The Regulation of Stock Trading and its Enforcement in China

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ACRONYMS AND ABBREVIATIONS

ADRs	American Depository Receipts
CESR	Commission for Economic System Restructuring
CSRC	China Security Regulatory Commission
GEM	Growth Enterprise Market
HK$	Hong Kong Dollars
ICBC	Industrial and Commercial Bank of China
IEC	Issuance Examination Commission
Interim Rules	The Interim Rules on the Issuance and Trading of Equities
NAV	Net Asset Value
NETS	National Electronic Trading System
PBC	People's Bank of China
PRC	People’s Republic of China
QFIIs	Qualified Foreign Institutional Investors
RMB	Ren Min Bi (the Chinese currency)
SAFE	State Administration of Foreign Exchange
SAC	Securities Association of China
SCSC	State Council Securities Committee
SEC	Securities Exchange Commission
SHSE	Shanghai Security Exchange
SOEs	State-owned Enterprises
SPC	State Planning Commission
SRCIs	Securities registration and clearing institutions
SSC	Specialized Securities Companies
STAQS	Securities Trading Automated Quotations System
SZSE	Shenzhen Security Exchange
TICs	Trust and Investment Companies
Y	Yuan (the Chinese currency)
$	US Dollars

The exchange rate used in this paper is 8.28 Yuan/USD, August, 2004.

Abstract

The first public share issue in the PRC took place in 1994. By the early 21st century, in the space of less than two decades, the Chinese stock market has become the largest one in Asia, with the exception of Japan. Along with this rapid enlargement of the market, the Chinese stock trading regulation system has experienced a process of continuous improvement. A national centralized stock trading regulatory system has been set up, and many securities laws and regulations have been published.

In the first part of this thesis, a brief introduction will be provided in order to give the reader an overview of the current state of the Chinese stock market and its regulatory system. In particular, some concepts which only exist in the Chinese stock market will be clarified. After that, the three main themes of this thesis will be presented.

The first intention is to introduce the history of the development of Chinese stock trading regulations and their enforcement measures. This is mainly, but not only, dealt with in Chapter two where the whole history is divided into three periods and the most distinctive features in each period are introduced respectively. Apart from that, the development of some specific regulations is covered in the other chapters.

The second goal is to present a detailed picture of the stock trading regulatory system in its current form. This is covered in the next two chapters. Detailed regulations will be discussed in Chapter three, which considers several different areas in stock trading. Key incidents in the development of the regulations are also introduced in this chapter. After that, the practical enforcement of the regulations is discussed in Chapter four.

Although the Chinese stock market has made great strides, we need to keep in mind that it is still a primitive market, and these achievements are still embedded within the framework of a transition economy. So my third aim, presented in Chapter five, is to point out some problems with the Chinese stock trading regulatory system and suggest some potential solutions. Instead of covering all the problems that the system has, this chapter will concentrate on where the difference between the Chinese stock market and more sophisticated stock markets lies, in the hope of helping the former to better prepare for the rigors of exposure to the international financial markets.

1. Introduction to the Chinese stock market

In this chapter, I will give a brief introduction to the Chinese stock market. I hope that I can give a broad overview of its current state before I go into detail in the following chapters.

1.1 Types of stocks

1.1.1 State-owned, legal person, and public shares

In the mainland PRC, the ordinary shares issued by the joint stock companies can be divided into three types according to their ownership:

i. *state-owned share:* shares formed when government departments or institutions, on behalf of the country, use state-owned assets to invest in a joint stock company. Most of the joint stock companies in the PRC were transformed from the original State-owned Enterprises (SOEs) or collectively-owned enterprises. Normally, in order to protect the state's controlling status, the state-owned shares are dominant in a stock company. In 2003, state-owned shares accounted for 51 percent[1] of all the listed companies' total capital.

ii. *legal-person share:* a "legal person" is defined as a non-individual legal entity or institution. According to a survey from the World Bank, legal-person shares "were created in the PRC to designate holdings in SOEs by official bodies such as state institutions, other SOEs and government departments. Individuals are prohibited from holding legal-person shares".[2] The proportion of legal-person shares was 14 percent in 2003.

iii. *public share or natural person share:* shares formed when individuals or institutions use their own assets to invest in a company's negotiable shareholding. A natural person is not allowed to own more than 0.5 percent of a company's public shares. Usually the proportion of public shares is fairly small, 35 percent in 2003, so the influence that private shareholders have on the company is limited.

State-owned and legal-person shares are non-negotiable. To avoid the dilution of the state's ownership, the sale of non-negotiable shares to individual shareholders is prohibited. Non-negotiable shares can only be transacted among institutional investors by auction in court if approved by the securities regulator.

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[1] Yu Yang, 2003. This source also covers legal-person and public shares.
[2] The World Bank "The Emerging Capital Market", 1995, page 84.

1.1.2 Ordinary public stocks

The ordinary public stocks are, essentially, categorized into five types as follows. A Chinese listed company can issue different types of shares, and all shares should enjoy the same rights and obligations.

i. *A shares:* for mainland individual or institutional investors; denominated and traded in RMB. The first A share was issued in 1984 by Shanghai Fei Le.
Starting from December 1st, 2002, Qualified Foreign Institutional Investors (QFIIs) have been allowed to invest in A shares. However, QFIIs are subject to verification by the China Security Regulatory Commission (CSRC), and to the quota set by the State Administration of Foreign Exchange (SAFE). Also, while trading in A shares, QFIIs should use domestic securities companies as brokers.

B, H, S and N shares are for overseas (Hong Kong, Macao, and Taiwan included) individual or institutional investors; denominated in RMB, but traded in foreign currencies. However, the companies which issue B, H, S and N shares are still registered in mainland China.

ii. *B shares:* for foreign investors, but listed only on domestic security exchanges (Shanghai and Shenzhen) and traded in either US$ (in Shanghai) or HK$ (in Shenzhen). The first B share was issued in 1992 by Shanghai Dian Zhen Kong.
Starting from February 19th, 2001, B shares have been accessible to domestic investors.

iii. *H shares:* for overseas investors in Hong Kong; listed on the Hong Kong Stock Exchange and traded in HK$. The first H share was issued in 1993 by Tsingtao Brewery.

iv. *N shares:* for overseas investors in New York; listed and traded on the New York Stock Exchange in the form of American Depository Receipts (ADRs). The first Chinese company listing on the NYSE was the Shanghai Petrochemical Company, in July 1993, as Level II ADRs.

v. *S shares:* listed in Singapore and traded in Singapore dollars;

Some companies are listed on other exchanges such as London Stock Exchange, while some other companies are listed on two overseas exchanges simultaneously.

After 20 years' rapid development in the domestic stock market, there are at present 1367 A and B share listed companies. The total market capitalization and negotiable market capitalization are $512.77 billion and $159.16 billion respectively. Details are listed in Appendix 1.

1. 2 Trading locations

1.2.1 Stock exchanges

There are two official domestic exchanges in China: the Shanghai Security Exchange (SHSE) and the Shenzhen Security Exchange (SZSE). The exchanges in China are non-profit legal person associations which are run by their members. A and B shares of a large number of SOEs, high quality private enterprises and three types of foreign invested companies are listed on them. The trading session is from 9:15am to 9:25am for centralized group bidding; from 9:30am to 11:30am and from 13:00pm to 15:00pm for consecutive bidding. The exchanges are closed on Saturday, Sunday and other public holidays.

Companies from all over China are permitted to list on either of the exchanges, but dual listing is not allowed and each exchange can only trade the shares listed on its own index. Members come from every province in the PRC. Most of them are actually members of both exchanges.

i. Shanghai Stock Exchange (SHSE)

The SHSE was formally opened on December 19th, 1990. By the end of 2003, there were 780 companies and 913 securities (including 770 A shares and 54 B shares) listed on it. The total stock market capitalization amounted to $360 billion.[3] The SHSE had 177 members, 135 of which were security dealers and 42 non-security dealers. The members had 2968 business departments with 4522 trading seats, 4222 for A shares and 300 for B shares.[4] The SHSE still retains trading floors to provide a market atmosphere and also to keep the market under better control.

ii. Shenzhen Security Exchange (SZSE)

The SZSE was officially recognized on July 3rd, 1991. It had 507 listed companies and 548 listed stocks on it at the end of 2003. The total market capitalization was $152.8 billion, and there were 205 members and 3427 trading seats.[5] 52 seats were for B shares. The SZSE is a completely floorless system, so brokers only need to operate from their own offices.

1.2.2 Over-the-counter trading systems

For the time being, there is no legal OTC trading system in China.

[3] SHSE, "Fact book 2003", page 1.
[4] SHSE, "Fact book 2003", page 120.
[5] SZSE, "Fact book 2003", page 149

Before the establishment of stock exchanges, stocks were traded in securities companies or in the securities departments of Trust and Investment Companies (TICs), banks, and so on. Nowadays, the ordinary public shares of listed companies can only be traded in two national stock exchanges.

There used to be two electronic OTC markets: the Securities Trading Automated Quotations System (STAQS) and the National Electronic Trading System (NETS). Legal-person shares started to be traded on STAQS in 1992 and NETS in 1993 as part of an experiment to liquidize the non-negotiable shares. However, due to excessive speculation and the lack of proper regulation, in June 1993, the listing of any more legal-person shares on any markets was banned by the CSRC. To further regulate the legal-person share market, both STAQS and NETS were closed by the government in 1999. At present, non-negotiable shares can only be auctioned in court.

1.3 Indices

The SHSE publishes different types of indices.[6] They act as a measure of stock market performance and even of the Chinese economy. Among them, the SHSE Composite Index, SHSE 180 Index[7], SHSE A Share Index and SHSE B Share Index are the most important ones. The SHSE also established the first "index expert committee" in China to give opinions about index compilation, the selection of component stocks, and so on. All SHSE Indices are calculated using a Passche weighted composite price formula:

Reporting Period Index = (Reporting period component stocks' total market value / Base day component stocks' total market value) × base day index[8]

i. *SHSE Composite Index:* the oldest index in the SHSE. It takes December 19, 1990 as the base day and the total market capitalization of all listed A and B stocks on that day as the divisor. The base day index was set at 100 points.

ii. *SHSE 180 Index:* the components are the 180 most representative sample stocks from the A share pool. The divisor is their average market capitalization from January to March, 1996. The base day index is 1000 points. The sample stocks are adjusted every half a year according to their performance.

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[6] As listed in Appendix 2.

[7] SHSE 180 Index is also called SHSE Component Index, which was transformed from the original SHSE 30 Index.

[8] SHSE, "Fact book 2003", page 27.

iii. *SHSE A Share Index:* this uses the total market capitalization of all A shares on December 19, 1990 as the divisor, and the base day index is set at 100 points.

iv. *SHSE B Share Index:* the total market capitalization of all B shares on February 21, 1992 is used as the divisor, and the base day index is also set at 100 points.

On the SZSE, the main indices are: the SZSE Composite Index; SZSE Component Index; SZSE A Share Index; and SZSE B share Index, etc. They are basically similar to the indices on the SHSE.

1.4 Clearance and Settlement

In China, an investor must have both a securities account and a capital account before he can buy or sell any stocks. The securities account is opened at one of the securities registration organizations, and it records the details of shares owned by the investor. The capital account is opened at securities companies. All capital flows occurring during stock trading should come from or go to the capital account.

Orders should be placed through brokers (securities companies) who are members of stock exchanges, in the form of counter-orders, telephone-orders, or computer-orders. All orders are processed through a centralized competitive bidding procedure. Orders representing the “best price” are matched first, and if two orders have the same price, the order placed first takes priority.

The Chinese exchanges can be viewed as order-driven rather than quote-driven markets. Brokers, acting on behalf of investors, enter buy or sell orders for a given quantity of shares at a limit price. The exchange’s computer system then searches for a match.[9] Selling short and buying on margin are not permitted. Upon each transaction, the computer checks whether the buyer has sufficient deposit in his capital account and whether the seller virtually owns the corresponding shares. If an order is not matched, it stays in the order system until the buyer cancels it or until the end of the trading session.

Before 1995, the SHSE implemented T+0 settlement, but the SZSE used T+1 settlement. In order to unify the two exchanges, starting from January 1995, both exchanges started to implement T+1 settlement for A shares, and T+3 settlement for B shares.

[9] The World Bank, “China The Emerging Capital Market”, 1995, page 112

1.5 Securities companies

The first securities company in the PRC was founded in 1985 in the Shenzhen economic zone. After less than 20 years, by March 2004, there were 129 securities companies with more than 3000 business departments all over the country, and the total registration capital amounted to $15.1 billion. Shenyin Wanguo, Guotai Jun'an, Yinhe, and Haitong are the biggest securities companies whose registration capital accounts for 15 percent of the total. After the boom in 2000 when a profit of $2.9 billion was achieved, the whole business, together with the stock market, has experienced a recession for three years. The loss in 2003 was $113.5 million.[10] On the other hand, the recession can be regarded as a filter for all the securities companies. Those that are not competitive or not properly run are being driven out of business. Only the really successful ones can survive.

