

The Development of Securities Markets in China in the 1990s



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Background

Following the Communist Party's accession to power in October 1949, securities markets in China went into a prolonged period of stagnation, as stock markets were closed and new issues dried up.

The re-emergence of securities markets commenced under the auspices of the economic reform programme of "socialist modernisation" announced by then party Vice Chairman Deng Xiaoping in 1978 under which market forces would be brought to bear on the economy and China's "doors would be opened" to foreign capital and entrepreneurs. Deng described the new policy as "socialism with Chinese characteristics". The development of securities markets was intended, amongst other things, to extricate the PRC Government from the funding problems arising from substantial budget deficits due in part to the heavy subsidies granted to loss making state-owned enterprises. In addition, it was thought that securities markets would enable state enterprises to mobilise and efficiently allocate the huge amount of domestic savings which is estimated to be in the region of US\$200 to US\$300 billion. As part of the process it is hoped that exposing state enterprises to the rigours of the capital market will improve internal management and raise productivity.

Following Deng's announcement, the PRC Government in 1981, after a break of 30 years, resumed issuing government securities. At

first, State Treasury Bonds were issued to various government institutions and enterprises and then, in 1984, permission was granted to some enterprises to issue bonds and shares to the public through approved financial institutions. Individuals were first "permitted" to purchase treasury bonds in 1982 through the enterprises for which they worked under a system whereby purchases were compulsory and formed part of the employees' total compensation. Circulation and trading of these bonds were prohibited. China opened its treasury bond market in 1988 when underwriting by non-financial institutions was permitted and it became possible for bondholders to trade their securities. Marketability and liquidity developed with the opening of treasury bond circulation markets in 54 cities. Recently, the Chinese Government has had difficulty in selling a 41-billion RMB treasury bond issue at current rates. The State Council responded by issuing a circular to the effect that there is to be no "public offering" of debt or equity until the bonds have been sold.

The authorities are currently planning the development of an RMB commercial paper market, while bonds and commercial paper targeted at foreign investors are also on the drawing board.

In order to facilitate the development of securities markets a number of experiments have been conducted over the past decade. One experiment involved the introduction of the joint-stock company system, which was regarded as a prerequisite to the establishment of markets for securities. In September 1984, the first joint-stock company was established under this system (Tianqiao Department Store in Beijing). The introduction of the joint-stock company system commenced in Shanghai in 1985 and in Shenzhen in October 1987.

Another experiment consisted of establishing securities trading markets. This occurred in 1986 when the People's Bank of China (PBOC), Shanghai branch, sanctioned the Industrial and Commercial Bank of China to establish an over-the-counter (OTC) market for bonds and shares. In 1988 shares in the Shenzhen Development Bank were traded on the Shenzhen OTC market.

On 19 December, 1990, the Shanghai Securities Exchange was officially opened for trading to replace the OTC market, while the official opening of the Shenzhen Stock Exchange took place on 3 July 1991. At present these two securities exchanges are the only two authorised Exchanges operating in the PRC, although there has been pressure at the Provincial level to establish more. The trading of shares on the Shanghai and Shenzhen exchanges is limited to securities listed thereon, while unlisted securities continue to be traded on OTC markets located in various major cities around China. At first, shares on both the exchanges were offered only to mainland Chinese investors and were denominated in RMB. However, in 1991, China's securities markets took a major stride forward with the removal of restrictions on foreign investors acquiring shares of Chinese enterprises. This was accomplished by permitting listed companies to issue a special class of shares, "B" shares, the purchase and sale of which is limited to foreign investors. The first "B" shares were issued by Shanghai Vacuum on 20 January 1992 in Shanghai and commenced trading on the Shanghai Securities Exchange on 21 February 1992. The Shanghai Securities Exchange and the Shenzhen Stock Exchange are the only two facilities through which "B" shares can be traded.

To improve the efficiency of the Chinese securities markets further, the Stock Exchange Executive Council (SEEC) was formed in March 1989 to create a nationwide treasury bond trading system (Securities Trading Automated Quotations System (STAQ)) which was established on 5 December 1990. Initially, STAQ linked approximately 30 cities and 80 licensed trading corporations in China, with an average monthly turnover of over RMB600 million.

