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GILDING THE IRON RICE BOWL: THE ILLUSION OF SHAREHOLDER RIGHTS IN CHINA

Matthew D. Latimer

Abstract: In the late 1970s, the People's Republic of China (P.R.C.) embarked upon a program of economic reform that has resulted in the issuance of equity securities in previously state-owned enterprises. With the recent advent of national stockmarkets, national securities legislation is emerging to supplement and further define prior local-level regulation. Despite these new laws, however, private investors still lack many of the protections enjoyed by investors in Western financial markets. This Comment examines these disparities and suggests that non-state investors in China's nascent financial markets still lack an effective means of overseeing the policy decisions of State-owned corporations and face difficulties in obtaining redress from fraudulent conduct within the marketplace. Moreover, this Comment argues that the status of ownership rights in China's socialist system still is uncertain. This Comment then proposes a program which would diversify state interests in enterprises that would be both satisfying politically and encouraging of further reform.

Translated literally, the Chinese word for "investor" (*touzizhe*) is one who throws or tosses capital.¹ Given the current state of Chinese securities legislation, this translation may not be far off the mark. Since the opening of national stock markets in Shanghai and Shenzhen in December 1990 and July 1991 respectively,² literally thousands of Chinese and foreign investors have been clamouring for the chance to "toss" their fortunes into these emerging markets.³ Unfortunately, China's securities laws have failed to keep pace with the significant growth of its burgeoning securities industry. Although legislation continues to be enacted, China's current laws fail to offer adequate levels of shareholder protection or to ensure that outside shareholders⁴ will be able to oversee and direct the governance of Chinese enterprises.⁵

1. *A New Chinese-English Dictionary* 1024 (1985).

2. Not all areas in China have the authority to establish national securities exchanges. Shenzhen has been designated by China's central government as a "special economic zone" (SEZ) which is given special autonomy in the area of economic liberalization. Shanghai is a "directly administered city" that, like provinces, is under the direct control of the central government.

3. For example, when three newly-quoted Shenzhen companies issued shares in August 1992, approximately one million potential Chinese investors showed up to register for the opportunity to purchase them. And during the summer of 1992, Western investors "tossed" upwards of \$1.5 billion into Chinese mutual funds. See, e.g., David Fairlamb, *Surgin, Churning China*, Institutional Investor, Jan. 1993, at 33. See also Robert Steiner & Robert McGough, *Mutual Interest: Investment Funds Let Individuals with the Capital and the Courage Get in on the Action*, Wall St. J., Dec. 10, 1993, at R17.

4. Currently, three major classes of shares are available in China: "A" shares which are held exclusively by Chinese nationals, "B" shares which are held exclusively by foreign individuals and

This Comment examines the rights available to outside shareholders under China's current regulatory framework, as well as the methods and procedures currently in place to enforce those rights. Specifically, this Comment addresses three significant areas of potential concern: the ability of shareholders to oversee management decision-making through voting power, the ability of investors to obtain adequate redress from fraudulent conduct in the marketplace, and the feasibility of private stock ownership in a socialist system. Part I provides an overview of the historical development of China's modern stock system and an explanation of China's current regulatory regime. Part II analyzes the specific rights afforded shareholders under China's regulatory framework and suggests that there are significant gaps within that framework that should concern potential investors. Part III outlines a proposal that helps bridge these gaps and provides a direction for further reform.

I. CHINA'S STOCK SYSTEM: AN OVERVIEW

A. Historical Development

Modern economic reform in China began in 1979. Up until then, China's economy had been subject to varying levels of government planning since the 1949 Communist Revolution.⁶ Consequently, budget allocations from the national government were the sole source of funding⁷ for all state-owned enterprises. The establishment of securities markets was a natural outgrowth of the economic reforms begun in 1979 when the central government, under the leadership of Deng Xiaoping, instituted the "Four Modernizations" program to increase China's

funds, and "State" shares which, as the name suggests, are held by the state organ that is the major shareholder in the enterprise. See, e.g., Julia W. Sze, *The Allure of B Shares*, China Bus. Rev., Jan.-Feb. 1993, at 42.; Roberta S. Karmel, *Tossing Capitalism in Shanghai*, N.Y. L. J., Aug. 19, 1993, at 3. In this Comment, "outside shareholders" refers to holders of A and B shares.

5. As used in this Comment, the term "enterprise" encompasses all state-owned and collectively-owned entities that engage in business.

6. Contrary to popular belief, China's economy has never been completely planned from the center. Unlike the former Soviet Union, in which over 60,000 commodities were planned and distributed, in China this figure has rarely exceeded several hundred. Donald C. Clarke, *What's Law Got to Do with It? Legal Institutions and Economic Reform in China*, 10 UCLA Pac. Basin L.J. 1, 5-6 (1991).

7. Jia Zhao and Li Qian, *Trading Stocks in China: Development Regulation, Issues and Prospects*, E. Asian Exec. Rep., June 1992, at 7.

competitiveness in the world market.⁸ The advent of securities markets in China stemmed primarily from a need to obtain new sources of capital for Chinese industry and to relieve the state's financial organs from the burden of finding investment funds for projects designated by the central government.⁹ A secondary purpose of the "privatization" program was to encourage reinvestment of the estimated 1.2 trillion (Renminbi) in accumulated savings by private individuals.¹⁰

Consequently, in 1981, government treasury bonds were issued for the first time, and by 1984, select enterprises had been given permission to reorganize as joint stock companies and to issue equity securities in addition to bonds.¹¹ By the late 1980s, China's central government had recognized that private issuance of stocks and bonds to investors was an effective way to raise the capital necessary for production¹²; however, fear of losing control of the economy prompted the State Council¹³ to limit the types of enterprises that could issue stock.¹⁴ Despite these limits, in 1986, the Shenyang Jinbei Auto Industrial Shareholding Corporation¹⁵ became the first state-owned enterprise reorganized as a shareholding company to issue shares to the public.¹⁶ The approval of this share subscription by the Central Bank signified a substantial change

8. Zhou Enlai, *Report on the Work of Government*, (delivered at the Fourth National People's Congress) reprinted in *Beijing Review*, Jan. 24, 1975, at 21-5. The goal of the "Four Modernizations" policy is to provide China with modern agriculture, industry, national defense, and science and technology by the year 2000.