2 History of Chinese stock trading regulation and enforcement

In this chapter, I will introduce the history of the development of the stock trading regulation system in the PRC. The whole development process can be divided into three periods according to their most distinctive features:

2.1 Resumption and starting period: 1984-1990

The origins of the very rudimentary securities market in China can be traced back to the beginning of the 20th century. However, the first real issue of public stock in the PRC was in 1984, when the gradual transition from the planned economy to the market economy began. "The Industrial and Commercial Bank of China (ICBC) Shanghai TIC", the first official stock trading counter in the PRC, underwrote stocks with a total value of Y 500,000 for the "Shanghai Fei Le Stock Company".

During this period, the debt market, especially that for Treasury Bonds, dominated the Chinese capital market. The stock market was very primitive. There was no proper stock operation mechanism, and the issuing of stocks was kept under very strict control. Only state-owned and collectively-owned enterprises were allowed to issue public stocks. Although the Shanghai and Shenzhen stock markets had been set up, stock exchanges didn't exist yet - trading was conducted over the counter. Consequently,

[10] Securities Daily, Aug. 9th, 2004, "Chinese Securities Companies at a Loss", page 1.

the market volume was quite small. Until the end of 1990, the total capital raised from the stock market was about $ 0.55 billion.[11]

2.1.1 How does an SOE transform into a joint stock company?

In the planned economy, enterprises were completely state-owned. In order that they could issue shares, they had to be transformed into joint stock companies. The reform of SOEs involves several procedures. First, an SOE has to get approval for the transformation from the local government, the People's Bank of China (PBC), the State Planning Commission (SPC), and the Commission for Economic System Restructuring (CESR), among others. The second step is to separate the non-productive assets of the SOE such as schools and hospitals from the productive assets. The productive part will account for the state-owned shares of the newly established stock company. The non-productive part is left in the SOE. Then, the SOE will try to contact other enterprises or institutions to see whether they want to invest in the new stock company and therefore become the legal-person shareholders. The next step is to select the managers, the board, and the supervisory committee members. If the new stock company is dominated by state-owned shares, the said persons will basically be decided by the state. It is very likely to appoint government officers as the new stock company's managers. On the other hand, if the stock company is dominated by legal-person shares, the legal-persons have the right to select managers. Because such companies are more democratic, they are more likely to choose professional managers rather than government officers. The last step is the IPO. At least 25 percent of the new stock company's shares should be issued to the public as public shares. The state-owned and legal-person shares are kept in vault.

2.1.2 People's Bank of China as the main regulator

During this period, the PBC was the main securities regulatory authority. On January 7th 1986, the State Council promulgated the "Interim Rules on the Bank Management of the PRC", which established the status of the PBC. According to this rule, "the People's Bank of China is the state authority which administers the national finance industry on behalf of the State Council. The PBC is the central bank of the PRC….The PBC administers corporation bonds, stocks and other securities." In

[11] China Finance Annals, 1993, page 373

addition to the PBC's role, the SPC, the CESR, and the State Administration of Foreign Exchange (SAFE) also started to take part in the administration of stock trading. A securities market administration system involving multiple state authorities was set up.

2.2 A period of rapid development: 1991-1996

Until the end of 1996, demand heavily exceeded supply on the primary stock market. The number of new shares to be issued each year was still strictly controlled by quotas set jointly by the State Council Securities Committee (SCSC), PBC and SPC. For example, the quota was Y5 billion for 1995. The 5 billion "total quota" was then broken down and allocated among provinces and cities. These quotas were sometimes used to adjust the secondary market's supply-demand imbalance.

The secondary market, on the other hand, experienced five big fluctuations, once every 14 months on average. Among the five bull markets which almost all lasted less than 3 months, four were directly stimulated by stock market policies. So the market during this period can be characterized as a "news market" or "policy market".[12]

2.2.1 Establishment of securities exchanges

The establishment of two stock exchanges was a major step forward during this period. At the beginning of the 90's, the stock market developed rapidly. The curb market was no longer able to cope with the volume of stock trading, and the low liquidity of stocks encouraged many unlicensed and illegal stock markets. To end this chaotic situation and build up a more healthy stock trading environment, two national stock exchanges were established by the State Council in late 1990. After the opening of the two exchanges, the number of listed companies, trading volume, and total market capitalization increased dramatically. During this early period, both exchanges were administered jointly by the municipal governments and the PBC.

2.2.2 The "8.10" incident and the establishment of the SCSC and CSRC

On August 7th, 1992, the PBC Shenzhen branch announced that 5 million "share-purchasing application forms" would be issued to the public on August 10th. On the issuing day, the branch claimed that all the forms had sold out in half a day. However, it was later discovered that over half of the forms had been sold internally to

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[12] Ma, Qingquan, 2003, "Chinese Security History 1978-1998", page 180.

government and bank officials. Later the same day, in front of the local government and the PBC, a large group of people who had queued for three days but had not received the forms demonstrated against the corruption and fraudulent conduct that had characterized the issuing process. To calm the situation, the government issued more forms the next day, and over 30 officials who had been involved in this episode of corruption were punished later on. This was the so-called “8.10” incident.

After studying the “8.10” incident, the government realized that an organ which specialized in regulating and supervising the securities market had to be established as a matter of urgency. Accordingly, the SCSC and the CSRC were set up in October 1992. The SCSC is responsible for macro policy issues regarding the securities market, and the CSRC is its executive branch. The embryo of a centralized securities regulation system was emerging.

2.2.3 Important regulations published in this period

The first nationwide regulation concerning stock trading in the PRC, the “Interim Rules on the Issuance and Trading of Equities (Interim Rules)”, was promulgated in April 1993. It covers most fields related to stock issuing and trading, but does not mention stock exchanges and securities companies. Moreover, it only applies to A shares. The first regulation concerning B shares was the ”Rules of the State Council on the Local Listings of Foreign-Currency Denominated Shares”, which was published in December 1995. And the “Rules of the State Council on the Overseas Issuance and Listings” issued in August 1994, was the first regulation on foreign listed shares. Both Rules are still the main regulations in their fields. Other regulations governing the stock exchanges and securities companies, and rules concerning information disclosure and prohibited acts were announced later to supplement the Interim Rules. Together, these laid a foundation for the Securities Law enacted afterwards.

The first Corporate Law was promulgated during this period too, in July 1994. It also has provisions concerning stock issuance and trading, but is written more from the perspective of regulating a company’s internal governance. The Amendment of the Corporate Law was passed in 1999 by the National People's Congress.

2.3 Regulating and adjustment period: 1997 until today

After more than ten years of rapid development, particularly after the impact on the Chinese economy of the Asian Economic Crisis, defects in the regulations concerning the Chinese stock market became especially obvious. A sound regulatory system had to be set up without delay. So during this period, the Chinese government made great efforts to facilitate the adjustment and regulation of the stock market: more regulations relating to almost every field in the stock market were published, the Securities Law being a particular example. Additionally, the authority and responsibility of the CSRC were strengthened, the penalties for violating securities regulations were increased, and the market participants were placed in better order. Consequently, the current stock investment environment is today much healthier than before.

2.3.1 The abolition of the SCSC and the reinforcement of the CSRC's functions

In the first several years after the SCSC and CSRC were set up, the governance of the stock market was actually still segmented in two ways. First, vertically, it was split between national and municipal governments. The latter had a great influence on the securities businesses within their own jurisdictions. For example, local governments had the right to choose companies they wanted to list. And the two exchanges were also under the administration of their local governments. Second, horizontally, the governance was split among different state authorities. The PBC was responsible for licensing all financial institutions; whilst the CSRC was mainly responsible for supervising the secondary market. But since the CSRC did not have any regional offices, day-to-day supervision could only be carried out by the PBC's branches all over the country.

This fragmentation badly weakened the authority of the SCSC and CSRC as the centralized securities market regulator. Moreover, it caused regulatory blind spots in areas where the different government departments did not coordinate well with one another. On the other hand, in other areas, multiple approvals and supervisions were often seen.

In order to put an end to this situation, in 1998, the State Council decided on the following measures:

First, in order to streamline the bureaucracy, the SCSC was abolished and its functions were merged into the CSRC. The latter became the sole securities regulator.

Second, all the functions of the PBC on the securities market were merged into the CSRC. The securities exchanges started to be regulated by the CSRC. Moreover, the securities regulation departments of local governments were also merged into the CSRC, and became its regional offices.

These actions have resulted in the creation of a national centralized securities regulation system.

2.3.2 The Securities Law

Another noticeable achievement during this period was the creation of "The Securities Law of the People's Republic of China" which went into effect on July 1st, 1999. The drafting process lasted six years, and the law was finally adopted and promulgated on December 29th, 1998 at the Ninth National People's Congress. As the Securities Law's general provisions say, the law was enacted to regulate the securities market and protect the legitimate rights and interests of investors. "This Law is applicable to the issuing and trading in China of shares, corporate bonds and such other securities as are lawfully recognized by the State Council."[13] The basic principle of securities trading is "openness, fairness and equitability". Fraudulent conduct, insider trading and manipulation of the market are the three main prohibited activities.

The Securities Law is divided into 12 chapters and 214 articles. It governs securities issuance and trading, the takeover of listed companies, securities exchanges, securities companies, securities registration and clearing institutions, securities trading service organizations, the securities industry association, the securities regulatory authority, and legal liability.

The Securities Law is the first comprehensive securities law in China. Before its enactment, more than 250 regulations and rules had been promulgated. But, some of them overlapped and even contradicted each other. On the other hand, some issues like the criminal liability for securities frauds were left as grey areas. The passage of the Securities Law ended this confusing and redundant regulatory system.

Notably, the Securities Law increased the penalties for prohibited activities. In particular, about half of the articles in the legal liability chapter impose criminal liabilities, which is unusual for a commercial law.[14] The criminal penalties are backed by the Criminal Law which criminalizes anyone engaged in severe securities fraud.

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[13] Securities Law, Chapter 1, Article 2

[14] Cai,Wenhai, The Journal of Asian Law, vol. 13, No. 1.

Moreover, the Securities Law granted more power to the securities regulatory authority. The CSRC was authorized to set up regional offices to perform its functions more efficiently. A centralized and unified regulation system nationwide was then established formally.

However, it has been five years since the Securities Law first came into effect, so there are definitely a lot of drawbacks from a contemporary point of view. In particular, because the Securities Law was promulgated just after the Asian Economic Crisis, it is understandable that the law places a greater emphasis on avoiding financial risks and averting crises. Therefore, there are a large number of restrictive and prohibitive articles, which seems to hold back the further development of the stock market at the current time. Also, although criminal and administrative liabilities were strengthened, the civil rights of public investors and civil compensation for fraudulent activities were almost completely neglected.

The amendment of the Securities Law started in July 2003 and is still in progress.

3 The regulations in detail

Having given an overview of both the history and current situation of the Chinese stock market, we can now go into the details of the stock trading regulations. Additionally, some incidents which contributed to the development of the regulations or which were particularly sensational will also be introduced in this chapter.

3.1. Stock Issuing

3.1.1 Issuing "domestic listed shares"

As defined in Chapter 1, A and B shares are "domestic listed shares". Stock companies need to apply for verification from the CSRC when issuing domestic listed shares. And the CSRC should make a decision within three months from the date of receiving the application. If the application is refused, the reasons should be stated.

According to the Interim Rules, for an IPO, the stock issuer must be a joint stock limited company which meets the following prerequisites:

i. It should conform to the national industrial policies. Companies in the energy, agriculture, transportation, communication, raw material and high-tech industry sectors take priority for IPOs;

ii. The shares subscribed by the promoters must not be less than 35 percent of all the shares to be issued, and the share value to be subscribed by the promoters must not

be less than Y 30 million (US$3.62 million), unless otherwise provided by the state; this clause ensures that a big shareholder can only gain control of the company if it is prepared to expose itself to significant financial risk. This measure protects small public investors, as the big shareholder will not be tempted to take reckless decisions on the company's behalf.

iii. To keep the liquidity of shares, attract society's idle capital and strengthen social supervision over the company's operation, the portion issued to the public must not be less than 25 percent of the total shares to be issued, and the internal employees must not subscribe to more than 10 percent of the shares issued to the public.

iv. The promoters must not have committed significant illegal activities in the last three years.

Qualified companies can issue additional public shares after an IPO. In May 2000, the CSRC published regulations allowing additional equity financing by listed firms if they have key technologies, competitive advantages, and great potential for future development; conform to the rules concerning major asset reorganizations; and if their proportion of public shares is less than a prescribed percentage of their total shares.[15] Moreover, according to the Corporate Law, companies applying to issue new stocks should also comply with the criteria as listed below:

i. The shares issued previously were fully subscribed, and the interval between two issues must be longer than 1 year.

ii. Over the last 3 fiscal years, the average weighted net assets earning rate of the company must not be less than 6 percent as proved by a certified public accountant, and the company must have been able to pay dividends to its shareholders.

iii. The company must not have made any false statements in any accounting document in the last three years.

iv. The anticipated profit margin should reach the simultaneous deposit interest rate.

Most of the above regulations apply to both A and B shares. The main difference lies in the capital requirements. For example, for B shares the share value to be subscribed by the promoters must not be less than Y150 million (US$18.1 million), much higher than for A shares. Furthermore, when a company wants to issue additional shares, its Net Asset Value (NAV) must not be lower than Y150 million (US$18.1 million). These clauses limit B-share issuers to large companies, which is a sound principle. Since the B-share issuers are exposed to more risks like foreign exchange risk

[15] Chinaonline, 2000, "China Securities Regulatory Commission (CSRC)"

and are also faced with more sophisticated international private and institutional investors, big companies are more likely to survive.

