its own actions.

In administrative litigation, the only reasonable role for an administrative agency is to be the defendant. It may only respond to claims; it has no right to bring suit itself. If prior to an administrative proceeding in which the agency is a defendant, the agency induces a court to answer a question it should address only when the agency is a defendant, the agency is effectively exercising a right that attaches only to a plaintiff. Such actions deprive the interested party of the right of prosecution and of a fair trial. By rendering a legal opinion to an interested party without first listening to the other party's side of the case, the court has in essence forced the other party to make its case after judgment has already been rendered. This "advice seeking" also creates a dangerous judicial precedent. It encourages administrative agencies facing litigation to open the door voluntarily and encourage the courts to expand their authority into what should be the administrative agency's area of jurisdiction. This encroachment by the judiciary can only serve to jeopardize the independent exercise of administrative power.

3. Other Legal Issues. The facts established in Yuanye might reasonably lead one to believe that Runtao used its position as controlling shareholder in Yuanye Industrial to encroach upon the interests of its subsidiary and benefit its own financial position. Runtao received an excessive return on its investment in Yuanye in a relatively short period. Runtao initially invested RMB 3 million into the company on August 27, 1988, when it first paid for its subscription. Thirty-eight days later, on October 4, 1988, that investment had appreciated eight times resulting in a profit of RMB 24.67 million. Runtao divided this profit into two parts: one part was reinvested in Yuanye and the remainder was taken by Runtao to be held in creditorship for Yuanye. Runtao maintained that the cash to honor the creditorship would be immediately accessible and could come from: (1) subscription funds for the company's newly offered

177. Articles 1, 2, 11, 25, and 26 of The Administrative Litigation Law make it clear that in administrative litigation, administrative agencies are defendants. Zhonghua renmin gongheguo xingzheng susong fa [Administrative Litigation Law of the People's Republic of China], arts. 1, 2, 11, 25, 26, reprinted in COMPILATION OF NEW LAWS, supra note 18, no.2, at 3.
shares; (2) loans borrowed by the company from banks; and (3) the company’s own business income. Regardless of the source of the funds, responsibility for the cash rested with Yuanye or its successors.

According to information published by the Leading Group for Restructuring, in February of 1993, the net capital of Yuanye Industrial was only RMB 15.41 million. The net value per share of RMB 1 Yuanye stock had fallen to RMB 0.17. Since its association with Runtao, Yuanye had lost RMB 85.3 million. Over this same period, however, Runtao’s creditorship of Yuanye amounted to more than RMB 130 million, about 1.4 times the total value of Yuanye shares. It is clear that the property of the subsidiary (Yuanye) had all flowed into the parent company (Runtao).

Leaving aside the issue of whether Yuanye can prove that Runtao illegally appropriated its property, the question remains as to whether Yuanye can bring suit against Runtao and its controlling shareholder, Peng Jiandong, as the Chairman of Yuanye’s Board of Directors.

Article 49 of the Civil Procedure Law of the People’s Republic of China provides that legal persons shall be represented by their legal representatives in litigation. However, the Supreme Court has interpreted the term “legal person representative” to mean the chairman of the board of directors. This interpretation leads to an anomalous result in this situation; it means that Peng Jiandong would have to file suit against himself. In effect, it will be impossible for the board of directors to sue the chairman in this situation.

As the law currently stands, where a company cannot sue the chairman of its board, the shareholders have no means by which they can protect their own interests. There are no provisions for the filing of a derivative suit under either the Civil Procedure Law or the new Companies Law. While the appellate court correctly held that the minority shareholders in Yuanye should be able challenge the legality of Runtao’s ownership, it remains to be seen whether they will be able to proceed with such a suit.


VI. THE COMPANY LAW AND THE EXISTING LEGAL FRAMEWORK

A. Draft of the Company Law

In April of 1985, under the leadership of the now defunct State Economic Commission, work began on drafting the Regulations on Limited Liability Companies (Youxian zeren gongsi tiaoli) and the Regulations on Joint-Stock Companies (Gufen youxian gongsi tiaoli). In October 1987, the two draft regulations were submitted to the State Council for deliberation.