9. Li Guixian, former president of the People's Bank of China (PBOC), has stated, "We can sell a number of enterprises or the stocks of some large state enterprises to reduce state investment and loans and lessen the burdens of the state and the enterprises." Dorothy J. Solinger, *Capitalist Measures with Chinese Characteristics*, *Problems of Communism*, Jan.-Feb. 1989, at 42.

10. David Fairlamb, *supra* note 3, at 33, 35. Experts believe twice that amount is hidden in Chinese mattresses, bringing the savings ratio close to 45%. *Id.*

11. Paul Schroeder, *Rebuilding China's Securities Markets*, *China Bus. Rev.*, May-June 1991, at 20.

12. Zhao & Qian, *supra* note 7, at 7, 8.

13. The State Council functions as the Executive branch of the Chinese government and has principle control over economic policy. See *infra* note 26 and accompanying text.

14. Directive of the State Council on Reinforcement of Administration on Stocks and Bonds, March 28, 1987. This directive sets forth three basic principles: (1) Only collective enterprises may issue stock; (2) state enterprises, upon approval, may issue bonds and debentures; and (3) shareholding joint ventures among state-owned enterprises through "stock for asset" transfer may not issue stock to the public.

15. Jinbei Automotive has since been listed on the New York Stock Exchange through a Bermudian Holding Company, Brilliance China Automotive Holdings Ltd. See generally Lee B. Spencer Jr. & Clark T. Randt Jr., *A Dragon Enters the Den of Capitalism*, *Bus. Law Today*, Sept.-Oct. 1993, at 22.

16. Zhao & Qian, *supra* note 7, at 8.

in policy among China's regulators, thus allowing any state-owned enterprise that had reorganized into a shareholding company to publicly issue securities.¹⁷

Also during the 1980s, regional securities exchanges began operating in areas such as Shanghai, Beijing, Shenyang, Wuhan, Tianjin, Chongqing, Guangzhou, Harbin, and Shenzhen. Although these exchanges were strictly regional and dealt almost exclusively in enterprise bond issues with fixed interest rates and no ownership rights,¹⁸ their existence gave rise to several previously unaddressed issues, such as the precise nature of ownership rights in a socialist stockholding system and the reconciling the disparate treatment among state and collective enterprises. There was also rampant speculation among private investors and disagreement among governing agencies over the types of securities that could be issued—all of which served to dampen investor enthusiasm. The establishment of national exchanges in Shanghai and Shenzhen at the beginning of the 1990s eventually served to quell some, but not all, of the problems associated with the scattered exchanges.

Currently, the Shanghai and Shenzhen national exchanges are enjoying wide investor interest both within and outside of China. As of December 1993, there are approximately 240 companies listed on the two exchanges combined,¹⁹ and 34 China funds²⁰ available world-wide with over \$1.5 billion in assets.²¹ Leading securities analysts are increasingly confident about the ultimate success of China's securities markets.²²

B. Existing Law

Despite these impressive beginnings, the recent advent of securities markets in China has resulted in a paucity, by Western standards, of legislation controlling market operations, although new legislation is being enacted on a continuing basis. To understand the context in which this legislation arises, it is important to understand the framework of the legislative system in the P.R.C.

17. *Id.*

18. Paul Schroeder, *Rebuilding China's Securities Markets*, China Bus. Rev., May-June 1991, at 20.

19. Andrew Quinn, *China: China Sees Careful Growth Key to Stock Success*, Reuters News Service, Feb. 24, 1994, available in LEXIS News Library, Non-US News file.

20. These funds are mutual funds that focus their investment on Chinese companies.

21. Steiner, *supra* note 3, at R17.

22. See Fairlamb, *supra* note 10, at 34.

1. Constitutional Structure

Under China's constitution, the National People's Congress (NPC) and its Standing Committee are the supreme holders of state power.²³ Beneath the NPC are four state branches nominally responsible to it: the Central Military Commission, the Supreme People's Procuratorate, the Supreme People's Court, and the State Council.²⁴ Though officially all national legislation is passed through the NPC or its Standing Committee, most laws are drafted by various regional administrative offices or by the State Council.²⁵ In addition, the State Council has been specifically authorized to enact regulations and laws to implement national laws affecting the economy²⁶ and economic reform.²⁷ These laws, though confined to the administration of government, are national in scope.

At the regional level, Regional People's Congresses are empowered to enact legislation to implement or supplement national laws or administrative regulations and to deal with specific local problems.²⁸ Like the State Council, regional governments may also enact administrative regulations for their regions.²⁹ This paradigm continues down to local governments at the city or township level. Special economic zones, such as Shenzhen, enjoy unique grants of legislative power from the central government due to their peculiar economic status and are afforded greater latitude in dealing with specific local economic problems.³⁰

23. P.R.C. Const. art. 57–59 (adopted Dec. 4, 1982 by the 5th Session of the 5th National People's Congress).

24. *Id.* at arts. 92, 94, 128, 133. The State Council is responsible for the administration of the national government. Keller, *supra* note 23, at 669.

25. Perry Keller, *Legislation in the People's Republic of China*, 23 U. Brit. Colum. L. Rev. 653, 664.

26. Resolution on the Government Work Report, May 31, 1984 (adopted by 2d Session of the 6th National People's Congress).

27. Decision Concerning the Delegation of Authority to the State Council to enact Temporary Regulations Regarding Economic Reform and the Opening to Foreign Countries, April, 1985 (adopted by the 3d Session of the 6th National People's Congress).

28. P.R.C. Const. art. 7, 38, 51.

29. Keller, *supra* note 25, at 681.

30. *Id.*

2. *China's Legislative Process*³¹

China's legislative process³² differs significantly from lawmaking in the United States. Observers trained in common law are often puzzled by the abstract generality of China's statutes and by the lack of guidance on how legislation is to be implemented. In this respect, it is important to note that in the Chinese system, legislation is typically directed toward members of the vast government bureaucracy, whose responsibility is to implement the policies set forth in the legislative document itself. Consequently, most interpretation is left to the local implementing governmental body, which establishes internal rules to further the purposes set forth in the original legislation.³³ These internal rules, however, are often not available to the general public, and hence, give rise to considerable confusion for anyone trying to gain an understanding of an existing regulatory framework.