3.1.2 Issuing "foreign listed shares"

Companies can also issue "foreign listed shares" such as H or N shares. However, the requirements for foreign listed shares are generally stricter than for domestic listed shares.[16] For example:

i. The NAV must not be less than Y400 million ($48.3 million); the after tax net income must not be less than Y60 million ($7.2 million) and not less than 10 percent of the NAV.

ii. The foreign currency earned by the company should be more than 10 percent of its after tax net income;

iii. The capital raised by issuing abroad is anticipated to be more than Y400 million ($48.3 million);

Furthermore, in 2000 the CSRC ruled that all firms operating within China's borders must get approval from the CSRC, the MII (for Internet companies) and the State Council in order to issue stocks and list overseas, which may have delayed the IPOs of Chinese firms seeking to list abroad.

Although the intention of these strict terms is to limit issuers of foreign listed shares to only high quality companies, at the same time the terms prevent companies which are not qualified now but have great growth potential from financing abroad for further development. This also applies to B shares.

Additionally, these restrictions are intended to increase overseas investors' confidence in Chinese stocks, which may have worked to some extent. However, rather than the substance of the regulations themselves, foreign investors' confidence is more likely to be affected by factors such as the Chinese government's policy interference on the financial market; the high frequency with which regulations are changed; a series of revelations of illegal activities which reflect the difficulties in enforcing regulations; and the lack of experience of Chinese companies in international operations.

[16] In exceptional circumstances, a company is allowed to increase its share capital by issuing foreign listed shares at intervals of less than one year.

3.1.3 Underwriting

Under the Securities Law, shares can be underwritten by means of "best-effort underwriting" or "bought-deal underwriting". A stock issuer has the right, independently and lawfully, to choose a securities company to underwrite its stocks. If the total face value of the issued shares exceeds Y50 million ($6 million), they should be underwritten by a syndicate which consists of a lead underwriter and participating underwriter(s).

The underwriting period cannot be longer than 90 days. During this period, the securities companies should ensure that subscribers are given priority to purchase the stocks first. The securities companies are not allowed to withhold any stocks in advance for themselves.

The securities companies are also obliged to examine the public offer documents. If there are any falsehoods, misleading statements or major omissions in the documents, the securities companies must not carry out the sale, or stop the sale immediately and adopt remedial measures. This clause, however, is very often violated in China due to fierce competition among securities companies. It is not surprising that some securities companies may go on underwriting the shares or help the stock company give false statements in order to increase their profits even if they have already found mistakes in the public offer documents.

When shares are issued at a premium, the issue price shall be determined together by the issuer and the underwriter and reported to the CSRC for verification. A securities company's profits, reputation and qualification depend greatly on its performance, i.e. what percentage of the underwritten shares it can sell, in the underwriting process, and as a result, the securities company is more inclined to underprice the shares so that they are more likely to be purchased by investors. But the costs of underpricing the shares are borne by the stock issuers.

3.2 Listing

3.2.1 Prerequisites and application for a domestic listing

Under the Corporate Law, a joint stock limited company applying for a listing must satisfy the following conditions:

i. Its shares have been issued to the public; a company is not allowed to apply for a listing as soon as it is established.

ii. The company's capitalization must not be less than Y50 million (US$6million)

iii. The company was set up at least three years before applying for a listing, and it has made a profit in each of the last three years.

iv. There are more than 1,000 shareholders, each of whom has shares with a face value of over Y1,000 ($121); more than 25 percent of the total shares are issued to the public.

v. In the last three years, the company did not engage in any significant illegal activity or make false statements in accounting documents.

It is unusual to put minimum listing requirements in the Corporate Law. Also, in mainland China, companies should apply for a listing from the CSRC first, rather than from the security exchange directly as companies in some mature financial markets do. Once the listing is verified by the CSRC, the company is qualified to be automatically listed on both domestic security exchanges, which will occur in 6 months' time. This partly reflects the weak role of the exchanges in the stock market.

3.2.2 STs, suspending and delisting

If a listed company's state deteriorates, several risk alarm and prevention instruments can be used to protect investors.

During the first stage, the stock will be "treated specially", i.e. the stock exchanges will give it "Special Treatments (STs)", if the company is experiencing "abnormal financial conditions" such as:

i. The net income was negative in each of the last two fiscal years.

ii. The company's NAV per share is lower than its stock's face value.

The Special Treatments include:

i. Putting "ST" in front of the company's stock in the quotation to distinguish it from other stocks.

ii. The daily price change of said stock is limited to 5 percent, rather than the normal 10 percent.

iii. The company's interim report should be audited.

The STs usually last for 12 months. Since they are not really supposed to be punishments for a listed company, the latter can apply for the cancellation of STs when its financial state has improved. However, if the company's net income is still negative in the third fiscal year, the exchange has the right to suspend trading in the stock, and then to suggest that the CSRC should suspend the company's listing.

The CSRC may take action if the company's situation is not rectified during the Special Treatment period. The CSRC is empowered by law to suspend a listing if:

i. The company's capitalization or its distribution of shareholders no longer meets the listing requirements.

ii. The company does not disclose its financial state properly, or makes false disclosures.

iii. It commits serious violations of the law.

iv. It has suffered losses in each of the last three continuous years.

In the worst scenario, the CSRC can even delist the listed company if the latter:

- violates article (ii) or (iii) above and causes serious consequences;
- violates article (i) or (iv) above and cannot solve the problem within a limited period of time.
- is dismissed, closed by the government, or goes bankrupt.

3.3 Daily stock price change limits: a trial and error process

As in many sophisticated financial markets, there are limits on daily stock price changes on the Chinese stock exchanges in order to prevent excessive fluctuations which would destabilize the market. At the moment, the price change limit is 10 percent per trading day for each stock on both exchanges. The establishment of the price change limit in China was a trial and error process, and involved many modifications.

3.3.1 The trial and error process

⇒ *Over-restrictive in the early years*

The first price movement limit was introduced in December 1990, when the SHSE was set up. In the first trading week the limit was 5 percent, which, due to the excessive demand, was reached almost everyday. The following week, the limit was adjusted to 1 percent to reduce the market risk. Later, in 1991, the limit was even reduced to 0.5 percent. These limits helped to prevent the stock price going sky-high. However, at the same time, they restricted the trading volume, because the investors believed the price would definitely go up, and no one wanted to sell the stocks at hand. To dispel the depression in the stock market produced by this over-restrictive limit, in 1992, the exchanges relaxed the limit back to 5 percent. As a trial, three stocks on the SHSE were even not subject to any limit at all. However, this relaxation didn't bring the expected result. The trading volume still remained at the low end although the upward

limit was always reached, which meant the stock price was still not able to reflect the level of demand.

⇒ *Complete opening-up: the "5.21 fountain" and the "three policies"*

On May 21st, 1992, the SHSE declared the removal of the 5 percent daily price change limit completely, which led to a one-day doubling of the SHSE Composite Index from 616.64 to 1265.79. Meanwhile, the trading volume also doubled to the highest trading volume ever, and on May 25th, the index even went up to 1428.79. The events of that day are known colloquially as the "5.21 fountain", a name which compares the rising stock price to a fountain. It was not at all surprising that the sudden lifting of the price change ceiling would cause a jump in prices, however, the market overreacted to the "good news". The price of some stocks far exceeded their internal values. This type of overreaction is actually quite common in an unsophisticated financial market.

Before long, the market took its "revenge". In the following half year, the SHSE Composite Index went downwards continuously, and reached 386.85 on November 17th, only 27.08 percent of the index level on May 25th. The prices of some stocks even fell below their issuing prices, which had never happened before.

In July 1994, the CSRC announced the famous "three policies" to support the market: first, no more new A shares would be issued that year (in order to raise prices by restricting supply); second, brokers would be supplied with easier credit; and third, the establishment of foreign invested funds and securities companies would be encouraged. Stimulated by the announcement of these policies, the SHSE Composite Index almost tripled in the next several months. However, only the first policy proved possible to enforce at that time, so in October, the index went down again.

⇒ *Reintroduction after the 1996 "overheating"*

In 1996, the stock market had been in recession for three years when, again due to some "good news", the stock market overheated once more. The indices on the SHSE doubled and the indices on the SZSE - incredibly - quadrupled. In one day, the price of some stocks increased by more than 100 percent. On December 5th 1996, the daily trading volume was as much as 37.3 percent of the total negotiable market capitalization at the end of 1995.[17] The market was flooded with illegal capital, overspeculation,

[17] Ma Qingquan, 2003, "Chinese Security History 1978-1998", pages 163 and 339.

market manipulation, rumors, and so on. The State Council and the CSRC released more than ten interim regulations but still could not stop prices from rising.

On December 14th, 1996, both the SHSE and SZSE reintroduce a 10 percent daily stock price change limit. On the same day, the indices went down almost 10 percent and the trading volume returned to the normal level.

The new limit was different from the one before 1992 in two respects. First, it was looser and more reasonable. According to the World Bank, the normal daily volatility over the December 1990 to September 1994 period was 6.3 percent on the Shanghai A share exchange; thus individual share price change limits could be set at that level or above.[18] Second, the market environments were different. Before the "5.21 fountain" occurred, the market was very small and the demand-supply was seriously imbalanced. By 1996, the market had developed to a much bigger size. This new 10 percent limit was soon accepted by the market and is still in operation.

Although a daily price change limit is believed to interfere with genuine price adjustments, it does help to stabilize the market. This is because, especially in an unsophisticated and poorly regulated stock market, it gives investors more time to think before they make hasty decisions. The limit also discourages market manipulation by prolonging the time needed to change the price and therefore increasing the costs for speculators.

3.3.2 Lessons learnt from the rough road

The incidents listed above again proved that the Chinese stock market during 1991 to 1996 was a "policy market". Both the regulators and investors were responsible for this situation. The regulators promulgated regulations too hastily and then changed them too frequently without careful contemplation. The intention behind the introduction and the abolition of the price change limit as well as the "three policies" was to mitigate fluctuations, but in fact they enhanced the market volatility. The investors, on the other hand, were too immature to use their own judgement of the stocks' value, and therefore chose to follow the policy or just follow the other investors. But maybe we should not blame them too much, since it is a phase almost every emerging capital market has to experience.

Fortunately, both the regulators and investors learnt from the trial and error process. The current 10 percent daily price change limit is more reasonable, as

[18] The World Bank, "China The Emerging Capital Market", page 103.

illustrated above, and is still working properly. In addition, fewer market-supporting or market-deterring regulations or policies have been published, and investors have also gradually become more sensible. In 1995, even before the price change limit was reintroduced, the daily fluctuation of indices and stock prices was fairly small, seldom surpassing 10 percent. After the reintroduction, the trading volume still stayed at a reasonable level, which is another example of the rationality of investors. Nowadays, investors are more concerned about the fundamental status of companies when they make investment decisions. So, after 1996, this type of "policy market" has occurred much less often than was the case before.

3.4 Disclosure of information

According to the Securities Law, the Corporate Law and some other regulations[19], a joint stock company which issues shares and whose shares are listed for trading has to announce share prospectus, listing report, financial or accounting reports, annual report, interim report, ad hoc report and M&A report. This also applies to a legal person who has more than 5 percent of a listed company's public shares. All the documents announced shall be truthful, accurate and complete. If they contain any falsehoods, misleading statements or major omissions, and thus cause losses to investors, the issuer or the underwriting company that produced them and the responsible persons shall be liable for the losses. Moreover, these announcements shall be published in designated newspapers or periodicals, and shall be available at the stock company and the exchange.

On the other side, information disclosure is also the responsibility of the CSRC and the stock exchanges. They are responsible for supervising the accuracy of these reports. If any false statement is discovered, they are supposed to impose penalties on the responsible companies or persons, and proclaim the penalties without delay. They are also obliged not to disclose the contents of the reports before they are published.

- A *share prospectus* should be published when new shares are issued. The stock issuer and underwriter should announce the share prospectus and be jointly responsible for it. The prospectus can be thought of as a contract between the stock company and the investors, and it should include information about shareholding structures, the

[19] E.g. the Detailed Implementing Rules on the Disclosure of Information by Companies Making Public Offerings of Shares, June, 1993; The Interim Rules, April, 1993.

dividends policy, capitalization, profit anticipation and underwriting, and so on. In particular, the purposes to which the capital raised will be put should be clearly stated. Normally, the stock company is not allowed to change those purposes arbitrarily. Any change in the use of the capital should be subject to the approval of the shareholders' meeting, and should be published without delay. However, in reality, this clause is often violated. Many companies misappropriate the raised capital to invest in securities or futures markets, to engage in illegal guarantees, or just leave the capital unused for years. The returns to public investors can be badly damaged by these unlawful or criminal behaviors.