Since the first stock market experiments were carried out in Shanghai and Shenzhen, these two cities have promulgated a series of rules and regulations, covering such matters as the management of joint-stock companies, stock issuance and trading, and securities firms and stock exchanges. Some rules have also been formulated in other Provinces and cities. However, the absence of a comprehensive legal and regulatory framework for the securities industry impeded market

development initiatives and prompted the Chinese government to embark on an energetic campaign to address these deficiencies. The Central Government encouraged the foundation of the Securities Association of China (SAC) in August 1991 and in late 1992 established the State Council Securities Policy Committee (SCSPC) and its operating arm, the China Securities Regulatory Commission (CSRC), which is currently working on legislation to establish corporate and securities laws in China.

A further experiment being conducted to develop China's securities markets is the conversion of major state-owned enterprises into joint-stock companies and the listing of the securities on exchanges both within and outside China, including Hong Kong. The first batch of these enterprises has been chosen and listings are likely to proceed from the middle of 1993.

Having set the background to the development of securities markets in China, I now propose to examine:

- The nature of the instruments traded on the markets.
- The issue and secondary trading of securities.
- The equities markets in Shanghai and Shenzhen.
- Regulation of the equities markets.
- Listing of China enterprises in Hong Kong.

Nature of Instruments Traded on the Markets

So far, PRC securities markets have been dominated by bond transactions which account for over 90% of the total volume of all trading that takes place. As previously mentioned, trading other than on the two authorised exchanges is conducted through the OTC markets and the STAQ.

At present there are four major types of bond issues - Treasury Bonds, Construction Bonds, Enterprise Bonds and Financial Bonds.

Quantitatively, *Treasury Bonds* are the most important fixed interest security. They are issued by the Ministry of Finance's (MOF)

State Debt Management Department and are floated to cover budget deficits and to raise funds for large domestic construction projects. Interest is paid in full at redemption with no interim payments. *Construction Bonds* are issued by enterprises or government agencies (or by the MOF on their behalf) to finance special investments in major construction projects or infrastructure projects. *Financial Bonds* are issued by specialized banks as an additional source of funding, distinct from the customary sources such as deposits, central bank credit and budgetary loans. Usually, the proceeds of bond issues are designated for specific uses such as supporting finance projects, etc. Unlike interest on Treasury Bonds, accrued interest on Financial Bonds is payable annually. *Enterprise Bonds* are those issued by "trading enterprises" to supplement general revenues and to extend budgetary financial support.

In addition to the various forms of bonds, there are four major types of stocks. They can be categorised according to their ownership, namely State Shares, Legal Person Shares, Individual Shares and Foreign Investment Shares.

State Shares are shares held by state-owned units designated by the Government and may only be sold or transferred with the approval of the State asset administrative departments. *Legal Person Shares* are shares held by a company or legal entity which does not include the State or natural persons. Taken together, State Shares and Legal Person Shares account for something around nine times the number of shares listed on the Shanghai and Shenzhen Exchanges. Although there are stringent restrictions on the transfer of such shares, an "underground" market has developed and this has been sufficiently active to cause the State Council to issue a Notice in April 1993 to the effect that the State Commission for Restructuring the Economy, the Ministry of Foreign Trade and Economic Relations and the State Council Securities Committee will be cooperating to curb illegal trading. *Individual Shares* are shares held by the staff and workers of the company or shares held by individual public investors.

Collectively, these three types of shares are referred to as "A" shares and may be purchased only by Chinese nationals, although enterprising persons in Hong Kong and Taiwan have been known to purchase "A" shares.

By the end of 1991 there were about 3,300 PRC enterprises which had converted themselves into "limited liability joint-stock companies" having issued legal person shares or individual shares. By the end of 1992 this number had grown to about 4,000.

Foreign Investment Shares (Special RMB Shares) are shares held by governments, legal persons and individuals outside China and are used as a means of attracting direct foreign investment into both Chinese enterprises and joint ventures, as well as a mechanism for assisting the development of the securities markets. Special Shares issued and listed on the two Exchanges are called "B" shares which are denominated, traded and settled in US\$ (initially they were denominated in RMB). Broadly speaking, owners of "B" shares enjoy the same rights and bear the same obligations as holders of "A" shares.