Thus, an analysis of Chinese securities laws must consider not only relevant national legislation, but also provincial and local legislation and rules. Though a national system of securities regulation is beginning to emerge, regional and local regulations still dominate the regulatory landscape and most likely will continue to do so in the near future. Therefore, in considering the rights afforded shareholders under China's current regulatory framework, it will be necessary to consider three distinct bodies of law: the national securities regulations, the Shenzhen securities regulations, and the Shanghai securities regulations.

3. *China's Securities Laws*

a. *The National Securities Law*

National securities laws are a relatively new development in China and, as a result, continue to evolve. Prior to 1992, market regulation was exclusively in the control of the Guangdong Provincial Government and the local governments and securities exchanges of Shenzhen and

31. For a more detailed explanation of the Chinese legislative process, see generally *id.*

32. For the purposes of this article, "legislation" refers to any laws, rules, regulations, directives, and other rule-making documents promulgated by national, provincial, and local governments.

33. For example, the National People's Congress might enact a statute requiring that all restaurants in China engage in sanitary food preparation practices. Local municipal or provincial governments would then promulgate specific laws governing the standards with which restaurants in their jurisdiction would need to comply. At the lowest level, administrators may author detailed rules governing enforcement actions.

Shanghai.³⁴ Though the new national regulations provide an “outline for the national system of securities regulation that is likely to emerge over the next few years,”³⁵ much must be accomplished before a comprehensive national system of regulation is established.

The Trial Measures on Share-Formulated Enterprises (the Share Enterprise Measures), the outline for all future national measures, were promulgated by the State Council in May 1992.³⁶ The Share Enterprise Measures provide the general objectives of stock-issuing enterprises and the principles by which the national securities markets are to be governed.³⁷ The Share Enterprise Measures and the regulations that followed have provided, for the first time, a national regulatory foundation for the development of China’s securities markets.

In addition to the Share Enterprise Measures, the State Council has promulgated several other significant pieces of legislation. In January 1993 the State Council issued a circular³⁸ creating the Securities Committee of the State Council (SCOSC) and its subordinate organ, the China Securities Supervision and Control Committee (CSSACC). The SCOSC is to be the source of regulatory and policy decisions while the CSSACC is charged with implementing and supervising the enforcement of the SCOSC’s decisions.³⁹

Three final pieces of national legislation promulgated by the State Council—the Provisional Regulations on the Administration of the Issuing and Trading of Stocks,⁴⁰ Provisional Measures governing Stock Exchanges,⁴¹ and Interim Procedures for Prohibiting Securities Fraud⁴²—have more fully defined the procedures for orderly

34. Guangdong Province, in the Southeastern corner of China, contains the Shenzhen Special Economic Zone and Shanghai. However, Shanghai is a specially administered city that takes its primary direction from the national government.

35. Pitman B. Potter, *Securities Regulation: A National System Begins to Emerge*, E. Asian Exec. Rep., May 1993, at 9.

36. Trial Measures on Share-Formulated Enterprises, translated in ¶ 13-570 China Laws For Foreign Business—Business Regulation, (CCH-Austl., Ltd. 1993).

37. *Id.* at ¶13-570(2)(1–5).

38. *State Council Circular on Macro-Control of Securities Markets*, FBIS Daily Report—China, Jan. 25, 1993, at 24.

39. *Id.*

40. Provisional Regulations on the Administration of the Issuing and Trading of Stocks, translated in China Laws on Foreign Business ¶ 13-754 (CCH-Austl., Ltd. 1993)

41. *Provisional Measures Governing Stock Exchanges*, July 7, 1993, BBC Summary of World Broadcasts, C1 (special supplement).

42. *Interim Procedures for Prohibiting Securities Fraud*, September 2, 1993, BBC Summary of World Broadcasts.

administration of securities markets in China. It is expected that more national legislation will follow. Though still far from comprehensive, these recent pieces of legislation have begun to provide a framework for China's national securities system.

b. Local Laws

Though sketchy by U.S. standards, by far the most comprehensive securities regulation in China takes place at the local level. Two principal sources of China's securities law are the regulations and rules promulgated by the municipal governments of Shanghai and Shenzhen.⁴³ While both sets of regulations attempt to maintain orderly markets and to protect the interests of investors,⁴⁴ the two measures have taken different approaches to achieve these results.

These varying approaches are reflected in the two primary pieces of legislation that regulate these markets: the Provisional Measures of Shenzhen Municipality on Share Issuing and Trading (Shenzhen Measures)⁴⁵ and the Administrative Measures of Shanghai Municipality Governing Securities Trading (Shanghai Measures).⁴⁶ The Shenzhen Measures delineate the requirements for public issuance of stock and provide detailed regulations on how approval for such issuance is to be obtained. The Shanghai Measures, by contrast, simply list the documents to be submitted in order to qualify as an issuer⁴⁷ and have less specific requirements for prospectus contents.⁴⁸ The result is that, while it is easier initially to list stocks in Shanghai, investors there face greater uncertainty in the stability of the issuing institution than their counterparts in Shenzhen.

Moreover, both the Shenzhen and Shanghai Measures provide for investor protection against fraud, but each approaches the issue differently. Shanghai, in addition to imposing administrative fines for distributing false or misleading information,⁴⁹ has provided a private

43. The municipalities of Shanghai and Shenzhen are the present locations of China's two existing securities markets.

44. See Shanghai Measures art. 1 and Shenzhen Measures art. 1.

45. Provisional Measures of Shenzhen Municipality on Share Issuing and Trading (1991), translated in *China Laws for Foreign Business* ¶ 73-553 (CCH Austl. Ltd. 1992).