In April 1990, deputies at the Third Meeting of the Seventh National People’s Congress requested enactment of a Company Law. In response, the Legislative Bureau under the State Council and the SCRES revised and supplemented the earlier regulations and that same year submitted a draft limited liability Company Law (Youxian zeren gongsi fa) to the State Council in 1990. However, because joint-stock companies had become a sensitive ideological issue, legislative work on the subject came to a temporary halt. To maintain the momentum and avoid a political battle, the legislature decided to direct efforts toward passing the Limited Liability Company with the hope that it would be able to use that experience to enact a more unified and comprehensive Company Law when the political climate was more favorable.

By August of 1992 the ideological mood had changed sufficiently for, the Standing Committee of the NPC to decide that the Limited Liability Company Law and the Joint-Stock Company Law should be combined into one Company Law. The Standing Committee also decided that the Legislative Affairs Commission and not the Legislative Bureau of the State Council should oversee the drafting of the new law, and In February of 1993 the Legislative Affairs Commission presented its draft of the New Company Law to the Standing Meeting of the NPC for discussion. Revisions and further discussion took place between the two groups through December of that year, when the Standing Committee approved submission of the final version to the National People’s Congress. In April 1994, the NPC approved the law.

B. Conflict Between the Company Law and the Existing Legal Framework

The drafters of the Company Law faced a dilemma. On the one hand they could not indiscriminately replicate the existing legal framework which revolved around administrative permits, was increasingly subject to criticism of its administrative arbitrariness, and was based on anachronistic rules and regulations. For example, China was no longer satisfied with conducting its reform on the matrix of a planned economy. It wanted to develop a socialist market economy. Yet, on the other hand, legislators could not suddenly change the order established by administrative authority: for example, the quota controls for issuing and listing stocks and the permits for promoting a joint-stock company. Unless more reasonable, more feasibly systematized rules replace it, an established system will not disappear overnight after promulgation of a new law. Therefore the Company Law can only serve as a link between the past and future legal frameworks, abandoning some of the current framework’s rules and preserving others. Yet because of the way it was drafted, the Company Law will inevitably generate more transitional problems than other legislation.

In the past, the NPC enacted laws that included veritable “blank check” (kongbai zhipiao) grants of power to administrative authorities. For example, laws provided that the State Council or one of its departments might “formulate implementing measures in accordance with the present law,” or a law might affirm a certain ministry of commission as “the department in charge” of implementing that law. But the Company Law made no such authorization to the State Council or its departments. It permitted the latter to exercise their administrative legislative power only regarding matters expressly stipulated in the Company Law. Previously, laws enacted by the NPC could peacefully coexist with the laws and regulations already in effect. Administrative authorities would not face the pressure of amending or invalidating extant administrative regulations and rules because the administrative agency which would be charged with implementing a new law would also have drafted that law. The law

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181. See, e.g., The Customs Law, art. 60, reprinted in 3 THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 23 (1990); Law on Technology Contracts, art. 54, id. at 39; Law on Industrial Enterprises Owned by the Whole People, art. 67, id. at 155; Law on Chinese-Foreign Contractual Joint Ventures, art. 27, id. at 164.
would have been submitted to the Legislative Affairs Commission, which, after some minor revisions, would have submitted the draft to the NPC Standing Committee for a vote.

However, the new Company Law was drafted independently by the Legislative Affairs Commission for the express purpose of supplanting the Standards Opinion and the Opinion on Standards for Limited Liability Companies. The legislators not only made little effort to adapt the new law to the existing rules and regulations, they also wrote provisions aimed at changing the status quo ante.

In at least five aspects, the Company Law imposed varying degrees of limitations on the power of administrative agencies. Article 8, paragraph 2 of the Company Law states that application for the registration of companies do not require the prior permission of an administrative agency except as otherwise provided for by the laws or administrative regulations.\(^{182}\) The abolition of the administrative permit power is a breakthrough for corporatization. Since nationalization in the 1950s, China adhered to a system of pre-registration examination and approval. This requirement placed substantial power in the hands of administrative agencies. Whether an applicant business engaged in a certain trade could be started and the manner in which it could be run were subject to the exclusive approval of the "competent department in charge of the trade." The applicant could apply to the bureau for industry and commerce for registration only if it had procured "gateway” approval from the competent agency. China’s move to a market economy has, contrary to expectations, aggravated rather than reduced agencies’ examination and approval power as new industries have appeared and existing ones have segmented. The scope of regulated activity has increased as agencies try to establish an examination and approval imperium in any new areas which might be profitable.