- The *Listing report* is published when shares are listed. Its contents are similar to those of the share prospectus, but listing related details should also be included.
- In addition, *financial or accounting reports* are subject to the Accounting Law, and should be verified by CPAs. The behavior of CPAs is regulated by the "Law of Certified Public Accountants". In particular, if a company has issued B shares or foreign listed shares, its reports should also comply with the International Accounting Standards.
- *Annual (interim) report*: listed companies shall, within four (two) months following the end (the end of the first half) of each fiscal year, submit to the CSRC and the stock exchange an annual (interim) report.[20] Notably, the annual report should contain the details of the shareholdings of the directors, supervisors, members of senior management, and the 10 shareholders who hold the largest number of shares in the company. This seems a reasonable clause which is consistent with the Securities Law's general provisions, as these put a great emphasis on the eradication of the three main prohibited activities.
- *Ad hoc report*: when a "significant event"[21] occurs that may markedly affect a listed company's share price, and that is not yet known to the investors, the company shall immediately submit an ad hoc report on the details of the event to the CSRC and the stock exchange and make the same known to the public.
- The rules for an *M&A report* will be discussed in section 3.6

To help enforce the regulations on information disclosure, the CSRC has also issued many supplementary rules on the standard contents and form of these reports. It updates these annually. Most of the regulations and rules seem sensible, but the main problem is with their enforcement. Most sophisticated financial markets have the same

[20] Please refer to Appendix 3 for detailed contents for annual and interim report
[21] Please refer to Appendix 4 for the meaning of "significant event".

problem - the Enron scandal being one example. The problem, of course, is more serious in a transition economy, which China currently is. To improve the mechanism of internal incentive and the external supervision system and to implement more severe punishments for illegal activities may be a possible interim solution for the Chinese stock market in its current form.

3.5 Prohibited activities

3.5.1 Insider trading

The Securities Law says, “Persons with inside information are prohibited from taking advantage of such information to engage in securities trading.” “Persons with inside information” are defined as:

i. directors, supervisors, and senior management personnel of the issuer or the holding company of the issuer; and other employees who can get insider information due to their positions in the company.

ii. shareholders who hold not less than 5 percent of the issuer’s shares; but this does not apply to shareholders who want to purchase the issuing company.

iii. relevant staff members of the regulatory authorities, securities companies, stock trading service intermediaries and clearing institutions, etc.

Inside information is information that is not made public because it concerns the company's business or financial affairs or may have a major effect on the company’s stock price. More specifically, it includes information about:

i. the significant events listed in Appendix 4.

ii. plans regarding dividends policy or an increase in capital.

iii. changes in the company’s equity or debt structure.

iv. any single mortgage, sale or write-off that exceeds 30 percent of the company’s major assets.

v. potential liabilities for major losses to be assumed as a result of the activities of the directors, supervisors, or senior management personnel.

vi. plans concerning M&A of listed companies.

Persons with inside information or other persons who have obtained such inside information illegally are not permitted to purchase or sell the stocks of the involved company, to divulge such information or to counsel others to purchase or sell the said stocks.

To prevent listed companies from engaging in insider trading, the Corporate Law stipulates that a listed company is not allowed to trade in its own stocks, except

when the company repurchases its stock to reduce capitalization or to merge with another company. The repurchased stocks should be written off within ten days.

The Corporate Law also says that a promoter cannot sell the shares he holds within 3 years after the stock company is established. The directors, supervisors, and senior management personnel are not allowed to sell the company's stocks during their terms or within 6 months after their terms are finished. If they violate this clause and make a profit, the profit belongs to the stock company. The Interim Rules say that when a stock company issues new shares, the staff members of the underwriting companies and service intermediaries should not hold or trade on the shares of the said stock company during the underwriting period and the following 6 months.

3.5.2 Manipulating the market

The "Note about Prohibiting the Manipulation of the Securities Market" (November, 1996) says it is prohibited for any individual or institution, for the purpose of obtaining profits or minimizing losses, to take advantage of his capital, information or position to manipulate the securities market, influence the prices of securities, or create a misleading impression on the markets, and therefore induce investors to make incorrect investment decisions because they are not fully informed about the real situation. Specifically, the following acts are considered to be a manipulation of the market:

i. Using one's own securities accounts to trade similar amounts of stocks at the same time but in opposite directions.

ii. Buying or selling securities jointly or successively, whether independently or in collusion with others, by building up an advantage of capital, shareholdings or information.

iii. Colluding with another person or institution to mutually trade securities which are actually not held by them, at a preset time and price, or by predesigned means.

iv. Trading securities from or to oneself without transferring ownership of the securities.

v. Buying or selling one specific stock continually to increase or decrease its price.

vi. Spreading rumors or misleading information in order to affect stock market.

vii. When a listed company, independently or in collusion with others, trades its own stocks.

3.5.3 Fraudulent conduct

It is prohibited for securities companies, stock trading intermediaries and their employees to commit any of the following fraudulent acts in securities trading, and then betray a client's real intentions or damage his interests:

i. Mix the brokerage and dealing operations within a securities company.

ii. Trade securities on behalf of a client but fail to follow his instructions, or trade securities in the name of a client without his authorization.

iii. Fail to provide a client with written confirmation of a transaction within the prescribed period of time.

iv. Embezzle the securities entrusted by a client or the capital in a client's account.

v. Inveigle a client into making an unnecessary securities trade in order to obtain a commission.

3.6 Takeover of Listed Companies

3.6.1 Takeover process

To avoid the erosion of state-owned assets and keep the state's holding position, there are many restrictions on takeovers through the stock market. The Securities Law and the "Interim Rules" each have "Takeover of Listed companies" as a separate chapter.

First of all, any natural person is not allowed to hold more than 0.5 percent of a listed company's total public shares. Otherwise, the company has the right to buy back the surplus part either at the current market price, or at the person's original purchasing price, depending on which is lower.[22] This article doesn't apply to overseas investors. However, overseas individual investors are only permitted to invest in B shares or foreign listed shares which merely account for a small part of a company's total public shares. Therefore this article completely precludes the possibility of any single person obtaining controlling status over a company via the stock market.

On the other hand, a legal-person is allowed to take over a listed company by offer or by agreement.

If a legal person, directly or indirectly, holds more than 5 percent of a listed company's public shares through trading on the stock exchange, he must disclose his holding to the listed company, the CSRC and the exchange within three working days.

[22] If the surplus is due to a reduction in the company's total public shares, this article doesn't apply.

Any change of 5 percent[23] or more in such a holding must be announced in the same way. During the period specified above, and within two trading days after the announcement is made, the investor may not continue to purchase or sell shares in the listed company. This clause allows the listed company more time to protect itself and figure out a counter-purchase strategy.

When a legal person investor holds 30 percent of the public shares of a listed company, he should, within 45 working days, make a takeover offer to all the shareholders of the listed company, unless he is exempted by the CSRC from issuing such an offer. The duration of a takeover offer should be between less than 30 days and 60 days. During this period, the purchaser may not withdraw his takeover offer, or buy or sell the company's shares by other means. Changes of any item in the offer should be approved by the CSRC and the exchange in advance.

When the period of the takeover offer expires, if the shares of the company which is the subject of the takeover bid held by the purchaser account for:

i. not less than 75 percent of the company's total public shares - the listing and trading of the company's shares shall be terminated on the stock exchange.

ii. not less than 90 percent of the company's total public shares - the remaining shareholders have the right to sell their shares on the same terms as those in the takeover offer, and the purchaser shall buy up the same.

In the case of a takeover by agreement, the purchaser and the company which is the subject of the takeover bid may transfer the equity by entering into an agreement. The agreement should be fulfilled after the purchaser reports it to the CSRC and the stock exchange as well as announces it to the public.

3.6.2 Bao'an & Yanzhong incident

The Bao'an & Yanzhong (B&Y) incident was the first takeover achieved through the secondary market in the PRC.

Yanzhong Company (YZ) was one of the earliest listed companies in China. In 1993, it had only 30 million shares and its total capitalization was only Y30 million. 78 percent of all its shares were public and therefore negotiable shares, which was quite unusual at that time. Moreover its shares were held by a highly diverse group of small shareholders rather than concentrated in the hands of several big shareholders. YZ's small scale and high negotiability made it a very good takeover target. In particular, in

[23] In the "Interim Rules", the limit is 2 percent, which is not consistent with the Securities Law.

June 1993, its stock price was quite low, at about Y9 per share. Another long-time listed company was Bao'an Company (BA), whose capitalization was about Y264 million in 1993.

On September 30th, BA purchased 3.42 million of YZ's shares in just a few hours, as a result of which the proportion of YZ's shares held by BA suddenly jumped from 4.56 percent to 15.98 percent. Shortly after that, BA declared only that it was holding more than 5 percent of YZ's shares, and then declared on the next trading day the exact number it held. BA claimed that since the SHSE used the T+1 settlement system, it could not know whether the trade really happened until the next trading day. It claimed that was the reason why it neither announced the holding at the exact point when it reached the 5 percent limit, nor stopped further purchases. By using this "excuse", BA cleverly avoided the 5 percent limit.

On October 6th, BA bought 2.73 percent more and became the biggest shareholder of YZ while the second biggest one only held 1.48 percent. However, according to the "Interim Rule" that was in force at that time, BA was not allowed to buy or sell any more of YZ's shares before November 4th.

On October 22nd, the CSRC announced that the takeover bid was valid. But due to the breach of rules mentioned in the last paragraph, BA was given a disciplinary warning and a fine of Y1 million.

The B&Y incident was a sensational case not only because it introduced a brand new idea into the Chinese stock market, but also because it sparked a discussion about the relevant regulations. During the takeover process, the stock price of YZ quadrupled, which provided a stimulus to the market. For the first time, both individual and institutional investors got to know what a takeover was like. From then on, there have been many other famous takeover cases. However, since in a listed company the proportion of shares that were negotiable was usually quite low, later takeover bids using the secondary market rarely succeeded. Instead, takeovers by agreement to transfer non-negotiable shares were more likely to be successful.

There were two schools of thought about the way in which BA avoided the 5 percent limit. The first was that the evasion was illegal. Otherwise, the clause "any holding of more than 5 percent must be announced and further purchases should be halted" would be made a mockery of. Any takeover bid would be able to jump from below 5 percent directly to the 30 percent limit and then make a takeover offer. On the other hand, in the opinion of others, as long as this "evasion through large purchases" was not explicitly outlawed, it was legal. At that time, the CSRC took the latter point of

view and encouraged this experimental behaviour which was regarded as helpful to the primitive stock market. Consequently, that regulation is unchanged and still in force.

3.7 Securities Exchanges

The securities exchanges are regulated mainly by the Securities Law and the "Rules on the Management of Stock Exchanges" (December 2001), as well as the rules set by the two exchanges themselves.

In China, a securities exchange is a non-profit legal person run by its members. It should ensure fair centralized trading at competitive prices. A securities exchange is established or dissolved by the State Council, but directly supervised by the CSRC. The general manager of an exchange is appointed and removed by the CRSC.

The "board of governors" is responsible for making most decisions within the exchange, and is answerable to the "Members' General Meeting". Between one-half and two-thirds of all the governors are selected from the members at the Members' General Meeting, and the rest are non-member governors. Answerable to the board of governors is a "supervision committee", which supervises the securities exchange's daily operations. Persons with criminal records or persons who were expelled from any financial institutions because they broke laws or regulations in the last 5 years are not allowed to hold responsible positions at a securities exchange. This clause also applies to securities companies.

A securities exchange's income is mainly derived from the transaction fees, membership dues and seat fees that it charges. It should earmark a certain proportion of its income for a risk fund, which is controlled by the board of governors. The accumulated gains of a securities exchange belong to its members, but cannot be distributed to the members during the lifetime of the exchange.

Only qualified domestic securities companies may become members of a securities exchange. Each member can hold one or more ordinary seats or special seats, and has to pay the corresponding fees. A member can trade its seats with other members as long as it keeps at least one.

- Special seat

A "special seat" is also called a "B share special seat" since it is especially used for B share trading. In China, foreign brokers are permitted to deal in B shares, but are not allowed to be members of stock exchanges. On the other hand, all trades on stock

exchanges should be performed by exchange members. Given these two conflicting requirements, foreign brokers who want to trade B shares have two choices: either use the exchanges as their brokers (broker's broker); or apply for a "special seat" on the exchange. The latter option is usually preferred.

In the SHSE, B share seats have to be held in the name of a domestic broker nominee. The foreign broker pays the nominee part of the fee for the seat. Both the foreign and domestic brokers are responsible for all transactions performed from this seat and share the commission together.

In the SZSE, a foreign broker can apply for a B share seat from the exchange directly, i.e. the seat is held directly in the foreign broker's name, but he is still not a full member with voting rights. And the foreign broker must also be a member of an international stock exchange. He assumes full responsibility for his actions, as well as for the fees, and enjoys the profit alone.

3.8 Securities Companies

3.8.1 Regulations in general

In China, a securities company should be a limited liability company or a company limited by shares. It is established with approval from the CSRC to engage in the securities business. Before the Securities Law started to take effect in 1999, securities companies were divided into "Specialized Securities Companies (SSC)" and "Trust and Investment Companies (TICs)". Nowadays, however, securities companies consist of "comprehensive securities companies" and "brokerage securities companies". The former can act as brokers on behalf of customers; dealers dealing on their own accounts; and underwriters for securities issues etc. But the latter can only work as brokers.[24]

The brokerage business of a comprehensive securities company should be separately operated from the business on its own account. The business staff and financial accounts for both businesses should also be completely separate. The capital belonging to clients should be deposited in full with a designated commercial bank in a separate account. The misappropriation of clients' capital is strictly prohibited. When carrying out business on its own account, a securities company should use its own capital or capital that it has raised by legal means.