As at 31 March 1993 securities listed on the Shanghai Securities Exchange consisted of 37 bond issues (of which four were Treasury Bonds, 11 were Financial Bonds, and 22 were Enterprise Bonds), 43 "A" shares and 10 "B" shares.

Trading activity on the Shenzhen Stock Exchange is basically confined to stocks and as at the end of March 1993, there were 24 "A" shares, nine "B" shares, one warrant and five bond issues listed on the Exchange.

The Issue and Secondary Trading of Securities

Issue

In China, regulatory responsibility for securities issues is dispersed amongst a number of authorities. While the MOF is responsible for the issue of Treasury Bonds, the State Planning Commission approves

the issue of Enterprise Bonds, and the responsibility for share and bond issues over RMB30 million lies with the PBOC. The newly formed CSRC and Provincial Regulatory Commissions also have approving responsibilities for listed equity issues.

An issue of "A" shares can be accomplished by way of a public offer, a private placement (in which case a transfer of shares can only occur between legal persons) or an internal issue (whereby shares are issued to the staff and workers of a company, provided that the issue does not exceed 30% of the total shares of the company). A public offering of "A" shares is made through the so-called "lottery" system whereby subscription forms in respect of selected potential issuers are made available to domestic investors whose applications "go into a barrel". The draw to determine the successful applicants is generally held in the format of a televised lottery.

An issue of "B" shares can be accomplished by way of either a public offering or a private placement. A public offering can only be conducted through an approved securities institution. If an issue is made through a distribution syndicate representing the issuer, it must be managed by an authorised PRC securities institution, which acts as the main distributor, together with approved foreign institutions. A private placement of "B" shares can be made to legal persons outside China with the prior approval of the appropriate regulatory authorities.

In order to issue and list securities in *Shanghai*, an issuer must apply to the Shanghai Securities Exchange and to the recently established Shanghai Securities Regulatory Commission, either directly or through a securities company or trust and investment company. The regulations require that a newly established joint-stock company must, amongst other things, obtain an asset valuation performed by a recognised asset valuation organisation, and that the organisers of the issue subscribe for not less than 30% of the total amount of shares to be offered. An existing joint-stock company which wants to issue shares to increase its capital must provide financial statements, certified by an accounting firm, reflecting continuous profits for at least the two preceding years and the preceding quarter of the current year.

There are additional regulations in respect of "B" shares, including requirements that the company has stable and adequate foreign currency income to fund dividend payments and that the proceeds of the issue must be used in accordance with State policies on the administration of foreign investment.

The regulations governing the issue of shares in *Shenzhen* are a little more stringent than those in Shanghai. A prospective issuer must apply directly to the Shenzhen Securities Regulatory Commission for approval - it must have net assets of at least RMB10 million; the ratio of net tangible assets to total assets must be not less than 25%; following any issue of shares, at least 25% of its shares must be held by the public and the company must also have a minimum of 800 shareholders. To issue "B" shares in Shenzhen, the issuer must also have a three-year operating record.

In *Shanghai*, bond offerings with a total value of RMB10 million or more must be open to public participation. In addition to certain required documentation, the issuer must submit financial statements of continuous profits for the two preceding years and the preceding quarter of the current year, certified by a registered accountant. The issuer must also apply to a credit-rating organisation designated by the PBOC for a rating of the bonds. Approval is only given to the issue if the bonds receive an A-rating or higher. There are no specific provisions governing the issue of bonds in Shenzhen since the market is relatively small at this stage. Although non-financial institutions have been made responsible for acting as underwriters, and specialised banks as agents, for issuing government bonds to individual investors, government bonds are still issued to institutional investors in a "compulsory manner" at lower interest rates and trading is prohibited.

The offer period for new issues varies as between regions. It must not exceed 90 days in Shanghai and 60 days in Shenzhen (the period commences with the date of approval and runs through to the conclusion of the distribution period). Securities remaining unsold after this period cannot be offered for sale again without the approval of PBOC.