46. Administrative Measures of Shanghai Municipality Governing Securities Trading (1990), translated in *China Laws for Foreign Business* ¶ 91-038 (CCH Austl. Ltd. 1992).

47. Shanghai Measures art. 9, 10.

48. *Id.* at art. 16.

49. Shanghai Measures art. 75(3).

cause of action to the aggrieved shareholder.⁵⁰ Shenzhen, on the other hand, only imposes a variety of administrative and criminal penalties for fraudulent conduct.⁵¹ Both Shenzhen and Shanghai have supplemented these basic statutes with other measures governing various aspects of regulating the new markets. However, despite the growing compendium of national and local securities laws, some fundamental shareholder interests remain unprotected.

II. CHINA'S CURRENT SECURITIES REGULATIONS FAIL TO PROTECT BASIC SHAREHOLDER RIGHTS

Despite the new national regulations and the body of existing regulations in Shanghai and Shenzhen, individual shareholders in Chinese companies still do not enjoy the basic shareholder protections available to investors in the United States. Consequently, holding shares in these institutions can expose investors to considerable risk. The lack of these protections can be attributed in part to China's relative inexperience in regulating securities markets and in part to historical, economic, and political forces.⁵² Nevertheless, if China is to continue its economic reforms and maintain the integrity of its securities markets, it must provide protection to the individual shareholders who provide the capital fuel for the economic machine. This Comment identifies three primary problems that must be addressed before securities markets can achieve lasting stability in China: inadequate shareholder oversight of management decisions, lack of a reliable source of redress, and the inherent resistance to reform spawned by the ambiguities relating to private ownership that are embedded in the Chinese Constitution, statutes, and ideology.

A. Shareholder Suffrage

China's current securities regulations fail to vest outside shareholders with the ability to oversee and influence management personnel. In the

50. Shanghai Measures art. 20.

51. Shenzhen Measures art. 87.

52. For example, one commentator has suggested that it may be a mistake to view China's rule-making environment as a "legal system" at all. Instead it might more profitably be analyzed as a "disciplinary system" like that of the military. The fundamental purpose of a legal system is to secure the freedom and rights of individuals within the society. A disciplinary system's purpose, on the other hand, is to establish order and to promote the purposes of the institution it serves. Viewing China's regulatory environment under the disciplinary model may explain why the laws are so hesitant to establish rights for individual investors. *See infra* note 64 and accompanying text.

United States, shareholders have the right to elect the directors of a corporation,⁵³ vote on extraordinary corporate matters,⁵⁴ and remove directors for cause.⁵⁵ In China, these rights either do not exist at all, or are so limited that they are de facto nonexistent. This inability to check the actions of management through voting power deprives outside shareholders of their collective voice and leaves their interests underrepresented.

Ideally, stock ownership would confer upon shareholders the right to participate in the major policy decisions of the enterprise and to select the leadership of the enterprise through director elections. Although the recently promulgated Company Law does provide for shareholder voting rights⁵⁶ and annual shareholder meetings,⁵⁷ there is still little opportunity for an outside shareholder to exercise influence over management. This is because when a prospective issuer goes public, the state organ responsible for its management generally only sells 25% of all stock available, and in no case does it sell more than 50%.⁵⁸ Thus, the state ultimately maintains control of the company's policies, directors, and operations despite the fact that private individuals, both domestic and foreign, share in the ownership.

The obvious problem is that the outside shareholders' interest in making a profitable investment may not always be consistent with the ultimate interests of the state majority shareholder. For example, the state may not have an incentive to pursue goals consistent with increasing the profitability of the corporation.⁵⁹ In fact, it may actually

53. Harry G. Henn & John R. Alexander, *The Laws of Corporations* 511 (1983).

54. *Id.* at 491.

55. *Id.* at 512.

56. P.R.C. Company Law art. 41 (adopted at the 5th Session of the Standing Committee of the 8th National People's Congress, promulgated on 29 December 1993 and effective as of July 1, 1994).

57. *Id.* at art. 104.

58. Roberta S. Karmel, *Tossing Capitalism in Shanghai*, N.Y. L.J., Aug. 19, 1993, at 33. However, recent developments suggest that the state is having difficulty maintaining this dominant position. For example, Shandong Petrochemical recently offered each shareholder the option to buy 8 new shares for every 10 shares held. Among the major shareholders, only the state failed to exercise its option, shrinking its stake from 51.2% to 38%. Keven Murphy, *Chinese Firms Slipping Into Private Hands*, Int'l Herald Trib., Apr. 19, 1994, at A1.

59. For instance, some enterprises may be used simply to manufacture raw components for other state enterprises. Profitability of the supplier may not be as important to the state as the allocation of enough components to the other enterprise. Because the state owns at least 50% of both companies, it will simply make an internal evaluation of the costs and benefits and make a decision on pricing, payment, and production costs. This evaluation may not take into account outside investors' interests. Likewise, enterprises whose principal shareholder is a municipal or provincial government agency may choose to overstaff their factory in order to reduce unemployment in the local area.

sacrifice the enterprise's profitability to achieve other state objectives.⁶⁰ The result is that unwitting outside shareholders place their investment in the hands of government bureaucrats⁶¹ who may be pursuing goals which are inconsistent with shareholder expectations.⁶²

Successful securities regulation in China must address this problem. Although some investors, at the present time, may feel that they are fairly represented by enterprise leadership, investor confidence in China's securities markets ultimately will depend on the ability of shareholders to exercise some degree of oversight over enterprise management. Lack of specific provisions mandating shareholder participation in deciding enterprise policies, coupled with ultimate control of share enterprises by the state, effectively places the outside shareholder at the mercy of the state's plans.

B. Limited Rights of Redress

Although current national and regional regulations provide basic definitions of securities fraud and allow compensation to the victim, the regulations ultimately fail to define exactly what type of action should be taken to secure that compensation, or in many instances, to specify whether a private right of action is available at all. Additionally, Chinese courts have been notoriously inconsistent in enforcing awards, particularly when an award would harm an interest of a major contributor to the regional economy.⁶³ To understand the reasons behind the relative absence of private rights of action in China, it is important to first understand the overall philosophy of China's dispute resolution system.