[24] The conditions for the establishment of a securities company are listed in Appendix 5.

A securities company may not finance the transactions of its clients by either providing securities or by providing funds. It may not promise its clients any profits or compensation for losses from securities trading. For a prescribed period of time, it should keep full and accurate records of the transactions and instructions for trading.

As a risk management measure, a securities company should set up a trading risk reserve from its annual after-tax profits, in order to make up for losses from securities trading. 5 percent of the after-tax profits should be kept back every month until the value of the fund is equal to 5 percent of the company's NAV. Additionally, there are many detailed regulations on a securities company's financial ratios. For examples, the debt to net asset ratio may not exceed 10 to 1. [25]

3.8.2 Relationship with banks

When many of the TICs, and most of the biggest SSCs, were founded, they were wholly or at least partially owned subsidiaries of China's specialized or commercial banks. Several were even originally bank departments and then became independent companies as their businesses developed. Moreover, many large securities dealers actually originated as TICs. For example, the Shenyin Wanguo Securities Company was originally the "ICBC Shanghai TIC Jing An Securities Department". In those early days, the customer resources, business networks and initial funds of the commercial banks helped to develop domestic securities companies.

However, the Chinese commercial banks were not actually able to operate as universal banks which could manage both banking and securities businesses, since the financial market and its regulatory system were still immature. The flood of bank capital into the stock market may cause the illusion of a boom. More importantly, allowing the commercial banks to invest in stock markets may expose the banking industry to higher risk, when that industry is still not sophisticated enough to cope with it.

As a result, in July 1995, the "Commercial Bank Law" clarified for the first time that the banking industry and securities industry should be completely separated. The law says that "Commercial banks are not allowed to be engaged in any operations related to stock trading or trust and investment businesses, or to invest in any non-bank financial institutions." In the following several years, the PBC, the commercial banks and the Ministry of Finance completely divested themselves of TICs and securities

[25] "Regulations of A Securities Companies' Business on Its Own Account", October, 1996.

companies. Later, according to the Securities Law, securities companies were also required to be established separately from TICs and insurance companies.

In 1997, the PBC issued more regulations[26] to stop bank capital flowing into the stock market. Bank credit for the purpose of stock purchases is also banned. But there appear to be many indirect channels through which credit and loans have been used to finance stock trading. For example, companies can borrow money from banks ostensibly for other purposes but then invest the money in the stock market.

Despite some imperfections, the Chinese stock market is much more stable now than it was before 1995. The separation of the banking and securities industries is perceived to be one of the factors that contributed to this stability. Now, the securities companies are more easily regulated by the CSRC in a central fashion, without jurisdictional conflicts with the PBC. The capital of securities companies is kept separately from the bank so that they can be required to meet the usual capital sufficiency requirements. Moreover, the traditional deposit-taking functions of banks can be protected from potential losses that may occur in the securities business.[27]

However, as the Chinese financial market becomes more mature and better regulated, universal banks which deal in securities as well as normal commercial business should once again become common.

3.8.3 Foreign securities companies

Foreign securities companies are allowed to become co-underwriters not only in the A share underwriting syndicates but also in the B share underwriting syndicates where their overseas distribution networks may play a crucial role. Foreign securities companies can also enter the Chinese underwriting market by setting up joint ventures with domestic securities companies. Such joint venture companies can even act as lead underwriters in a syndicate.[28]

If foreign securities companies meet all the requirements set by the CSRC, they may also be authorized to act as brokers in the trading of B shares. These requirements include having: a good reputation and sufficient experience in the business; adequate

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[26] "Notice Regarding the Prohibition of Bank Capital Illegally Entering the Stock Market", 1997. "Notice about Stopping Spot Transaction and Repurchase by Commercial Banks on the Stock Exchange", 1997.

[27] The World Bank, "China The Emerging Capital Market", November 1995

[28] The first joint venture securities company in China, the China International Capital Corporation Limited (CICC), was set up by Morgan Stanley and the People's Construction Bank of China in 1995.

qualified securities staff; satisfactory financial status; no history of illegal B share trading activities, etc.

Although the government has promised to allow more foreign securities companies to enter the Chinese securities market through joint ventures or other routes, the CSRC is cautious about opening up the sector. It is worried that the domestic securities companies cannot compete with their foreign counterparts given their incomplete-risk management systems, small scale, comparative lack of experience and lack of diversification and specialization. [29]

3.9 Legal Liabilities

There are 36 articles in the Securities Law concerning legal liabilities, which shows that the government puts a great emphasis on punishing transgressions of the securities laws. Various measures, such as administrative sanctions, forfeitures, fines, revocation of business licenses and criminal liability, are used to help implement the law effectively.

The activities outlawed by the articles include: issuing or underwriting securities without verification or by forging documents; illegally establishing a securities exchange or securities company; misappropriating securities or public capital; financing clients by securities or capital; prohibited conduct; fabricating and disseminating rumors to disrupt the market; handling business on one's own account illegally; violations of the takeover process; trading in unlisted companies; approving unqualified applications; malpractice for personal gain or neglecting duties; and obstructing the securities regulatory authority with violence or threats, and so on.[30]

- The emergence of civil cases relating to securities

As I said previously, civil compensation for public investors who have suffered due to violations of the securities regulations was neglected in the Securities Law. However, in reality, the number of securities civil cases has been increasing.

The first civil compensation case due to false statements was back in 1998 when Hongguang Industries was sued by its investors. Later on, the investors of Zhengzhou Baiwen, ST Monkey King, Yi'an Technology, and Yinchuan Guanxia all demanded compensation for their losses resulting from illegal conduct by those companies.

[29] Chinaonline, "China Securities Regulatory Commission (CSRC)", 2000.
[30] Please refer to the Securities Law to determine which penalties apply to a given breach of regulations.
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However, none of those investors successfully obtained compensation, and most cases were declined when they were first brought in front of the court. In September 2001, the Supreme Court even issued a circular which instructed the local courts at all levels not to accept any securities civil compensation cases for two reasons: first, there were only principled rather than specific regulations concerning civil liabilities on securities irregularities, which made it difficult for the courts to operate; and second, the judges did not have any knowledge or experience in handling such cases.[31]

The situation did not change until January 2002 when the Supreme Court issued the so-called "1.15 Notice"[32] which, for the first time, gave a clear right to investors to seek compensation for their losses through civil litigation. In February 2002, an investor sued Jiabao Industries, because the latter had made a false statement in its annual report, and had thus directly caused the investor to make an incorrect investment decision. The company agreed to compensate the investor and the case was ended through mediation in court. This was the first case where an investor successfully obtained securities civil compensation. After that, the investors of Hongguang Industries also obtained compensation through the same means.

The "1.15 Notice" solved the problem of getting the court to accept such cases, but the regulations about litigation procedures were still not detailed enough. In January 2003, the Supreme Court issued a new regulation - the so-called "1.9 Regulation"[33] - which was the first systematic and workable regulation concerning securities civil compensation in China.

However, there is still a long way to go before a comprehensive securities civil compensation system is in place. A civil law system has to be established, and this is still a grey area in China. More stipulations regarding civil liabilities should be added into the Securities Law. This will be discussed in detail in Chapter 5.

4. Enforcement

Just as traffic regulations need to be enforced by traffic policemen, the securities regulations also need the help of effective enforcement measures.

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[31] Hu, Baohai, 2001, page 2.

[32] "Notice From The Supreme Court Concerning Accepting Civil Cases Relating To False Statements On The Securities Market", issued on Jan. 15th, 2002.

[33] "The Regulation From The Supreme Court Concerning Hearing Civil Cases Due To False Statements On The Securities Market", issued on Jan. 9th, 2003.

In China, the enforcement system consists of several levels: the CSRC's centralized supervision; the securities exchanges' front-line supervision; professional supervision by self-regulated securities industry associations; internal supervision by listed companies and other market participants; media supervision; and so forth.

4.1 The CSRC and its functions

At present in China, the securities regulation system is a national centralized supervision system, similar to the American, Japanese, and Korean systems. In this type of system, there normally exists an external national securities regulatory authority run by the central government. By contrast, the self-regulation type of system mainly relies on the self-regulation of market participants, and involves no such authority. The securities markets in the UK and Italy are typical examples of self-regulated markets.

Similar to the Securities Exchange Commission (SEC) in the U.S., the national securities regulator in China is the CSRC. The CSRC was set up to regulate and stabilize the securities market. Its headquarters in Beijing have 20 departments and offices,[34] and it has 36 regional offices scattered all over China to supervise local securities markets. The SHSE and SZSE, and other organisations engaged in securities, are also under the centralised supervision of the CSRC.

The main stock-related functions of the CSRC are:

i. to draft legislation and regulations concerning securities;

ii. to supervise the issuance, listing, trading and settlement of securities;

iii. to monitor the listed companies, securities firms, and other intermediaries, to make sure that information is properly disclosed;

iv. to supervise the senior management of securities exchanges and associations, and set up qualification criteria and issue licenses for securities professionals;

v. to supervise the issuance and listing of securities abroad; and

vi. to investigate and punish violations of the regulations;

To increase transparency, the CSRC stipulates that 78 percent of its committee members must be from outside the CSRC. No members may concurrently hold a position in an institution under the regulation of the CSRC. Any committee decision can only be passed with a two-thirds majority by secret ballot. In the future, the CSRC even

[34] Please refer to Appendix 6 for the organizational structure of the CSRC

plans to include only market professionals, rather than government officials, as committee members.[35]

In the following sections, some of the measures the CSRC has taken in order to perform its functions will be introduced in detail.

4.1.1 Verification always required: the "Continental" approach

Generally speaking, there are two ways of stopping problems from occurring. One way is to use the "Continental" approach.[36] Let's look at an example. When new issues of securities take place, officials decide whether the securities are "appropriate" for investors, and if so, they give permission. On the other hand, the "Anglo" approach consists of looking for any violations of pre-set standards, and punishing them when they are detected. A new issue of securities is only required to be disclosed and registered. But if it is later discovered that there were inaccuracies in the disclosure, or that it was less than honest, a prosecution may result.

If we look through all the regulations mentioned in the last chapter, it is immediately apparent that in mainland China the "Continental" approach is used. Almost all the securities related activities, such as issuing, listing, takeover, or the establishment and dissolution of securities associations, need to be verified by the CSRC first. This is considered to be a more direct and effective way of controlling the quality of the market.

Let's again take the issuing of stock as an example. When a company meets all the conditions needed to issue stocks, it can apply to the CSRC for verification. There is an "Issuance Examination Commission (IEC)" operated by the CSRC which is specifically responsible for examining applications for the issuance of shares. Most members in the IEC are professionals from outside and only a small fraction is from the CSRC. This is intended to ensure the independence of the IEC. The members vote on the applications and state their opinions after examining the qualifications of the issuer, and the reports and documents submitted by the issuer. If an application is passed with a majority by the IEC, the CSRC will then grant the issuer the issuance verification.

Essentially, the adoption of the "Continental" approach was a sensible decision. The current Chinese financial market is not yet ready for the "Anglo" approach where more sophisticated accounting, auditing, and juridical systems are needed. On the other hand, since everything needs to be "decided" by the CSRC, the stock market is

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[35] Chinaonline, 2000, "China Securities Regulatory Commission (CSRC)"
36 Kohn, Meir 2004, "Financial Institutions and Markets", 2nd ed., page 648.

significantly less efficient and responsive. The evolution of the market also happens relatively slowly. In reality, most countries use a mixture of the “continental” and “Anglo” approaches. As the Chinese financial market becomes more mature, some “Anglo” elements should eventually be introduced.

4.1.2 Routine supervision

After shares are issued, or the securities institutions are established, the routine system of supervision over the listed companies or institutions should commence. The routine supervision is basically performed by the regional offices around the country and by the supervisors sent to the stock exchanges by the CSRC.

Each regional office should supervise all the listed companies and institutions within its ruling precinct. The regional offices are authorized to check the records, reports, financial documents or other relevant materials regularly to find out whether the companies and institutions concerned are working properly, for example, whether information is disclosed truthfully and promptly, whether capital raised is used in the prescribed way, whether there are any prohibited activities, and so on.

The responsibilities of the supervisors who are sent to the exchanges include understanding and reporting the trading and settlement status of stock exchanges; checking the records and financial documents of the stock exchanges; observing and analyzing the stock market; and reporting to the CSRC regularly, particularly if unusual situations occur.

Moreover, there are “whistleblower hotlines” in each regional office. Anyone can easily contact the CSRC through these hotlines if he or she discovers something suspicious or unusual. This helps to ensure that listed companies and the institutions behave themselves.

4.1.3 Investigating measures

The “Continental” approach and the system of routine supervision can be regarded as a set of proactive and preventative measures. In addition, the CSRC is authorized by the State Council to use the following investigative measures if an illegal act does happen:

i. to enter the site where an illegal act is committed to investigate and collect evidence; and to question the parties involved and require them to give explanations concerning the event under investigation;

ii. to inspect and make copies of the relevant securities trading and settlement records, financial, accounting and other relevant documents and materials; to seal up items that are likely to be removed or concealed; and

iii. to examine the capital accounts and securities accounts of the involved parties; to apply to a judicial organ to freeze the accounts if there is evidence showing that illegal capital or securities have been removed or concealed.

If the CSRC suspects an illegal act may constitute a criminal offence, it shall hand the case over to a judicial body.