Trading

Trading of stocks and bonds is conducted through OTC markets via the STAQ system as well on the two exchanges, whilst trading of listed shares takes place only on the two exchanges. By the end of 1992, there were approximately 70 specialised securities companies, 1,000 enterprises with securities operations, and 5,000 securities trading counters throughout China.

OTC trading takes place through securities agencies which match buying and selling orders. The markets are far from perfect and demand and supply differences between different OTC markets frequently result in disparate pricing in respect of the same security.

The STAQ facility currently links 43 cities and more than 70 licensed trading corporations via a satellite communication network and computer interfaces, with its centre located in Beijing. The functions of the system include dissemination of market information and price quotations for the various OTC markets, statistical analysis, scripless trading and clearing and settlement services. At the end of 1992, there were 10 bonds trading in the system and since July 1992, the system has also provided a pilot trading facility for Legal Person Shares. In March 1993 it was announced that 15 companies with a flotation value of RMB750 million were seeking quotations for Legal Person Shares on the STAQ system and that STAQ plans to approve one or two companies per month with each flotation worth about RMB30 million.

Trading on the Shanghai and Shenzhen Exchanges is carried out by means of a computerised, automatic matching system which executes each transaction based upon price and time priority. Trading information is displayed on an electronic screen in the trading hall and is transmitted electronically to members' trading terminals. "A" shares are quoted in RMB and "B" shares in US\$. Only cash account trading is permitted. Margin trading, index trading and short selling are prohibited.

Trading of "B" shares must be conducted on the two exchanges through an authorised local broker or through an approved foreign broker. Overseas investors must have an account with the clearing house of the exchange and execute transactions through authorised foreign brokers, who in turn instruct authorised local brokers (recently Shanghai moved to give some foreign brokers direct access to "B" shares). Foreign securities houses wishing to become authorised foreign brokers must file applications with the PBOC, and if approved are required to enter into agency agreements with only one of the local brokers prior to their participating in any purchase and sale of "B" shares.

Settlement of On Market Transactions

Both exchanges have adopted central clearing systems to facilitate the clearing and settlement of "A" share transactions. In order to clear and settle bonds and "A" shares, each authorised broker must open an account with the PBOC and maintain a balance sufficient for settlement purposes. Clearing and settlement is done on a "net settlement" basis whereby a broker is only required to settle the net monetary balance after offsetting the amounts payable with the amounts receivable. For shares, the system is scripless, working on the basis of electronic book entry.

In respect of "B" shares, the clearing and settlement cycle must be completed on T+3. In *Shanghai*, all "B" shares are settled in US\$ at a rate representing the weighted average exchange rate of US\$/RMB at the Shanghai swap centre during the preceding week. As from April 1993 clearing and settlement functions are performed by the new Shanghai Central Securities Registration and Settlement Company, which will enhance the efficiency of the previous two-stage settlement process.

In *Shenzhen*, all "B" shares are settled in HK\$ at a rate based on the preceding day's closing price of HK\$/RMB at the Shenzhen swap centre (the settlement currency is expected to be US\$ as from 1 June

1993). Clearing and settlement is handled by one of the three approved banks: Citibank, Standard Chartered Bank and Hongkong and Shanghai Bank.

In Shanghai, the administration of securities' listings, trading, clearing, settlement, custody and registration rests exclusively with the Shanghai Securities Exchange, whilst in Shenzhen, the registration of shares rests with the clearing agent of an issue, which maintains a list of shareholders of the issue and reports to the Shenzhen Registrars Company Ltd., the central registrar for securities in Shenzhen. At present, in Shenzhen, the appointment of a clearing and registration agent is issue specific, i.e. an issuing company can only appoint one of three approved banks as the central clearing and registration agent for its shares.

Membership of the Two Securities Exchanges

The two PRC Exchanges operate on a not-for-profit basis, adopting a membership system which permits institutions engaged in the securities business to access the trading market. Both Exchanges have a diversity of members including securities companies, trust and investment companies, insurance companies, banks, finance companies and credit co-operatives. Approvals must be obtained from both the CSRC and the PBOC before admission can be obtained. Members can conduct both agency and principal business.