This permit power may be curtailed by the implicit ultra vires (yuequan wuxiao) principle contained in article 8 of the Company Law. That is, the power of the administrative agencies originates from the laws enacted by the NPC and the administrative regulations formulated by the State Council. Acts exceeding the scope of this delegated authority in the form of either administrative rules or decisions are presumptively void. Thus, under the Company Law the permit power may now be delegated to an agency only through

\(^{182}\) Zhonghua renmin gongheguo gongsifa [Company Law of China], art. 8, reprinted in CHINA'S COMPANY LAW: THE NEW LEGISLATION 10 (Guiguo Wang trans., 1994).
specific regulations issued by the State Council and any attempt to
claim a permit power without specific authorization has no legal basis.

A caveat must added to this analysis. Article 77 of the law also
provides that "the establishment of a joint-stock company shall be
subject to the approval of a department authorized by the State
Council or of a people's government at the provincial level." This
language indicates that the changes in the permit may apply only to
limited liability companies and may be illusory with regard to joint-
stock companies in that the prior approval requirement still exists. As
far as the joint-stock company is concerned the authority structures
formed after the promulgation of the Standards Opinion are
unaffected the enactment of the Company Law. Enterprises
belonging to the central government are still subject to the examina-
tion and approval of the corresponding ministries and commissions,
and the enterprises belonging to local governments are still subject to
the examination and approval of the local governments. For joint-
stock companies, the change is no more than a redistribution of the
examination and approval powers among the "competent departments
in charge of the trades" and the other governmental organs.

Since the 1980s, one of the fundamental causes of economic
disorder in China has been the involvement of government officials
and agencies in trade and business. Between 1984 and 1993 the
Central Committee of the CPC and the State Council have issued
fifteen documents prohibiting such involvement and ordering agencies
and officials to "unhook" (tuikou) themselves from the companies
they had set up. However, as evidenced by their repeated promulga-
tion, such proscriptions have been utterly ineffectual.

Article 58 of the new law admirably attempts to solve this conflict
of interest problem by prohibiting government officials from serving
concurrently as directors, supervisors or managers of companies, but
it leaves unanswered practical questions of enforcement. What
happens if a government official violates the law and serves concur-
rently as a senior manager in a company. Based on Article 58 does
an interested party have standing to sue? And are government
functionaries who served concurrently as high ranking officers of a
state monopoly exempt from Article 58's controls?

Another problem addressed by the new law is the quota controls
on the issuance of stock. However, the effect of the new law in this
area seems identical to the old regime. While the law neither affirms
nor negates quota controls, articles 85 and 139 do provide that the
offering of new shares by a company shall be subject to the approval
of the department in charge of securities under the State Council. Thus, issuance approval and quota controls still fall within the discretionary power of the relevant agency.

Perhaps the most important distinction between the Company Law and the existing legal framework is the deregulation of share transfers. Article 143 states simply that all shares are transferable and makes no mention of the previous classification system. Under article 144, it appears that the door seems to have been opened for an OCT market as listing of shares in securities exchanges is no longer the only channel for transfer of stock. And although no companies have yet issued unsigned shares (wu jiming gupiao, that is shares with no signature), this more conveniently transferred form of shares is likely to be increasingly used since article 145 allows such shares to be exchanged on any legally established exchange. Significantly, the new law contains no limitations on the proportion of shares which may be held by employees nor does it authorize an agency to create such restrictions. This suggests that such matters will be governed by individual companies' articles of association rather than by public law. Of course, the effectiveness these provisions depends on how soon an OCT market is established and whether the forthcoming securities law departs in significant ways from the Company Law.

Because of the substantial approval power vested in government agencies, the Company Law creates administrative and criminal sanctions for dereliction of duty in the examination and approval process. While dereliction of government duty was already criminalized under the penal code, and no one has yet been sanctioned for dereliction of duty in granting approval to a company that fall short of the legal requirements for incorporation or share listing, the Company Law's general provisions were intended as reminder of the consequences of dereliction. To make the consequences even more explicit, the Standing Committee of the NPC, on February 28, 1995 passed a resolution that added to the Criminal Law a group provisions spelling out tough sanctions for criminal violations of the Company Law. The provisions deal with corporate fraud as well as

abuse of the approval power and impose on convicted government officials sentences up to five years of hard labor.  

C. Compatibility of the Company Law with the Existing Legal Framework

Despite the changes discussed above, the Company Law seems to have strengthened the administrative permit system in two key respects.