When the CSRC performs its functions lawfully, the parties involved shall cooperate and provide truthful information. On the other hand, the CSRC should carry out its investigation faithfully and impartially. The members of the CSRC may not take advantage of their positions to seek illegitimate gain. The results of the investigation and the penalties imposed for illegal acts shall be made public, but commercial secrets may not be let out.

Normally each department within the CSRC is responsible for the investigation of illegal acts within its own field of business. If an illegal act is significant or gets several departments involved, the "Enforcement Bureau I" and "Enforcement Bureau II"[37] will take over the investigation. The enforcement bureaux are also responsible for giving opinions on the penalties imposed for illegal acts and for carrying out those penalties. These include administrative sanctions, forfeitures, fines, the termination of stock issuing and the revocation of business licenses. If the parties involved do not agree with the penalties, they can apply for a second hearing at the CSRC within 15 days, or appeal to the courts within 3 months. During the second hearing or appeal period, the penalties will continue to be applied.

However, in practice, the CSRC sometimes meets serious obstacles to the implementation of the aforementioned measures. For example, when the CSRC applies to freeze illegal capital and securities, the related judicial organs may be too cautious to grant its requests. In a case of stock market manipulation involving "Yi'an Technology", the court was reluctant to freeze the stock assets of the company. And in the case of "Tonghai Hi-tech", the court demanded a huge amount of money as a guarantee.[38] As a result, the court rulings could not be implemented effectively, and the investors who had fallen victim to the fraud were not properly compensated.

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[37] As shown in the diagram illustrating organizational structure of the CSRC. Please refer to Appendix 6.

[38] Hu, Baohai, 2001, page 5.

4.2 Securities exchanges' front-line supervision

Apart from the CSRC, the securities exchanges are the most important supervisors within the system. The supervision they provide is closest to the market and therefore most direct, which is why it is described as "front-line supervision". A securities exchange shall supervise the stock trading activities that it hosts, its members, and the companies listed on it.

4.2.1 Measures used to supervise stock trading

A securities exchange shall enact detailed trading rules concerning: the types and terms of listed stocks; trading methods and procedures; prohibited activities; settlement and clearing; trading fees; abnormal situations; indices; suspension and delisting; information management; penalties for the violators of regulations; and so on. Some of these measures are described in more detail as follows:

- Technical suspension of trading of stocks or of the market

A stock exchange shall carry out real-time monitoring of securities trading. In order to prevent illegal trading at an early stage, in 1998, the securities exchanges introduced the "technical suspension" system. According to this system, "the securities exchanges have the right to employ a technical suspension of the trading of a stock with abnormal fluctuations, until the parties involved provide an explanation." Such abnormal fluctuations include:

i. the price change of a stock has reached the daily limit, or the swing in a stock's price has reached 15 percent, on each of the last three consecutive trading days;

ii. the trading information about a stock has had to be published on each of the last five consecutive trading days;[39]

iii. the trading volume of a stock has increased by 50 percent per day on each of the last five consecutive trading days; or

iv. the trading volume of a stock has been ten times the last month's average trading volume in each of the last three consecutive trading days.

If a sudden event of force majeure occurs, the securities exchanges can even suspend the whole market temporarily to protect the normal trading order. Such events include: significant technical failures, natural disasters which prevent more than 15 percent of the members from being able to work normally, and so on.

[39] Starting from December 1996, on each securities exchange, trading information about the top 5 stocks whose closing prices increase or decrease by more than 7 percent of the previous day's closing prices has had to be publicized.

The securities exchanges shall report to the CSRC without delay if there is a technical suspension of trading of stocks or of the market.

- Securities registration and clearing institutions (SRCIs)

SRCIs play a very important role in supervising the securities trading on the stock exchanges. In China there is only one centralized and unified SRCI.[40] It has two branches in two stock exchanges. It has the following functions:

i. *central registration*: this includes the establishment of securities accounts and clearing accounts; registration of stock issuing; management of non-negotiable shares, and so on. A securities issuer can get information about its shareholders from the SRCI.

ii. *central custody*: this includes the custody and transfer of the ownership of securities; the allocation of securities rights and interests upon entrustment by the issuer, and so on. Before securities are traded on the exchanges, they should all be put in the custody of the SRCI.

iii. *central clearance*: this includes the clearing and delivery of listed securities traded on the stock exchange; the transfer of capital; and so on. Each securities trade should be recorded by the SRCI.

The original evidence of registration, custody and clearing should be kept carefully, and important evidence should be kept for no less than 20 years.

With the help of the SRCI, the transparency of the market has greatly increased. Stock trading can be traced very easily, and illegal activities are more likely to be discovered and investigated.

4.2.2 Measures used to supervise members

Stock exchanges should also enact rules[41] governing members in the following areas: the qualification of a member; seat management; business reports made by members; the behavior of brokers; penalties for violators of regulations; and so on.

Supervision is carried out in several ways such as:

- When a securities company applies to become a member of a securities exchange, it has to submit details of its capital, company background, and business fields, and so on. The exchange shall examine the applicant's qualifications very carefully before membership is granted. Moreover, members have to promise to observe the exchange's constitution and business rules.

[40] The "China Securities Depository & Clearing Corporation Limited"

[41] Please refer to Appendix 7 for detailed rules.

- In order to undertake brokerage business, a securities company has to sign with its clients "deputy agreements" whose content and form are prescribed and later examined by the exchange. The securities company should open a separate capital account for every single client. On the other hand, when a securities company trades "on its own account", it should open a capital account under its own name in the SRCI. This account is specifically for the business "on its own account" which has to be separated from the clients' account.
- At the beginning of each month, a member shall submit his financial reports, the details of the stocks it holds, and a report of any complaints from clients during the last month to the securities exchange. The annual and interim reports shall also be submitted without delay. The exchange puts great emphasis on supervising members whose financial situation deteriorates or whose level of operational risk is relatively high.
- The securities exchange should select several members every month to carry out a spot check on them to see whether they are following the trading regulations. The selected members should not be informed of the test beforehand. The test results should be reported to the CSRC.

If a member commits illegal trading, the exchanges have the right to punish it according to the securities laws or the agreements signed between the two parties. The penalties include: a fine; censure by other members of the exchange; public censure; limiting or suspending that member's trading; and the revocation of membership. Particularly important or sensitive cases should be handed over to the CSRC.

4.2.3 Measures used to supervise listed companies

The rules enacted by the exchanges regarding listed companies should cover the following areas: the qualifications and procedures for listing; the content and form of the Listing report; the required qualifications for and responsibilities of listing sponsors; listing fees; information disclosure; penalties for violators of regulations; and so on.

- Listing sponsors

A stock issuer must have a "listing sponsor" (a securities company) who acts both as a recommender and a warrantor before the issuer's shares can be listed on the securities exchange. As a recommender, a sponsor should recommend the issuer to the CSRC and the exchange, help to examine whether the issuer discloses information properly, and help the issuer to achieve verification of issuing and listing. As a warrantor, the sponsor will be responsible for compensating the investors' losses if the

issuer commits any falsehoods, or makes misleading statements or major omissions. Even if the sponsor itself doesn't commit any mistakes, as a warrantor it still has to assume these responsibilities. The warranty period should last for at least several years after the issuer's shares are listed.

A sponsor must be a securities company which is a member of the securities exchange where the issuer's shares will be listed. But the requirements for a sponsor are much stricter than for an ordinary member. For example, it should have adequate capital to ensure it is qualified as a warrantor. Also, since the risk that a securities company is exposed to when it acts as a sponsor is quite high, its staff should be more sophisticated and well-trained than average in order that any potential risks are more likely to be discovered by them.

Since the interests of the sponsor are closely linked to those of the issuer, the sponsor will naturally try to supervise the issuer with great care. With a guarantee from a sponsor, investors will also feel more reassured and invest more actively. In short, a sponsor works as the first safeguard against unqualified companies joining the stock market. The introduction of "listing sponsors" has helped the Chinese stock market to become more regulated.

- Information disclosure

A stock exchange should supervise the prompt and accurate disclosure of information by listed companies through the following measures:

First, the exchanges should give vocational training to the senior management of listed companies and organize meetings where they can compare their experiences, in the hope of improving the listed companies' internal awareness about information disclosure.

Second, the exchanges should examine the reports submitted by the listed companies very carefully, especially the annual and interim reports, in order to keep up the pressure on those companies to follow the rules. Once something unusual or unclear is discovered, the relevant listed company must provide clarification. After examining all the reports, the securities exchanges should use a designated securities newspaper to praise those companies who have done a good job, and criticize companies who have submitted unsatisfactory reports.

- Measures against insider trading

In the SHSE's computer-based trading system, the shareholdings of a listed company's directors, supervisors and senior management persons are frozen, which

ensures that their shares cannot be traded at will. The shares can only be unlocked after the terms of the said persons are finished.

If a listed company violates the securities regulations, the exchanges can carry out penalties such as: ordering ameliorative measures; public censure; fines of between Y30,000 and Y300,000 imposed on the responsible companies or persons; a recommendation to the listed company to change its senior management, and so on. Particularly important cases should be handed over to the CSRC.

4.3 The Securities Association of China and its professional supervision

The Securities Association of China (SAC) is the first and the only Chinese national self-regulated securities industry association. It was founded in August, 1991. The SAC is a public organization with the status of a legal person. According to the Securities Law, all securities companies should become members of the SAC.

The functions of the SAC include:

i. to enact self-regulated rules to be observed by members;

ii. to assist the CSRC in enabling members to understand and implement securities regulations;

iii. to maintain the reputation of the securities industry and good order on the securities market; to mediate disputes between members or between members and their clients; and to protect the lawful rights and interests of members;

iv. to arrange training for securities professionals, and carry out qualification tests for them; and

v. to offer professional consultancy services to its members and the public.

If a member violates the regulations or rules, the SAC can impose sanctions on that member, such as public censure in written form or in the media; or suspension or revocation of membership. If the breach of rules is significant, the SAC can hand the case over directly to the CSRC. Although the SAC itself can not impose any forfeiture, fine, or revocation of business licenses on those who break the rules, the said sanctions are very likely to have a disciplinary effect on its members. For example, it is extremely difficult, if not impossible, for a securities company that was expelled from the SAC to be accepted again by investors.

On the other hand, if a member has made a distinguished contribution to the SAC or to the securities industry, that member will be rewarded correspondingly.

To build up a consistent image of its members, the SAC gives every member a "credit archive". The penalties imposed on and rewards received by that member are recorded in the archive, and reported to the CSRC. Moreover, other information about the members, concerning their registration, qualifications, reputation, business data, financial reports, internal management, and so forth, are also recorded in the archives.

Every year the SAC is authorized by the CSRC to organize the "Competency Tests Securities Professionals". Those who pass the tests are entitled to the "Securities Professional Certificate". The SAC is responsible for issuing the certificate, and has therefore also set up a "credit archive" for every certificate holder, similar to the system for members. Employees in the securities companies are required to obtain the certificate. Starting from July 1st, 2005, no securities company will be allowed to employ anyone who doesn't hold the certificate to engage in securities related business. The SAC will supervise the implementation of this provision and carry out the necessary penalties if someone breaks it.

4.4 Media supervision

Supervision of the media is mainly performed by securities newspapers designated by the CSRC. The three most authoritative securities newspapers are: *China Securities*, *Shanghai Securities News,* and *Securities Daily*. They are normally regarded as reliable and comprehensive, and investors often consult them before making investment decisions. It is stipulated in many regulations that listed companies and other market participants have to disclose any important securities related information about themselves, such as issuance, listing, financial reports, penalties, and rewards, in one of these designated newspapers, so that investors can be kept properly informed. These designated newspapers provide an efficient information channel between investors and the securities industry, and therefore enhance the regulation and development of the stock market.

As far as internal supervision within listed companies and other market participants is concerned, the main factor is the company's internal governance. This is dealt with by the Corporate Law. Due to limitations of length, we will not go into the details of it in this thesis.

5 Problems and potential solutions in the regulations and their enforcement

The Chinese securities regulatory system has experienced great changes in the last two decades, but it is still far from satisfactory. In this last chapter, we will discuss some problems in the regulations and their enforcement. Potential solutions for each problem will also be suggested.

5.1 Artificial division of shareholding and conversion of state-owned shares

As was outlined in the first chapter, in China the ordinary shares are divided into state-owned shares, legal person shares and public shares. Only the public shares are negotiable. This artificial division of shareholdings has several obvious drawbacks:

First, although all three types of shares are ordinary shares, the rights and obligations associated with them are very different. For example, the issuing price of non-negotiable shares is normally much lower than that of the negotiable shares.

Second, because the portion of public shares is not big enough, private shareholders have very weak powers of scrutiny in the company's decision making process. It is often the case that a joint stock company's biggest shareholder (who is normally a legal person or who represents the state) has the real powers of decision making and the shareholders' general meeting turns out to be pharisaical.

Third, most shares are non-negotiable, so the capital mobility is very low. Resource optimal allocation, the most basic function of the stock market, is hard to achieve. Company recomposition, takeover or capital operation through the secondary market is almost impossible. The stock market is mainly used to raise fresh capital.