Shanghai has admitted members from the local region as well as from other areas such as Beijing, Shandong, Shenyang, Anhui, Jiangxi, Zhejiang, and Hainan. In mid-1992 Shanghai had 81 approved members and 106 seats, but this was increased to 200 seats and more recently to 600 seats, all of which have been taken up. The Exchange is currently constructing a new building and it is understood that it is planning to accommodate 1,600 seats. Recently, Shanghai created a new class of membership (which falls short of full membership) by establishing new seats to be made available to foreign brokers (to be held in the name of a Shanghai broker nominee) to enable them to deal directly

in "B" shares. As at the middle of May 1993, 23 foreign brokers had been admitted to this category of membership.

Shenzhen has a much smaller number of members, 85, of whom about half are from Shenzhen itself and the other half mainly from the neighbouring Guangdong Province. In view of the move by the Shanghai Securities Exchange to open its membership to foreign brokers, the Shenzhen Stock Exchange has recently put forward a proposal to allow foreign brokers "full membership" of its Exchange. This proposal is currently under study by the Shenzhen Securities Regulatory Commission.

The Equities Market in Shanghai and Shenzhen

In common with many other developing markets, the markets in both Shanghai and Shenzhen are highly speculative, exhibiting significant volatility, in terms of both price and volume. As at the end of February 1993, the two Exchanges had a combined market capitalisation of about RMB184 billion (Shanghai RMB119 billion and Shenzhen RMB65 billion). This is equivalent to US\$32 billion and compares with US\$198 billion in Hong Kong. Exchanges with a similar market capitalisation to Shanghai/Shenzhen are Santiago (US\$34.8 billion), Copenhagen (US\$34.6 billion) and Tel-Aviv (US\$29.8 billion).

Because of the different characteristics of the shares, it is useful to consider the "A" and "B" share markets of Shanghai and Shenzhen separately.

The Markets for "A" Shares

"A" share listings on the two Exchanges obviously coincided with their openings in late 1990 and mid-1991 - by mid-1992 there were 14 "A" share listings in Shanghai and 17 in Shenzhen, and by 30 April 1993 there were 43 in Shanghai and 24 in Shenzhen.

Shanghai: The novelty of stock markets together with the availability of a substantial supply of savings in cash form created an

overheated market throughout the first part of 1992 which saw the Shanghai share price index move rapidly upwards. However, upward movements were constrained by PBOC (Shanghai Branch) daily price fluctuation limits of 1% (they were tightened from 5% to 1% in July 1991) so that market efficiency problems emerged as demand clearly outstripped supply. In May 1992 the authorities focused on various measures to tackle these problems, including varying the price limits (they were eventually abolished), extending trading hours and banning trading syndicates. In response, prices rose by between 350 and 450% but after June the market went into decline for the rest of the year as more new issues were floated and investors became far more cautious. During the first six weeks of 1993 the "A" share market took off for a second time but since then prices have again gone into decline. Throughout 1993 excessive speculation has remained a significant problem and the Shanghai Exchange has responded by bringing in a rule to prohibit bids which exceed the current quoted price by more than 3%.

In similar vein to prices, volumes have also fluctuated considerably, for example, during February 1993, volume built up to significant levels - on 9 February the Shanghai "A" share market had a record turnover of RMB1.65 billion (equivalent to HK\$1.56 billion on a day when the Hong Kong market experienced a turnover of HK\$1.57 billion). Currently turnover is much quieter.

Shenzhen: Similar factors to those operating in Shanghai established a highly speculative bull market until May 1992. The index reached a peak on 27 May but then declined by about 25% in two weeks, remaining in a downward consolidation phase for the remainder of 1992. With one exception, Shenzhen has not set "price limits" to curb excessive speculation, but the Authorities have established a "fund" to smooth out price fluctuations by way of open market operations.

The image of the Shenzhen Exchange was tarnished to a considerable extent by the widely publicised share subscription form riots of August 1992 and by the events surrounding a company - Shenzhen

Champagne - which involved detention of some of the company's executives. Throughout 1993, Shenzhen has been working at rebuilding its image, but market volatility continues.