Previously, issuing of shares to organizations and internal employees, so-called directed or fixed channel offerings, were not subject to quota controls or to the approval of the CSRC. Although this type of shares can almost never be listed or traded on the exchanges, people still enthusiastically subscribed for them, enabling the issuing companies to raise large amounts of capital. Thus, when issuing and listing of shares was restricted, enterprises entered the capital markets under the guise of directed offerings. Probably because of worries about the fraud, insider trading and disorder associated with directed offerings, the Company Law proscribed such offerings. Therefore, with the exception of "promoter establishment" (faqi sheli), in which the promoter buys out all the shares, the State Council's subordinate department in charge of securities (guowuyuan zhengquan guanli bumen), namely the CSRC, must approve the establishment of any joint-stock company.

Article 151 of the Company Law provides that the listing of shares shall be subject to the approval of the State Council or the department in charge of securities under the State Council. This provision categorically affirms the permit power of administrative agencies to approve the listing of shares and actually extends the scope of such power beyond that enumerated in the Regulations on Issuing and Trading which did not expressly provide the approval right over listing applications.

Under the prior statutory framework, a joint-stock company in Shanghai and Shenzhen which wished to make a public offering within the prescribed quotas was only required to receive approval from the local government under special provisions which granted these local

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185. Quanguo renmin daibiao dahui changwu weiyuan hui guanyu zhengzhi weifan gongsifa de fanzuidu jueding [Decision of the Standing Committee of the National People's Congress Concerning Penalties for Breaking the Company Law] reprinted in RENMIN RIBAO [PEOPLE'S DAILY], March 2, 1995 at 2. Notably, article 8, par. 2 imposes sanctions not only on the directly responsible agency but also on any supervising agency that forced its subordinate to violate the rules.
governments more autonomy in carrying out corporatization. The company was not subject to examination by the CSRC nor did it require the final approval of the Securities Policy Committee. However, article 151 of the new law limits the authority of the local governments in Shanghai and Shenzhen to approve incorporations of companies and to manage their securities market. Article 151 unequivocally states that without exception, all shares will be subject to the approval of the department in charge of securities under the State Council.

D. Criticism of the Company Law

The new Company Law has been the target of much criticism since its enactment. In this section I respond to a number of critiques that appeared in the spring of 1994 in a leading securities market journal. As I demonstrate here, much of the criticism fails to realize the contribution this legislation makes toward the development of Chinese corporate law.

Opponents of the new law allege that by lifting the Standards Opinion's prohibition on individuals and private enterprises initiating joint-stock companies, the new law encourages deceptive trade practices. This criticism fails in two respects. First, the conclusion that individuals and private enterprises tend to be more deceptive is not supported by any evidence. Second, assuming that individuals and private companies are likely to engage in such deceptive acts, at least their actions are more likely to be exposed to legal sanctions. Unlike state-enterprises, private bodies are not as immunized against prosecution by multi-threaded ties to government organizations. Finally, no law will be able to completely insulate investors from deceptive trade practices; law exists on the premise that violations will occur. The role of the law is to determine the limits of legal activity and then to provide judicial remedy for violations.

Critics also allege that the new law totally negates companies established under by directed offerings under the provisions of the Standards Opinion and completely nullifies the market for the circulation and transfer of legal person shares.

According to article 8, initial offerings other than those solely to promoter must be made to the general public. Thus, the critics are correct in positing that article 8 is a prohibition on the ability of a company to make a directed offering. However, the prohibition will

186. ZHENGQUAN SHICHANG ZHOUKAN [SECURITIES MARKET WEEKLY], 1994, Number 4.
not be applied retroactively; under article 229, companies which existed legally prior to the law's enactment are not affected and stock ownership can remain with the parties to whom the directed offering was made.

Further, existence of a market in legal person shares is not an issue that can be settled by a single Company Law. Indeed the transferability of legal person shares may actually be enhanced by the Company Law. Once the quota system is abolished and legal person shares are permitted to be listed and traded on existing exchanges as well as a legalized OCT, the survival of trading centers specializing in legal person shares will depend on the laws of the market. The Company Law has not followed the provisions of the Standards Opinion concerning directed offerings because the drafters of the Company Law sought to anticipate change and to avoid using legal forms to perpetuate an unstable state of affairs.