Fourth, the stock price cannot represent the real value of the entire company. The stock price only reflects the market value of the negotiable shares, not the non-negotiable part. But when calculating the company's total market capitalization, the non-negotiable shares are also evaluated at the same market price, which seriously distorts the value of the company. Moreover, the transaction price of the non-negotiable shares is normally much lower than the market price, which actually damages the private shareholders' benefits.

For these reasons, the simple solution is to convert part of the state-owned shares (which account for the majority of non-negotiable shares), into negotiable public shares. However, how to correctly perform this conversion is a crucial problem:

First, one must consider what percentage of the state-owned shares should be converted. If the percentage is too low, the current situation cannot be changed; if too

high, the market may be flooded by state-owned shares which vastly outnumber the existing public shares, and as a result the stock price may fall dramatically.

Second, at which price should the state-owned shares be converted? If too low, there is the danger that the state assets will be eroded. And it is also unfair to existing public shareholders who have bought public shares at a higher price, if all the investors can now buy the converted shares at a lower price. In particular, after the conversion the stock price will go down even further. So in this scenario, the management of a stock company wants the state-owned shares to be converted at the public share's market price, which is much higher than the company's current NAV per share. However, by doing so, the company's NAV will be spuriously increased, and this will not be accepted by the market either.

Third, what kind of state-owned shares should be converted? The Chinese economic system is basically still a public-ownership system, so in some crucial industries, such as key raw materials, infrastructure, and high-tech industries, the state shall keep the controlling position. However, holding the state-owned shares back will slow down the development of these crucial industries.

How to overcome these problems is a controversial topic of debate. No ideal solutions have been found yet. Some potential solutions are suggested as follows. Whether they will work or not still needs to be tested by trial and error.

The state-owned shares can be converted in batches to reduce or at least to disperse the impact on the market. Different criteria shall be set for different batches. For example, the first batch can be companies whose proportion of state-owned shares is high and whose performance is the most satisfactory. Companies which are in need of foreign investment can even convert their state-owned shares to B shares or H shares. Moreover, the trading of converted shares shall be limited at first and then released gradually in the succeeding years.

For non-crucial industries such as process or commercial industries, the proportion of state-owned shares to be converted to public shares can be set at a higher level, in order to fully utilize the efficiency of the market. But for crucial industries, the proportion should be lower. Instead, some state-owned shares in the crucial industries can be converted to legal-person shares. This is done for two reasons. First, legal-person shares are still publicly-owned non-negotiable shares, so the controlling power of public-ownership will not be diluted. On the other hand, the converted shares will no long be administered by a governmental department but by legal-persons. This is a more democratic and efficient system. Additionally, legal-person shares are more easily

transferred among legal-persons, which can increase the mobility of publicly-owned assets.

The conversion price can be set based on the NAV per share plus a certain percentage of the premium. The latter should take into account factors such as the stock company's current market price and performance. During the conversion process, the existing public shareholders should be the first to have the opportunity to buy the converted shares. The remaining shares can then be sold to other investors. The conversion price is much lower than the current market price, which will bring the share price down even further after the conversion. Thus, the existing shareholders should be compensated by other means. For instance, the premium collected from conversion can be delivered to the existing shareholders in the form of dividends. By doing so, the ostensible increase in the NAV can be cancelled out. Another means of compensating the existing shareholders is to allow them sell the converted shares immediately, but prevent other investors from doing so.

5.2 Features of the planned economy still remain

China is still a transitional economy, so some features of the planned economy still remain. For example, every year the State Council, through the National Development and Reform Commission and the CSRC, sets annual limits on the amount of shares that can be issued. Although the "policy market" has occurred much less frequently than in the early 90's, the government still imposes temporary bans on share issuance in order to satisfy macro economic objectives. On the SZSE, the issuance of new shares was halted for 3 years before June 2004, which was intended to avoid malicious competition between the two securities exchanges.

The drawbacks of a planned economy are obvious. These manipulations reflect a policy choice rather than a market choice, and thus the market cannot perform its functions fully. The confidence of investors is impaired by fears that temporary policies imposed by the government could always supersede the securities regulations.

Actually, however, government intervention occurs even in the most sophisticated financial markets, since the market itself does not always work properly. This is especially true for primitive markets. In China, for example, if there were no limits placed on stock issuing, a huge number of companies would rush into the stock market purely in the hope of "raising capital". Given the relatively small scale of the

current market and the existence of immature investors who might be panicked by such an overflow, a market crash would be very likely to occur.

The government's temporary intervention policy can also be regarded as a remedial measure necessitated by the imperfections of securities regulations in China. Moreover when the CSRC tries to enforce some securities regulations, conflicts of interests between the CSRC and other governmental departments may arise, which need to be mediated by the State Council. Although the CSRC is the central securities regulator, due to its short history and lack of experience it is not always able to deal with abnormal market fluctuations appropriately and quickly. As a result, government intervention is sometimes used to help stabilize the market.

So in China at the moment, the continued existence of government intervention is still justified for a certain period of time. However, as the Chinese stock market becomes better developed, the need for intervention should diminish gradually. Instead, the market should be governed strictly by laws or rules set by the centralized securities regulation authority or self-regulated organizations.

5.3 Independence of the IEC

The issuance of new shares has to be approved by the IEC, so the independence of the IEC is very important. The Securities Law says that the members of the IEC cannot have personal contact with the applicants. However, since the role of the IEC is so critical, it is very likely that the applicants will try to bribe the members. What makes things worse is that the manner in which the members are elected is not transparent, so the independence and qualifications of the members cannot be supervised by the public. On the other hand, once it is discovered that a listed company is actually not qualified, the IEC does not assume any responsibility.

Several measures can be taken to improve the situation. First, the members should be elected openly and fairly, rather than be appointed by the securities regulator. The candidates can be recommended by the securities associations or investors associations. Second, each member's opinion on an applicant should be both recorded by the CSRC and announced to the public. The opinions should also be added into the share prospectus, so that investors can be well informed of the issuer's status. Third, an evaluation mechanism for members should be set up. For example, if a member approves unqualified applicants on several occasions, he should be expelled from the

IEC. On the other hand, members who carry out their responsibilities properly should be praised and rewarded.

5.4 Lack of a multilevel stock trading market

As was described above, there are two securities exchanges in China and stocks have to be traded on the exchanges. However, because the listing requirements on both exchanges are quite stringent, many small but prosperous companies, in particular high-tech companies, are not able to get listed. To a great extent this prevents those companies from developing rapidly. Also, the structure, listing requirements, and trading and supervision methods of the two exchanges are almost the same. This is unusual even in other parts of the world. Since the two exchanges are so similar, together with the fact that not so many companies are qualified to be listed, the competition between the exchanges is very fierce. They do not want to lose listings to each other. One negative consequence of this is that the exchanges may not properly supervise the companies that are listed on them. For example, if it is well-known that the supervision of one exchange is much stricter than the other, it is very likely that companies may choose to be listed on the other exchange. That is one of the reasons why new issuance on the SZSE has been suspended for the last three years: to stop malicious competition.

Moreover, since there are no OTC markets, it is impossible for shares of unlisted companies to be legally circulated. This makes the liquidity of the Chinese capital market especially low.

So it is suggested that a multilevel stock trading market should be set up so that each level of the market will attract a different type of firm and malicious competition will be minimized.

First, a second board can be established on at least one of the two exchanges; or, one exchange can be transformed into a so-called “Growth Enterprise Market (GEM)”. A separate indices system should be used. Companies to be listed on the second board or the GEM should be subject to less strict listing requirements, such as lower profitability and registration capital limitations; or more concentrated shareholding. Important companies which are in need of capital urgently can be given priority in issuing and listing. On the other hand, to avoid companies from flooding onto the second board or the GEM to take advantage of the less stringent restrictions, the stock

companies should be sorted carefully. Special criteria should be set to filter out both unqualified and overqualified companies.

Second, OTC markets should be reintroduced. Unlisted negotiable shares and even legal-shares should be allowed to be traded on the OTC markets in the future. However, because the OTC markets are more difficult to regulate than the securities exchanges, the establishment of an OTC trading system in China should be a long-term and gradual process. Regulations should be improved beforehand to ensure that overspeculation and irregularities can be minimized.

One hopeful sign is that, when this thesis was being written, the first moves towards a multilevel stock trading market were underway. From June 2004, qualified "small-and-medium companies" have been allowed to be listed on the SZSE. Many high-tech or private companies, which are not qualified for listing on the SHSE, now can resort to the SZSE because the listing requirements of the latter are much lower.

5.5 Lack of Credit Trading

Credit trading includes selling short and buying on margin. Both are forbidden now in China. This helped to reduce market risks and overspeculation when the Chinese stock market had just been established, but after about 20 years' of development, this stipulation now seems to be having a serious effect on the efficiency of the market. The market cannot fully reflect the expectations of investors and therefore the price of a stock greatly deviates from its internal value. For example, since selling short is not allowed, investors can make a profit only when the stock price goes up. Therefore, investors may keep on buying stocks even if the price is already very high. This can cause stock market bubbles. On the other hand, when the stock price goes down, an investor can do nothing to make up for his losses directly. So he may stop trading and wait until a bull market comes along. If most investors choose to do the same, the trading volume will go down dramatically along with the stock price, which will also cause losses to securities companies. As a result, the market recession will be exacerbated.

So it is recommended that credit trading should be permitted, and securities companies should be allowed to finance their clients with stocks or capital. However, most Chinese investors are not yet familiar with the concept of credit trading, and selling short is widely regarded only as a factor that drives the market price further

down in a bear market. So it is important to ensure that investors correctly understand credit trading before selling short and buying on margin can be introduced to the market.

5.6 The business model of securities companies is limited.

It is stipulated in the Securities Law that comprehensive securities companies can act as brokers, dealers and underwriters. There are two problems here. First, explicit definitions of these three businesses are not given. Second, other securities related businesses, such as securities investment consultation, M&A consultation and assets management, are not mentioned at all. In practice, some securities companies do engage in these businesses, but there are no regulations for them to follow.

For a long time, the Chinese securities companies have relied heavily on their brokerage business from which about 70 percent of their profits come.[42] When the stock market is prospering and trading is active, the brokerage business is very profitable. However, when the market goes into recession as is currently happening to the Chinese stock market, trading and therefore the commission income generated from the brokerage business both shrink dramatically. That's why the Chinese securities industry is suffering huge losses at the moment. In order to improve the oversimplified business model of securities companies, the state should encourage them to exploit new businesses. It is recommended that the Securities Law should explicitly allow the securities companies to engage in other securities related businesses as mentioned above. Moreover, the definitions of all the securities businesses and detailed regulations of how to undertake these businesses should also be provided, at least in supplementary regulations if not in the Securities Law itself.

When more securities businesses are allowed, the division of "brokerage" and "comprehensive" securities companies may become too rigid. Instead, different criteria should be set for different securities companies according to the businesses they are engaged in. For example, securities companies which only carry out brokerage business only need to meet the minimum requirements for all securities companies; but in order to deal with businesses which are exposed to more risk or which demand higher proficiency, the securities companies should, for instance, have more registration capital or have better professionals. There can be several levels rather than only two. A securities company may switch from one level to another according to its qualifications,

[42] Security Daily, "Chinese Securities Companies at a Loss", Aug. 9th, 2004

but the switch-over should be strictly regulated so that chaos in the stock market will not occur. Through getting rid of the rigid divisions between securities companies, more competition can be introduced, and different securities companies can fully utilize their own business strengths.

5.7 Separation of banking and non-banking operations

From as early as 1995, Chinese commercial banks have not been allowed to deal in the securities business, and also, the capital of banks is not allowed to flow into the stock market. However, experience in recent years has proven that the separation of banking and non-banking operations doesn't necessarily prevent risk from spreading among the different financial sectors. On the contrary, this separation sets up obstacles that inhibit resources from flowing freely and therefore being optimally allocated. So, mixing the operations of commercial banks, TICs, insurance and securities companies - i.e. allowing the establishment of universal banks - has become increasingly popular throughout the world. Compared with commercial banks, universal banks are more likely to resist risks and have higher profitability.

Starting from 2006, China will have to open its financial markets. Under pressure from abroad, there are already some changes underway. For example, Chinese commercial banks have started to issue funds and deal with securities custody; and capital from the insurance industry has flowed rapidly into the stock market. Thus, the 'mixed operation' system is emerging in China. So it is proposed that in the future, the commercial banks should be gradually allowed by law to engage in non-banking business.

However, as we said in Chapter 3, given the primitive Chinese financial market, for the time-being the separation currently in force still has good reasons to exist. The reintroduction of universal banks must be a gradual and gentle process. During this process, the risk due to mixed operations should always be taken into account. For example, at first, a "bank group" should only be allowed to set up subsidiary companies to deal with non-banking business. However, the operations of banking and non-banking subsidiary companies within the group should be separated completely, and the capital flow within the group should also be strictly controlled. Therefore, the mixed operation should only occur at the level of the "bank group" rather than at the level of the "subsidiary company". By ensuring this, the risk due to mixed operations will be limited but the ability of the "bank group" to make a profit and to compete with foreign

universal banks will be strengthened. As the Chinese financial market becomes more regulated and Chinese bankers get more experience in mixed operations, it will become possible to completely abolish the separation of banking and non-banking operations, but this will not happen in the near future.