60. For example, the "state plans" required by formal socialist ideology might simply be replaced by inequitable "state contracts," whereby the former quotas are now sales orders offered to the state at a reduced price. Though it is unclear whether there is any shareholder "duty of loyalty" under Chinese law, it is probable that such a duty, in practice, could not be applied to the State successfully.

61. These may be the enterprise's directors or other managerial officials appointed by a "competent authority" designated by the majority state shareholder or employee representatives. Henry R. Zheng, *Business Organization and Securities Laws of the People's Republic of China*, 43 Bus. Law 551, 559 (1988). As a result, there is no guarantee that they have outside shareholders' profit interests at heart.

62. See *supra* note 60 and accompanying text.

63. Matthew D. Bersani, *The Enforcement of Arbitration Awards In China*, J. of Int'l. Arb., June 1993, at 47-48.

1. *Chinese Philosophy of Law and "Rights"*

Most commentators agree that it is not entirely accurate to describe China's system of rules and regulations as a "legal" system: rather, it might better be described as a "disciplinary" system.⁶⁴ Under a legal system, the emphasis is on justice and securing the rights of the individual. A disciplinary system, on the other hand, strives to maintain order, to achieve common objectives, and to quell disputes.

For example, most traditional American families operate under a disciplinary system. The supreme holders of authority are the parents. When making rules for family members, the focus is typically on what will most benefit that family as a whole, with the needs of its individual members being secondary. Rarely is the focus on vesting children with irrevocable rights that limit the parents' authority. Such is the general nature of China's disciplinary system. Law typically does not create private rights for individuals; rather, it is the method by which the state asserts its "parental" authority to discipline anyone who may hinder the state's ultimate goals.⁶⁵

2. *Shareholder Compensation Provisions*

Because China has traditionally followed a disciplinary model of rule enforcement, its legislation typically has not provided rights to its citizens that may be privately enforced. Violations of national or regional securities laws generally subject violators only to fines or imprisonment and not to civil liability. Nevertheless, some of China's securities laws have made an attempt to define private causes of action. Both the national⁶⁶ and Shanghai regulations⁶⁷ call for the payment of compensation to injured parties in the event of issuer fraud, though they

64. See generally Thomas B. Stevens, *Order and Discipline in China* (1992).

65. See *id.* at 8. Stevens states that most Eastern commentators have considered Chinese justice to be "parental" rather than "adjudicative."

66. Provisional Regulations on the Administration of the Issuing and Trading of Stocks (1993) translated in *China Laws for Foreign Business* ¶ 13-574 (CCH-Austl. Ltd. 1993)

67. Measures of Shanghai Municipality for Administration of the Trading of Securities (1990). Under these regulations, an issuer may be personally liable for any damages incurred by a shareholder resulting from a false or misleading prospectus. However, unlike U.S. securities law, liability is contingent upon actual knowledge of the false or misleading statement, rather than upon negligence. See Securities Act of 1933, § 11, 15 U.S.C. § 77(e).

fail to define exactly what constitutes a fraudulent act.⁶⁸ The Shenzhen regulations, on the other hand, treat a violation of the disclosure obligation like any other technical violation, by imposing penalties such as criticism in the newspaper, a fine of up to 10,000 yuan,⁶⁹ and a temporary suspension of quoted trading of its stocks.⁷⁰ However, because the national regulations technically preempt all local regulations, the national requirement that compensation be paid to those injured by fraudulent statements will likely hold true in Shenzhen as well.⁷¹

The difficulty with the current regulations is that they fail to define causes of action with specificity. For example, article 20 of the Shanghai Measures states that fraudulent statements or omissions by an issuer shall result in liability for "compensation." Just what is meant by this term is unclear. Perhaps this problem will be solved during the coming years as the national and local governments further experiment with new policies and legislation. However, in the interim, the possibility that a shareholder will be able to bring a successful private action under the current vague provisions is questionable.

3. *Difficulty with Enforcement*

A second, perhaps more onerous bar to redress of shareholder grievances in China is the limited power of Chinese courts to enforce their judgments. Although in theory China's court system is independent from other government institutions, in reality a court's power to enforce its judgments depends upon cooperation from local banks, Public Security Bureaus,⁷² and political leaders. Varying relationships between the court, the heads of these local organizations, and the party against whom judgment is being sought often inhibit satisfactory resolution for the plaintiff.

For example, management of large enterprises in China has traditionally been assumed by members of the Communist Party. Indeed, Party leadership is constitutionally guaranteed and is one of the

68. Regulations of the Shanghai Municipality on the Administration of the Issuing and Trading of Stocks, art. 39 (1990); *see also* Pitman B. Potter, *Shanghai Securities Regulations*, E. Asian Exec. Rep., August 1991, at 10.

69. This amount equals approximately \$1,154 U.S. dollars.

70. Zhao & Qian, *supra* note 7, at 10.

71. Keller, *supra* note 31 and accompanying text.

72. The Public Security Bureau is comparable, though not identical, to a local police department in the United States.

fundamental principles of the current political system.⁷³ Therefore, a large, state-owned enterprise often wields substantial influence over the local Party leadership of other governmental organizations. The result is that an enterprise issuing stock can often effectively evade civil liability by using its *guanxi*⁷⁴ to influence local government leadership and court officials.⁷⁵

Another difficulty with enforcing civil awards in China is the reluctance of local authorities to enforce judgments against a major contributor to the regional economy.⁷⁶ Should the local or regional governments decide that enforcement of the award would unduly hamper the local or regional economy, they may simply direct those under their charge not to comply with the issuing court's request for enforcement. A good example of this was the experience of a British company, which received a favorable disposition of its case before an arbitration panel. The company applied to the Beijing intermediate court⁷⁷ for enforcement against a Ningxia⁷⁸ company.⁷⁹ Despite the repeated requests of the Beijing court to the Ningxia intermediate court to enforce the award, the Ningxia court refused to do so.⁸⁰ Eventually, Beijing court personnel paid a personal visit to Ningxia. Upon arrival, the court personnel were told by local bank officials that the Ningxia company no longer retained any substantial deposits at the bank (a statement that there was good reason to believe was false), and the local Ningxia court also claimed the amounts awarded by the Beijing court had been miscalculated.⁸¹ As a

73. P.R.C. Const. Preamble, art. 1; Zheng, *supra* note 61, at 559.

74. This term is Chinese for "relationships." *A New Chinese-English Dictionary* 364 (1985). Building and cultivating personal relationships is a vital part of the social and political system in China. An individual with good *guanxi* can often avoid much of the procedural red tape associated with government administration.