Finally, critics contend that article 58's prohibition on government officials serving concurrently as companies' directors, managers, and supervisors is a mistake, for when the government owns a significant number of shares in a company, it is perfectly reasonable for government officials to undertake such responsibilities.

The new law actually does not prohibit government organs in charge of state shares in a company from nominating government officials to the board. Rather, the prohibition is that once government officials assume board responsibilities, they must relinquish their status as officials and their positions in government organizations. Otherwise, it is like having a referee participate in the game.

Of course, government officials' concurrent service as directors and managers in state monopolies is an exception to the rule. Article 58 need not be applied to this circumstance, which constitutes no threat to the public interest.

VII. CONCLUSION

A. Problems in Planning a Market

Over the last fifteen years, as the Chinese government's enormous effort at reforming state enterprises through joint operation, contract lease, and other methods failed to produce significant results, it shifted its emphasis to the experiment in corporatization. At its earliest stage under the jurisdiction of localities, the experiment was subjected to little limitation. The participants had a broad scope of autonomy to explore, and their explorations gave birth to a myriad
of proposals from which to choose. Not long after, the central government’s ministries and commissions began to use these early structures as a model to unify the various experiments in corporatization. This unification created a legal framework chiefly characterized by control through permissions to start a company, permissions to issue and list stock, and quotas on stock issues. Until now, this legal framework has been used primarily not to create rules of behavior or develop a socialist market economy; rather it has been used to extend to the experiment in corporatization and the attendant securities market the distinctively Chinese system of special permissions and to insert a nascent, immature market into a highly centralized planned economy.

The intention to bring the practice of corporatization into a previously designed legal framework derives from the same assumptions that drove the establishment of the planned economy: the state can replace individuals’ decision making about their own affairs; the information necessary for a nationwide economic plan could be defined, gathered and processed; the social order must be maintained even at the expense of restricting individual autonomy. On the one hand, the means employed to regulated corporatization in the 1990s is deeply rooted in an unchanged context of planned economy. On the other hand, some provisions of foreign law are simply translated without taking into considering the necessity, feasibility, and compatibility of such transplantation. The co-existence of indigenous measures originally applied to the planned economy and exogenous measures alien to the planned economy results in legal confusion and unusually high transaction costs not needed by either a planned or market economy.

One cannot overemphasize the importance of order in the process of reform. If order were suddenly to be destroyed or there were fundamentally no order, we would have neither social justice nor economic efficiency. However, the question revealed by corporatization is this: at a time when the intrinsic order is incompatible with the direction of society and a new order must be established, can the original rules, methods and operational mechanisms achieve this goal of order? Can these rejected methods of the planned economy be used to establish a market economy order? I think that the defects exposed in the present legal framework are sufficient to cause us to answer in the negative.

Under this legal framework, whether one considers it from the perspective of their seriousness or from the perspective of the
difficulty in resolving them, man-made problems are significantly greater than those that can be attributed to the market economy itself. There are at least five major problems with the existing legal framework:

(1) One day the gates will be opened and several billion “directed placement” (dingxiang muji) shares which have been deprived of their right to enter the market, will be thrown into the market by the huge number of shareholders anxious to transfer their stock. There will inevitably be a sharp price drop. Investors will be unable to recover their principal unless even more of society’s savings enter the stock exchange market once the gates are opened, or the issuing market is temporarily closed. Either circumstance will produce a huge waste of society’s resources.¹⁸⁷

(2) After establishing an unstable, sporadically open securities market with barriers dividing the various types of shares and stock issue quotas, to suddenly remove the barriers and completely open the market could lead to disaster. In the issuing market, after the government, securities dealers, lawyers, accountants, and issuers have all distributed among themselves the issuing income that is more than ten times the face value of the shares and that comes largely from individual shareholders, even more individual capital flows into this narrow stock exchange market. It exerts itself to keep stock prices propped up above the subscription cost so that a profit can be earned when shares change hands. It seems that the costs expended in the process of issuing can be completely recovered in the exchange market. But in an exchange market where the total amount of capital fluctuates within a narrow range, individual shareholders can realize a profit only if the large number of “frozen” shares issued to and held by the state and legal persons are excluded from the market by the barrier of listing permis-

¹⁸⁷ In the first half of 1994 when the price of shares fell, the CSRC adopted measures to slow the listing of new shares. At the beginning of the year, it announced that the release of 5.5 billion share issuing quota would be delayed. Then in August 1994, it announced “a temporary halt in the issuance and listing of various types of new shares, including, shares in the planned quota for 1994, shares remaining from the 1993 quota that had been authorized but not yet issued, and enterprise shares with problems left over by history.” ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], Aug. 2, 1994, at 1.
sion. Any measures that would eliminate the barriers or open the market would dilute the capital already in the trading market and cause panic selling.