5.8 Lack of civil liabilities in the Securities Law

The securities civil compensation system gives investors the right to get compensation for losses they incur, when such losses are due to violations of the securities regulations by listed companies, securities companies, or other intermediary institutions. This system of civil compensation works together with administrative and criminal liabilities to ensure the enforcement of securities regulations, and therefore maintain good order in the stock market and protect the interests of investors. Unfortunately, this important consideration is almost completely neglected in the Securities Law. Among the 36 articles concerning legal liabilities, more than 30 impose administrative liabilities, and 18 impose criminal liabilities, but only 2 mention civil liabilities. Moreover, these 2 articles, as well as the “1.15 Notice” and “1.9 Regulation” only cover civil liabilities due to making false statements, and the civil liabilities regarding prohibited activities are still blank. This is a big drawback of the current Securities Law, and therefore I will now make some proposals to improve this situation:

- More articles with respect to the civil liabilities imposed for insider trading, manipulation of the market, and fraudulent conduct should be added into the Securities Law. Most importantly, the new articles should be adaptable and feasible so that the courts can properly apply them, and the victims can make full use of them.
- To help enforce the securities regulations, the cooperation between the CSRC and judicial organs should be strengthened. Judicial interpretations for civil liabilities arising from acts violating securities regulations should be provided. Also, the judges should be given training about the operation of the securities market. It is even recommended that a special securities law court should be set up so that securities lawsuits can be handled under special procedures and by judges with professional securities knowledge.
- Most investors who become victims are small and vulnerable individuals that are scattered all over the country. When faced with the huge amount of time and legal expenses a civil lawsuit may incur, most victims have to give up their litigation. On the other hand, the listed companies and securities companies that cause the losses have

much deeper reserves of time and money. This situation is very unfair to the victims and harmful to the development of a healthy stock market. In order to improve the situation, investors should be allowed to set up an “association of individual investors”. The association should be able to provide judicial aid to its members. In a civil case involving securities, the association will be able to bring together the scattered victims. Also it may sue, on behalf of a group of its members who have become victims, companies which violate securities regulations. With the help of an association that has a relatively stronger financial and professional background, the interests of individual investors can be protected more effectively and efficiently.

5.9 Overlap and contradictions in the securities laws and regulations

At present, the Chinese stock market is mainly regulated by two national laws: listed companies are mostly regulated by the Corporate Law; and stock trading, stock exchanges and securities companies by the Securities Law. The current system is already much better than it was when there were more than 250 regulations and rules governing the market. However, we can still find some overlaps and contradictions.

For example, the Securities Law says, “refer to the Corporate Law for the requirements of stock issuance”, but actually they are only stipulated in the Interim Rules. Moreover, both the Corporate Law and the Interim Rules have provisions concerning listing requirements, which is a big overlap. In the regulations concerning takeovers, the Securities Law says, “any change of 5 percent or more in the holding of a target company should be announced”, but in the Interim Rules, the limit is 2 percent. Although the criminal liabilities listed in the Securities Law are backed by the Criminal Law, the standards for penalties stipulated in the two laws are not unified.

So, the government should try to further coordinate the current regulatory system. For example, the Interim Rules was promulgated more than ten years ago, so many of its clauses are out of date, or are covered by other laws. It is suggested that the useful clauses of the Interim Rules should be incorporated into the Securities Law, and then the Interim Rules itself should be repealed. Also, the penalties for securities irregularities expressed in different regulations and laws should be unified so that the system of punishments and compensation will become more fair and feasible.

There are definitely other problems with the Chinese stock trading regulations and their enforcement, in addition to those listed above. However, most of them can

also be found in more sophisticated financial markets, so they are not the focus of this chapter. Instead, this chapter is more intended to point out the deficiencies of the Chinese stock market as compared with more mature stock markets, and to provide suggestions of how to narrow the gap. We believe that if the problems mentioned above can be improved before the Chinese stock market is completely opened up to the rest of the world, it will be more likely to survive and to participate actively in the fiercely competitive global financial market.

Conclusion

The regulation of stock trading and its enforcement in China has three particularly distinctive features. The first is centralized regulation. The CSRC is the national centralized regulator, and almost all securities-related activities should be verified by it or reported to it. The second is government intervention. The government still publishes interim policies to directly manipulate the stock market from time to time. The CSRC is actually run by the State Council, so the government also has an indirect influence on the stock market through the regulator. The third distinctive feature is that China is a transition economy. However, although the Chinese economy is being transformed from a planned economy to a market economy, at the same time the state does not want to lose the controlling position afforded to it by its publicly-owned assets. Under these circumstances, some so-called “Chinese features”, such as legal-person shares, were invented to solve this dilemma, and in addition, many very restrictive regulations are being used to protect the transition economy. Most of these regulations seem to hold back the further development of the stock market from a contemporary point of view, and thus should be relaxed.

The rapid development of the Chinese stock market has grabbed the attention of the world’s financial markets. Moreover, due to entry to the WTO, the Chinese stock market will start to be opened up completely in less than two years’ time. At this crucial juncture, it is hoped that this paper may be of use to both domestic and foreign investors who wish to better acquaint themselves with the Chinese stock trading regulatory system.

Due to limitations of length, this thesis is far from comprehensive. Some other important issues, such as the stock issuing process, rights offering, capital gains tax, stock trading service intermediaries, internal governance of listed companies, are not mentioned in this paper. Interested readers may wish to investigate these topics further.

Appendix

Appendix 1: Summary of A and B shares.

Time	A or B Share Listed Companies	Total Market Capitalization (100000000 Yuan)	Negotiable Market Capitalization (100000000 Yuan)	Total Capital (100000000 Yuan)
200312	1287	42457.71	13178.52	6428.46
200407	1367	40377.19	12717.65	7000.41

	Total Raised Capital (100000000 Yuan)	Stock Turnover (100000000 Yuan)	Total Inventors (10000)	Stamp Duty (100000000 Yuan)
200312	391.61	4257.58	7025.41	17.03
200407	219.91	2536.77	7156.58	10.09

Source: The CSRC official website. Aug. 9th, 2004

Appendix 2: The SHSE Index Series

Constituent Stock index:	(1) The SSE 180 Index
Composite index:	(2) The SSE Composite Index
Classified index:	(3) The SSE A Share Index;
	(4) The SSE B Share Index;
	(5) The SSE Industrial Index;
	(6) The SSE Commercial Index;
	(7) The SSE Real Estate Index;
	(8) The SSE Public Utilities Index;
	(9) The SSE Composite Index。
Other index	(10) The SSE Fund Index
	(11) The SSE T-bond Index
	(12) The SSE Corporation-bond Index

Source: The SHSE, “Fact book 2003”, 24.

Appendix 3: Contents of interim and annual report

Contents of interim report:

(1) the company's financial and accounting reports and business situation;

(2) major litigation involving the company;

(3) the particulars of any changes in the shares or corporate bonds already issued;

(4) any important matters submitted to the shareholders' general meeting for consideration; and

(5) other matters specified by the securities regulatory authority under the State Council.

Contents of annual report:

(1) a brief account of the company's general situation;

(2) the company's financial and accounting reports and business situation;

(3) a brief introduction to the directors, supervisors, managers and the senior management persons and information with respect to their shareholdings;

(4) the details of shares and corporate bonds already issued, including the name list of the 10 shareholders who hold the largest numbers of the shares in the company and the number of shares held by each of them; and

(5) other matters specified by the securities regulatory authority under the State Council.

Appendix 4: Significant event

"significant event" means:

(1) a major change in the company's business guidelines or scope of business;

(2) a decision made by the company concerning a major investment or major asset purchase;

(3) conclusion by the company of an important contract which may have an important effect on the company's assets, liabilities, rights, interests or business results;

(4) incurrence by the company of a major debt or default on an overdue major debt;

(5) incurrence by the company of a major deficit or incurrence of a major loss exceeding 10 percent of the company's net assets;

(6) a major change in the external conditions of the company's production or business;

(7) a change in the chairman of the board of direction, not less than one - third of the directors or the manager of the company;

(8) a considerable change in the holdings of shareholders who each hold not less than 5 percent of the company's shares;

(9) a decision made by the company to reduce its capital, to merge, to divide, to dissolve, or to apply for bankruptcy;

(10)major litigation involving the company, or lawful cancellation by a court of a resolution adopted by the shareholders' general meeting or the board of directors; or

(11) other events specified in laws or administrative regulations.

Appendix 5: Conditions for establishment of securities companies

Conditions for the establishment of a comprehensive securities company:

(1) to have a minimum registered capital of Y500 million;

(2) to have chief administrators and business persons who are qualified to engage in securities business;

(3) to have a fixed place of business and up-to-standard trading facilities;

(4) to have a sound management system and a standardized system for the separate administration of business on its own account and brokerage business.

Conditions for the establishment of a brokerage securities company:

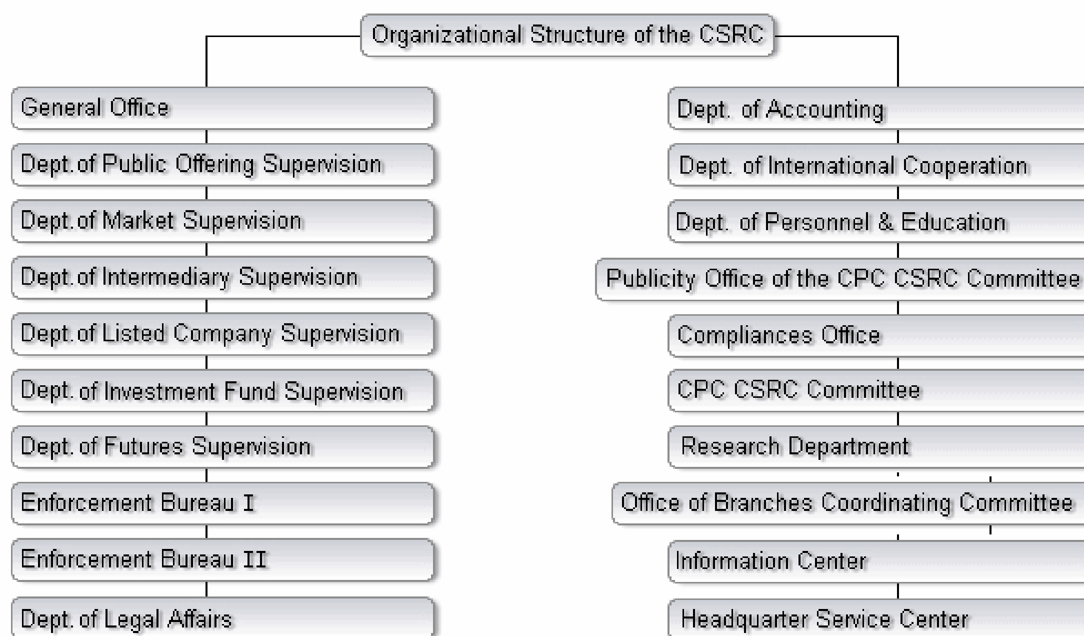
(1) to have a minimum registered capital of Y50 million;

(2) to have chief administrators and business persons who are qualified to engage in securities business;

(3) to have a fixed place of business, up-to-standard trading facilities;

(4) to have a sound management system.

Appendix 6: Organizational structure of the CSRC



Source: The CSRC official website:

http://www.csrc.gov.cn/en/homepage/index_en.jsp

Appendix 7: Regulations of members on the SHSE

Under the stipulations of the Exchange's constitution, a member of the Exchange refers to a securities firm possessed with a legal position that is approved by the CSRC to be established by law and admitted by the Exchange as its member.

A member enjoys the following rights:

a. participate in the members' meeting;
b. elect and to be elected;
c. put forward suggestions about the Exchange's business and vote;
d. participate in securities trading at the Exchange's premise and enjoy the service provided by the Exchange;
e. supervise over business of the Exchange and other members;
f. seat transfer provided that one seat is maintained;
g. other related rights.

A member undertakes the following obligations:

a. observe law, legal regulations, rules and policies and undertake securities business activities pursuant to the law;
b. adhere to the constitution, business rules and other relevant regulations of the Exchange and implement resolutions of the Exchange;
c. dispatch qualified representatives to trade securities at the Exchange's premise;
d. fulfill trading and settlement obligation;
e. protect the legal interests of investors;
f. maintain stability and promote the development of the market;
g. pay all required fees and provide relevant information and materials;
h. accept supervision from the Exchange;
i. other related obligations.

Member's Required Qualifications

a. a securities firm possessed with a legal position that is approved by CSRC to be established by law;
b. enjoy high creditability and outstanding business performance;
c. organization framework and business executives qualified by CSRC and the Exchange and the firm's precaution measures against technical risks that meet the Requirements of the Exchange;
d. accept the constitution and business rules of the Exchange and pay member's fee, seat fees and other fees as required.

A securities firm submits its application to the Exchange, which will accept it as its member upon the approval by its board of governors.

Termination of Membership Due To One of The Following Reasons

a. application by a member to terminate its membership that is approved by the Exchange's board of governors;
b. failure to complete the trading preparations or failure to commence its business at the Exchange within 3 months after it is admitted as a member;
c. dissolve as a legal entity, revoked or bankrupted by law;
d. failure to continue to conform to a member's qualifications as stipulated in the constitution of the Exchange;
e. failure to continue to fulfill regular trading and settlement obligations;
f. other behaviors that violate the nation's law and legal regulations.

Source: The SHSE website

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