75. Anthony Dicks, *The Chinese Legal System: Reforms in the Balance*, 119 *China Q.*, 1989, at 565.

76. Matthew D. Bersani, *supra* note 63, at 47-48 (Although Eersani's article concerns enforcement of arbitration awards, the same general principles regarding a Chinese court's ability to enforce awards apply equally in this case).

77. In China, there are three levels of courts: basic level courts, intermediate courts, and high-level courts. The intermediate court's jurisdiction generally extends to reviewing cases heard by the basic level courts and to cases that are of particular significance to the local area in which they sit.

78. Ningxia Province is located in North-Central China.

79. Bersani, *supra* note 63, at 48.

80. *Id.*

81. *Id.*

result, the plaintiff was left without a remedy despite the Beijing court ruling to the contrary.⁸²

Even before judgment is rendered, however, there are strong indications that the deck may be stacked against a plaintiff who is making a securities fraud claim against an influential issuer. A judge's decision in any given case can be overridden by the Adjudication Committee⁸³ attached to each People's Court, even if the committee members are not actually present during the courtroom proceedings at the trial level.⁸⁴ Because the Committee consists of appointed Party officials, it may at times be influenced by political or economic factors. Furthermore, although all levels of courts are in theory answerable to the Supreme People's Court of China, their operating expenses and the benefits of individual court personnel are controlled by local or regional governments. Political pressure can therefore play a significant part in influencing an individual judge's or an Adjudication Committee's final decision.

In sum, the court system offers a very unreliable avenue for redress in China. Indeed, most native Chinese hesitate before bringing any matters before an official tribunal. An old Chinese maxim states, "Win your lawsuit, lose your money."⁸⁵ For the aggrieved shareholder, this means that even if his or her complaint is heard, it may not be impartially adjudicated or a judgment may not be actually enforced. This is a substantial risk that many outside investors might think twice about taking.

C. *Constitutional Restrictions on Ownership*

1. *The Role of China's Constitution*

Chinese constitutional law scholars have distinguished the role the constitution plays in China from the role a constitution plays in Western democracies.⁸⁶ Unlike its Western counterparts, China's constitution, though explicitly stating that it has the force of law, serves more as a

82. *Id.*

83. The Adjudication Committee's function is to oversee the judgements of the courts. Its ostensible purpose is to make sure that the individual judge or panel does not make mistakes.

84. Donald C. Clarke, *What's Law Got to Do with It? Legal Institutions and Economic Reform in China*, 10 UCLA Pac. Basin L.J. 1, 60-61 (1991).

85. Sybille Van der Sprenkle, *Legal Institutions in Manchu China* (1966).

86. For an excellent explanation of the form and purpose of China's Constitution, see William C. Jones, *The Constitution of the People's Republic of China*, 63 Wash. U. L.Q. 707 (1985).

policy statement of the government.⁸⁷ Its revision is a signal that a significant change has taken place in the government or in society and that the change is perceived to be long-lasting.⁸⁸ Consequently, while many of these "policy" statements are not always binding as law, they do give a good indication of the attitudes and goals of present leadership and of the direction China may be expected to go in the future. In this sense, policy is more important than law.⁸⁹

As a result, China's current constitution does not define the rights and responsibilities of the people and their government.⁹⁰ To secure individual liberties, an effective constitution must be essentially contractual,⁹¹ in that it defines the relationships among individual members of society and between the government and the citizenry. This usually requires a limitation on rights of the individual as well as a restraint on the power of government; "it must define with clarity the basic structure of rights of society as a whole."⁹² Thus, one of the principle shortcomings of China's current constitution is its failure to define, in concrete terms, exactly what kind of rights are available to the individual and how those rights will be protected from government and private interference. To be sure, national and local statutes provide a clearer picture of the restraints imposed upon government, but the ambiguities inherent in the current and overriding constitution leave the ultimate validity of these restraints in question.⁹³

87. *Id.*

88. *Id.* For example, the first constitution promulgated in 1949 signified the victory of the Communist forces over the Nationalists. The 1954 Constitution, which remained unchanged for more than 20 years, signaled the firm entrenchment of the new regime and the stabilization of power within China. The 1975 Constitution followed the victory of the "Gang of Four" faction over intra-party forces that opposed it throughout the Cultural Revolution. The 1978 Constitution resulted from the overturning of the "Gang of Four" and signaled the establishment of the coalition led by Deng Xiaoping. Finally, the 1982 Constitution is said to "indicate a complete rejection of the Cultural Revolution and all 'leftist' ideas and a return to the 'good old days of the 1950's.'" *Id.*

89. "A clear statement of policy may, in consequence, be of considerably more value than a more detailed set of rules. As a result, the preamble is generally the most important part of the constitution. Thus, the statements in the preamble to the 1982 constitution that emphasize the importance of modernization and the necessity to make use of foreign capital and almost to eliminate class struggle may be rather more significant to a person who is contemplating a joint venture than a whole portfolio of legal materials of the usual type." *Id.* at 474.

90. Steven N.S. Cheung, *Will China go "Capitalist?"*, Hobart Paper 94, at 24. (1982)

91. *Id.*

92. *Id.* at 25.