(3) Under the system of stock issue quotas, a large amount of resources are wasted for no reason, ordinary order is assaulted, and all written rules become meaningless.

(4) Permission to issue and list shares leads to repeated arbitrary administrative decisions. Faced with mutually contradictory ambiguous administrative rules and regulations, parties are totally at a loss about what to do. It is not so much the formation of rules as it is the formation of unconstrained power.

(5) Given the complex, multi-stranded ties between the government organs that possess the power to set the quotas for issues and to permit the issuing and listing of stocks on the one hand and the securities dealers, lawyers and accountants who receive special permission from those authorities on the other hand, insider trading and market manipulation may be ever more hidden and dangerous.

Concurrent with the experiment in corporatization, there seems to be another experiment underway—taking all the government functions under a planned economy and transplanting them into a tiny market economy nursery. I do not intend to undervalue the role of the government in the market, but I similarly believe that if the government’s interference exceeds reasonable limits, the problems it creates will be far greater than the problems it resolves.

Recently we have seen the repeated occurrence of an inexplicable phenomenon: strengthening administrative authority as a way to solve problems originally caused by the abuse of administrative authority. In the 1980s government organs’ and government personnel’s abuse of their administrative powers to authorize permission and to allocate resources created the disastrous consequences of official profiteering (guandao), but the three “company rectifications” each successively strengthened the government’s power “to examine and permit” (shenpi). The chaotic condition of the stock market was caused by ill-considered measures of administrative management and loss of control over conflicts of interest, yet the solution was to establish an administrative organization with still more concentrated power.

The establishment of order certainly cannot be accomplished without administrative power, but on the other hand without
measures that effectively control administrative power, order can certainly not be established.

The economist Han Zhiguo made the following comment on this question of order.

In establishing a joint-stock company, one must go through the process of examination and approval \([\text{shenpi}]\) by the competent administrative agency. From a certain perspective, the enterprise’s dependence on administrative power is greater and more serious \([\text{than under the prior system}]\). It is only the form of dependency and government agency that has changed \(\ldots\). Comparing the traditional planning regulation under the old system to the power held by competent government organs to approve a quota for share issuance and to choose which enterprise may list, it is hard to say which is worse, but regardless of how great entrepreneurs’ skill or contribution may be, standing before administrative authority they must all bow their heads and acknowledge their vassalage \([\text{fushou chengchen}]\). \(\ldots\) If one says that at present our nation’s share economy is not standard, then I think even more important than the lack of standards in the forms and procedures of operation is that the legal documents concerning the share economy not only are not standard but are also suffused by an administrative coloration.\(^{188}\)

B. Ownership and Control

Since the 1980s, those advocating the corporatization of SOEs have essentially argued that the creation of joint-stock companies will lead to the separation of ownership and control. Moreover, the advocates for corporatization argue that the difficulties faced by SOEs arise precisely because they have not separated ownership from control. However, this point of view utterly lacks a factual basis and is reasoning based purely on imagination. It is not so much raising a theoretical question seriously as it is expressing a favorable mood about corporatization.

Joint-stock companies do not necessarily lead to the separation of the right of ownership and the right of control. Separation of ownership and control occurs only when the shareholding is so dispersed that there’s no way to constitute either majority or minority control, so dispersed that a single shareholder, either on its own or in

\(^{188}\) Han Zhiguo, \(\text{Zhongguo fazhan gufenzhide lu gai zenne zou [How Should China Go Along the Road to Developing a Share System],} \) \(\text{ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES DAILY], Aug. 11, 1993, at 6.}\)
league with others, cannot influence the board of directors. Though the beneficial owners of the company's property, shareholders have lost any means of control and can only "vote with their feet" (yongjiao qu toupiao). As the recipient of the owners' entrustment, the directors and the managers acquire a sort of power without property right—the right to control the company. Separating control from ownership is not necessarily the path to efficiency and fairness; rather the separation appears following the distribution of the share right and ought to be a phenomenon increasingly subject to adjustment by law. The problems thus produced—what duties do the directors and managers have to shareholders? what sort of rules should be followed when there is a conflict of interest between directors, managers, and shareholders? when the directors and managers injure the interests of shareholders, how can the shareholder use the law to help them contend with the directors?—raise a challenge to law based on traditional concepts of ownership. In contemporary China, more and more evidence shows that the injury caused to companies by directors' and managers' conflicts of interest is no less serious than that caused by excessive government interference. As the litigation concerning Yuanye and Runtao demonstrates, under the current legal framework there is still neither a reliable method for preventing this sort of problem nor a channel for stockholders to obtain judicial relief.

Whether or not the separation of ownership and control is connected to efficiency is entirely contingent on the degree of distribution of the right of ownership. Family owned companies epitomize the unification of ownership and control. However, there is no evidence to show that family companies are less efficient than public ones. To the contrary, whether in the mainland in the 1930s or in Hong Kong and Taiwan in the 1990s, the most successful companies are family owned. From the end of the 1970s when individual commercial and industrial households revived, private enterprises without exception have unified ownership and control. But unlike SOEs, they have not lost their vitality because of this structure. The owner's hiring of a manager and the manager's control of the owner's property are by their natures two utterly different things. For, regardless of the breadth of authority granted to the directors and managers, so long as the owner may dismiss and replace directors and managers, the control is still entirely the owner's. However, when a dispersed ownership united to the greatest degree
still lacks the strength to change directors and managers, having professional managers control a company is probably the best choice.

An analysis of shareholding and control in ten listed companies shows that regardless of what path SOEs have taken to reorganize into joint-stock companies, ownership and control have not been separated. The unity of ownership and control is manifest in both majority and minority control. If there has been any change at all, it would be that after corporatization, the controlling shareholder not only continues to have authority over its own property, it also has authority over what may be the even greater property of other shareholders. In a situation in which the state's shares may not be transferred and the number of shareholding individuals is limited, the way in which majority and minority shareholders relate to control of the company is unwavering and the possibility of a takeover by outside shareholders is completely eliminated. Moreover, the old systematized internal rules and customs of enterprises will be transferred to the body of the new share company. Consequently, until the state shares are dispersed to a certain degree, corporatization has no way of accomplishing a separation of right of ownership and right of control.

The chief reason for the lack of vitality in state enterprises is the excessive and willful administrative interference, a problem unrelated to the right of ownership or control. When the government interferes in enterprises, it has absolutely no need to use its ownership right as a justification. Any activity that impinges on society's common interest falls within the scope of the government's intervention. If the government considers it necessary, it may interfere even more seriously in an enterprise in which it has no ownership right: for example, to nationalize a private enterprise, or to change a collective enterprise into a state owned one. Thus, even a thorough separation of the rights of ownership and control would not have a significant effect on the problem of administrative interference.

C. Some Suggestions for Equity

It is beyond the author's capacity to propose a comprehensive program to solve the existing problems. What follows are merely some thoughts which may be of some benefit in shaping an agenda.

First, the road to organizing and starting a company ought to be equally open to all individuals and organizations and not simply a measure for the rescue of state enterprises. At present there have been established on this road a number of barriers: the quota on
issuing shares, permission for issuing, and permission to launch a company—these ought all be eliminated. Only in this way can a competitive environment be created.

Second, the Company Law ought to be an amalgam of voluntary and mandatory norms. Freedom of contract ought to be a basic rule that penetrates and suffuses the Company Law, subject to restriction only under circumstances that impinge on the public interest. Therefore in matters within the sphere of contract, the Company Law only provides to the parties provisions from which they may choose or provisions to be used when a company’s articles of association do not have correspondingly provisions. For matters that concern the public interest, such as the veracity of stock prospectuses or the full disclosure of material information, there ought to be stricter, more concrete rules.