93. One writer has concluded:

[O]ne major hindrance to China's going capitalist is a cumulative stock of resistance built on a base of ambiguity and indoctrination. Communism in China has long been bolstered by the vagueness of its sloganism, by the hazy popular belief that the nature of 'capitalism' is

2. *Shareholding and the Socialist Economy*

Consequently, a final problem confronting those who hold shares in Chinese enterprises is the fundamental conflict between a system of stock ownership and the Marxist ideals perpetuated in China's most recent constitution.⁹⁴ Despite the Chinese constitution's specific recognition of general property rights, there are provisions that seem to conflict with the principle of stock ownership. For example, article 6 describes the basis of the economic system as "socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people."⁹⁵ Moreover, this system of public ownership "supersedes the system of exploitation of man by man"⁹⁶ If the constitution declares public ownership to be the basis of China's economic system, it appears, in theory at least, that the measures enacted by the national and local governments vesting private individuals with the right to own shares of enterprises are *per se* unconstitutional. Arguably, article 13, which provides for the protection of "the right of citizens to own lawfully earned income, savings, houses and *other lawful property*"⁹⁷ recognizes stock ownership, in that the existence of various current securities regulations make ownership "lawful" and therefore protected. However, on the whole, the status of private stockholders in China is ambiguous.

This ambiguity of constitutional protections does not necessarily mean that shareholders are in imminent danger of having their investments expropriated. Nor does it mean that eliminating the conflicting provisions from the constitution would immediately vest shareholders with a blanket of security.⁹⁸ Political and economic forces within China itself wield great power to protect or destroy a stockholding system regardless of the wording of its constitution. However, shareholders should focus their concerns on the long-term implications of these ambiguities and

represented in the repeatedly told horror stories, and by the rhetoric enbalm in the Chinese Constitution itself.

Id.

94. The most recent P.R.C. Constitution was promulgated on December 4, 1982.

95. P.R.C Constitution art. 6.

96. *Id.*

97. *Id.* at art. 13 (emphasis added).

98. See Nikos A. Stamos, *China's Nascent Securities Market: Some Observations*, 10 Harv. J.L. & Pub. Pol'y, 691, 697 n.26 (1987) (arguing that since 1954, the right to own income, savings, and homes has been constitutionally protected, but that in practice, protection may have been less consistent).

their effect on China's economic reforms. As a whole, the constitution's conflicting terms reflect the ongoing ambivalence of China's leadership regarding market reforms. This ambivalence presents a hindrance to further regulation and places the status of stock ownership on uncertain ground.⁹⁹

Several commentators have made valiant efforts to reconcile the existence of a stockholding system with a socialist economy.¹⁰⁰ Some commentators argue that shareholding is a natural step in the development of a socialist economy. To illustrate their point, they note the stockholding systems extant in several of the former Eastern Bloc countries.¹⁰¹

A second group of theorists differentiates between stock ownership in a capitalist economy and a socialist economy. In a capitalist economy, the argument runs, the shareholders are bourgeois, living off the labors of the working class; in a socialist economy, the owners of the shares are communes, government collectives, or the individual workers within the factory itself. This argument ignores the fact that many shareholders in Chinese enterprises are foreigners who cannot be considered "workers" or "the people" in any sense. It also fails to recognize that shareholders in capitalist countries are often individual employees or pension funds that represent employees.¹⁰²

A third group argues that capitalist shareholders seek to exploit the labor of the workers, whereas in the socialist system, shareholding is a tool to meet the needs of the people.¹⁰³ However, even these commentators must concede that China's current shareholding system is driven by shareholders' desire for profits.¹⁰⁴ Finally, it is said that a

99. A good example of this ambivalence is the delay in promulgating a comprehensive national securities law. The law was originally to have been enacted in January 1994. As of this writing, it is still in draft form.

100. See, e.g., Stamos, *supra* note 98, at 694-96 (critiquing the various economic and political arguments set forth by Chinese economists seeking to justify shareholding under China's socialist system).

101. E.g., Hungary, Romania, and Yugoslavia; see, e.g., Yan Simao, *PRC Journal Discusses Socialist Joint Stock Companies*, JPRS, Mar. 13, 1985, at 7; Li Kehua, *Methods of Stock Issuance Under Socialism Discussed*, Nov. 20, 1985, at 35. It should be noted, however, that all these countries are currently moving away from socialism.

102. Stamos, *supra* note 98, at 694-95.

103. Kehua, *supra* note 101, at 37. Presumably these needs are met by providing the necessary capital for economic growth.

104. As one commentator has stated, "Seen from the long-term . . . people will see that purchasing ordinary shares will be profitable." Cao Wenlian, *Jingji Yanjiu on Changing Enterprises to Stock Companies*, JPRS, Nov. 19, 1985, at 21, 26.

system of checks and balances between the enterprise management, board of directors, and the workers council will protect the workers, government, and shareholders from being harmed by a shareholding system.¹⁰⁵ Unfortunately, in practice these checks and balances are unlikely to provide adequate protections because the party with the most power (read “government”) will prevail on almost any issue.

Consequently, the system of shareholding currently in place in China faces many ideological and political obstacles. It is easy to dismiss these apparent contradictions between private shareholding and socialist theory by citing the fact that a shareholding system is continuing to be developed despite the conflicts. However, long-term growth, stability, and regulation of securities markets and of China’s economy depend upon reconciliation between these two principles.

III. DIVERSIFIED STATE OWNERSHIP: A PROPOSAL FOR FURTHER REFORM

Any real solution to the problems of share ownership in China must address both the ideological resistance and practical problems that exist in China today. A program of diversified state ownership, whereby a state entity’s controlling interest in an enterprise is divided among several separate state agencies and institutions, will maintain ideological integrity while offering a solution to the problems facing China’s securities markets. Diversified state ownership was first discussed in a 1985 report by the World Bank Mission (WBM) to the Chinese government.¹⁰⁶ In the report, the WBM examined various stock reform policies implemented in China prior to 1983 and provided suggestions on how reforms might fruitfully continue. The WBM believed that a fundamental problem in the relationship between the state and the enterprises still existed.¹⁰⁷ The state still maintained rigid control over the state-owned enterprises, causing enterprises to be “subordinate bodies of administrative organs”¹⁰⁸ rather than functioning, independent entities.

To address this problem of enterprise autonomy, the WBM advocated the establishment of boards of directors vested with strategic decision-

105. *Id.*

106. World Bank, *China: Long-Term Development Issues & Options* (1985).

107. *Id.* at 164.

108. *Id.* at 165.

making power.¹⁰⁹ These boards would consist of workers, representatives of society at large, and, most importantly, representatives of institutions with a strong interest in the enterprise's profits.¹¹⁰ However, the WBM recognized that even semi-independent boards of directors would be insufficient to ensure enterprise autonomy. Accordingly, the WBM proposed that

[a] possible solution might be to spread the ownership of each state enterprise among several different institutions, each in some way representing the whole people, but with an interest mainly in the enterprise's profits rather than directly in its output, purchases, or employment. Examples of such institutions, in addition to central and local governments, are banks, pension funds, insurance companies, and other enterprises In China, such a system of socialist joint stock ownership could perhaps be created initially by suitable dispersion of the ownership capital of existing state enterprises. Over time, it could be reinforced by a more diversified pattern of investment finance, with a variety of state institutions acquiring financial interests in existing and new enterprises.¹¹¹

This proposal to diversify state ownership of enterprises offers a concrete plan of reform that is consistent with socialist ideology and provides shareholders with assurance of increased rights and protections.

A. Diversified State Ownership Would Allow All Shareholders To Exercise Greater Oversight of Enterprise Management and Policies

The allocation of the state-owned portion of a given company among separate state bodies would dilute the overall influence of any single state entity upon the policies and management of the organization. Because no corporate policy decisions or company directors could be selected by a single majority shareholder, only those policies or directors upon which all major stockholders could agree would be chosen. Most, if not all of the time, the interests of these various entities would differ. For example, a municipality's principal interest in an enterprise may be its ability to provide employment for the local citizenry, while a government agency in charge of heavy industry may be more interested in providing inexpensive component parts for other projects. If both

109. *Id.*

110. *Id.*

111. *Id.* at 166.

state shareholders are to benefit, they must reach a consensus as to what their goals for the enterprise are. It is likely that a strong common interest would be profits. This interest would subsequently be reflected in the types of directors selected to direct the enterprise, and the policies they pursue. In this sense, the division of state assets among several different state entities resembles the structure now existing in the United States, where a large segment of stock in many major corporations is held by institutional investors.¹¹² Minority stockholders, that is, individuals and smaller private investment groups, would be assured that their interests are furthered because the shared interest of the state shareholders is profits.

Additionally, diversified state ownership would necessarily bring about greater adherence to the formalities of stockholder participation in the enterprise. Although the current corporate law in China requires the holding of shareholder meetings and confers voting rights,¹¹³ these procedures are not consistently implemented by the enterprise.¹¹⁴ State organizations that have a primary interest in the enterprise's profits but not a majority interest in the enterprise would demand a voice in determining the enterprise's policies and in electing the enterprise's board of directors so that they could more adequately protect their investments. Moreover, state shareholders would have the ability to apply sufficient political pressure to ensure that securities laws are vigorously enforced, and outside investors would reap the benefits of these actions.

B. The Proposal Would Result in Increased Protection of Investors' Interests

Another result of diversified state ownership is that each individual state organization would demand more consistent protection for its ownership interest. Under a system of state majority ownership in an enterprise, incentive to protect minority investors against fraud is lacking because the state itself is not a minority shareholder. Consequently, although some antifraud provisions have been enacted, development of further protections has been slow, and enforcement inconsistent.

112. Approximately 35% of all outstanding stock in the United States is held by institutional investors. Henn, *Law of Corporations* 486 n.8 (1988).

113. See *supra* note 36 and accompanying text.

114. An owner with majority control over the enterprise *and* control over the enforcement of any laws governing that enterprise's operations does not have a great deal of incentive to adhere closely to procedural rules.

Moreover, individual state institutional shareholders who have a shared interest in the profits of an enterprise would be able to apply significant political pressure to the central and local governments to enhance the protections available and to increase enforcement actions. Even the traditional impotency of Chinese courts to enforce judgements would be reduced if state ownership was dispersed widely enough. Because incentive to protect local enterprises would decline when a local government's stake in those enterprises was diminished,¹¹⁵ less political and economic pressure would be applied to a court attempting to adjudicate a claim based on the securities laws. As a result, protection against fraud would increase for everyone—including outside investors.

C. The Proposal Is Consistent with Current Socialist Ideology in China as Embodied in the Chinese Constitution

There is little doubt that diversified state ownership has the potential to reform the socialist ownership system; however, it is also evident that such a proposal is still far short of complete privatization. If China is to continue down a road of reform, it must do so on its own terms.¹¹⁶ Diversified state ownership allows ownership of "the means of production"¹¹⁷ to remain in the all-encompassing hands of the state but still to serve private interests by focusing state interests on profits, thus, allowing enterprises to pursue plans consistent with this interest. The result is a "baby step" toward privatization that is politically and economically safe yet provides needed stability and protection to ensure the future growth of China's burgeoning financial markets.

IV. CONCLUSION

The future stability and growth of China's nascent securities markets depend upon how well investors in those markets are protected. The markets in Shanghai and Shenzhen have grown considerably over the past several years and have been a strong source of the investment capital

115. For example, a local government would be more likely to support a judgment against a local enterprise by a court in another region if the local government only owned a small percentage of the enterprise itself and felt confident that it would have the same protection provided for its holdings in other regions.

116. Xu Jing'an of the China Economic System Reform Institute in Beijing stated, "The biggest obstacle to the implementation of a share system is the resistance of traditional [communist] ideas." Xu Jing'an, *The Stock-Share System: A New Avenue for China's Economic Reform* 223 (1986).

117. P.R.C. Const. art. 6.

that China so desperately needs. However, unless China is willing to allow enterprises more autonomy, it will find that this wellspring of capital funds can quickly dry up. As a possible solution to the dilemma posed by a socialist securities market, diversified state ownership would leave primary control of enterprises in the hands of the state, while allowing each enterprise to pursue goals that are more compatible with outside investors' interests. By restructuring the ownership of China's enterprises in this way, the integrity of socialist ideology would be protected while the aims of capitalism were advanced. In the interim, it is important for investors to remember that, in China, all that glitters is not necessarily gold.