Third, the abuse of administrative power that is impeding China’s smooth and stable transition from a planned to a market economy constitutes the most serious problem. From the “official profiteering” (guandao) of the 1980s to the “morphing companies” (fanpái gōngsī)\(^\text{189}\) (literally, “turning over nameplate companies”) of the 1990s, from the various noisome “assigned contributions” (tanpái) imposed on the peasants to the barriers at every stage along the road of state enterprise corporatization—all are related to the abuse of administrative power. However, under the Administrative Litigation Law, the victim of arbitrary administrative power cannot challenge the rationality and constitutionality of a generally applied administrative statute, no matter how unreasonable the statute may be. Moreover, the court can review only whether an administrative decision against a plaintiff is inconsistent with the relevant administrative statute, which, in all probability, was drafted by the defendant itself. Therefore we must establish new administrative litigation rules to resolve this problem:

(1) we must subject the legality of administrative rules to judicial review: When a person’s rights and interests are subjected to unreasonable limitation by administrative regulations, that person ought to have the unarguable right to challenge the legality of that rule, and to have a court make a ruling. Moreover, the court’s ruling should protect

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189. This term refers to companies which were originally government organizations. By “turning over the nameplate” (fanpái), the government organization becomes a company.
not only the litigant's rights and interests, but also be applied to anyone who might be harmed by being constrained by the regulations.

(2) We must subject the legality of administrative procedures to judicial review. When an administrative organization makes a decision that may disadvantage someone, those who will be bound by that decision should have the right to be heard *ex ante*. Decisions that violate this procedure, regardless of the agency's reason, should be unenforceable. The problem of administrative organs' and government personnel's conflicts of interest should be controlled by the legislature, the administrative supervisor, and judicial review.

Fourth, compared to the state holding shares, selling off state assets is the way to corporatization with relatively lower transactional costs. State assets will be directly metamorphosed in this process, society's savings will flow into the nation's treasury, and the state, of its own will, can distribute resources anew. On the other hand, if the state holds shares, then it is subject to the limitation of not being able to transfer its shares for a number of years. If a set of regulatory methods for state shares is designed, and a relevant organ established, it will lead to another round of organizational expansion. Moreover, it can only be a one-time redistribution of the fragmented regulatory power over state property.

Fifth, through the sale and corporatization of state enterprises there should develop a system of social security. At the same time, pension funds and unemployment insurance funds should be used to stabilize the securities market. This may be one of the ways to make a stable transition from a planned to a market economy. The experience of Eastern Europe and Russia has already shown that as a market economy replaces a planned economy, ordinary workers pay a heavy price for the change. At first, they had no choice but to accept the "unit" arranged for them by the government and the work arranged for them by the "unit." Now, owing to competition and financial losses, the workers may lose not only their work but also the retirement benefits they expected in exchange for a lifetime of work. If an effective social security system is not established first, the hard work of developing a market economy may suffer a setback or result in widespread inequities.

Over the last several years the situation of the Chinese securities market has repeatedly shown that every time excessive speculation is
extinguished, it bubbles up again, gratuitously depleting society's resources in a crazy, rising and falling wave of speculation. Under these conditions, the securities market cannot rise to its role of optimally allocating resources. If corporatization is accompanied by concern with social fairness, the two aforementioned problems (that is, the burden on workers and speculation) may be resolved, or least may not develop to an uncontrollable stage. Below are some possible directions to choose:

(1) Any company in the process of being transformed into a share enterprise ought to take a portion of its property equivalent to its staff's pensions and invest in a retirement fund or make it into a long term liability to its staff.

(2) Any company issuing stock ought to give its retirement fund a preferred subscription right. Regardless of whether the enterprise is issuing shares to sell assets or has already listed and the shares are either frozen state shares or state legal person shares which are allowed to be transferred, in all cases a certain percentage of shares should be reserved for subscription by the retirement fund. Pension fund organizations may be based on staff categories, and established at the central and local levels. Staff from a single enterprise may participate in two or more pension funds to guard against the risks of monopoly and corruption.

(3) Unemployment insurance should be developed as quickly as possible. Insurance companies may establish specialized unemployment insurance funds and on the basis of the size of the fund decide the scope of its risk. Companies in the developing unemployment insurance industry may have a right of preferential subscription in regard to shares issues by companies in the locale or in the industry of the insured. Local governments may also take a portion of the revenue generated by the sale of state-owned companies' assets and use them to buy unemployment insurance for the staff of companies which have long-term losses.

(4) At a relatively low issue or transfer price, provide shares to lower income people. For example, farmers with annual incomes of less than RMB 500 (approximately U.S. $60), retirees with annual incomes of RMB 1200 (U.S. $150) or less, the employed with incomes of RMB 3000 (U.S. $375) or less, should all be able to buy shares at relatively low
prices. Banks might use the stocks these people are entitled to buy as security and give them low interest loans while securities companies ought to handle their stock transactions either gratis or at low cost.