There is no doubt that at this stage, the "A" share market is still very much in the experimental phase with trading by speculators dominating market activity. Price-earnings ratios (P/Es) are at very demanding levels (estimates indicate an average of about 120 times in Shenzhen and 135 times in Shanghai) and the evidence points to buyers holding stocks for short periods only. Official concerns have been expressed about these matters and it seems likely that continuing efforts will be made to dampen down the speculative elements (in March 1993 regulations were released to limit speculators from cornering the markets).

The Markets for "B" Shares

"B" shares first emerged on the two Exchanges in early 1992 - as at 30 June 1992 there was one "B" share issue listed in Shanghai and seven in Shenzhen, and by the end of 1992 each Exchange had nine "B" share listings, the initial offerings for which raised US\$640 million in Shanghai and US\$170 million in Shenzhen. Currently there are 10 "B" shares listed in Shanghai and nine in Shenzhen and it is expected that by the end of 1993 total listings of "B" shares might have grown to between 30 and 40 companies.

Shenzhen: The initial launch of the seven "B" share listings in Shenzhen coincided with intense interest by some fund managers in Hong Kong which pushed up prices quickly on strong turnover. P/E ratios for the initial public offerings averaged 8.5 times, but increased rapidly to a peak in mid-May as newly launched funds built up their portfolios. However, from early June 1992 the market went into a state of almost continuous decline as prices retreated and turnover stagnated with liquidity becoming a major problem. The correction was a normal reaction to an overheated market, but was also associated with the launch of large tranches of "B" shares in Shanghai and the decline in investor confidence as a result of the share subscription

form incidents in August. Despite this, at year end 1992 all "B" shares listed on the Shenzhen Exchange finished at significant premiums to their issue prices, although well off their year highs.

Sentiment recovered in early 1993 and Shenzhen "B" share prices again rose rapidly. There was a 49% surge in prices over six trading days from 1 February to 8 February (largely associated with rumours that "B" share quotations were to be changed from RMB to HK\$) and valuations became unsustainable with P/Es in excess of 30 times. Under these circumstances prices began to decline and have remained subdued since then. Liquidity has also been a problem and it is not unusual to find days on which only about half the "B" shares trade.

Shanghai: The launch of "B" shares in Shanghai took place in the second half of 1992 with significantly larger offerings and at significantly higher P/Es than had occurred in Shenzhen during the first half of the year. The Shanghai listings raised four times the amount of capital on P/Es of about 18 times 1992 earnings. These demanding requirements, together with the factors mentioned earlier, placed considerable pressure on the Shanghai "B" share market with the result that, by year end, with one exception, all the stocks finished at large discounts to the issue price.

As has been the case in Shenzhen, Shanghai "B" shares have also been volatile throughout 1993. Intra week volatility has been substantial, for example, prices rose by 7.9% and 9.2% on 14 and 15 February (due to Lunar New Year Bulls) whereas they fell by 7.4% on 3 February, following news that the Shanghai Foreign Exchange Administrative Bureau was to crack down on "local" buying of "B" shares which had become more open.

Some "B" share problems: There is no doubt that international investors continue to remain wary of "B" share stocks despite the strong rate of economic growth which is expected to take place in China for any medium term forecast period. Investors remain cautious because of such factors as continuing depreciation of the RMB, the embryonic state of companies and securities regulation, failure of companies to publish results in accordance with International

Accounting Standards, failure of management to publish results in a timely manner and via a medium convenient for international investors, concerns about selective release of shareholder information, concerns about the methodology of rights issues, and concerns about "quality of earnings" in that China companies seem to be interested in "investment speculation" rather than building core-business strengths.

China Funds

The emergence of China "B" shares for listing and trading in Shanghai and Shenzhen was rapidly followed by the launch of "China funds", the first of which appeared within a month of the listing of the first two "B" shares in February 1992.

Between March and August 1992, over 20 China funds, both open and closed-end, were launched in the face of wide institutional and retail investor interest in the development of China's securities markets. Most of these funds were closed-end vehicles, listed in Hong Kong, London or New York, raising some US\$1 billion for investment in "B" shares, unlisted Chinese issues and China concept stocks listed in Hong Kong. A number of these funds have been structured to become open-ended within two years.

In addition to the closed-end funds, some US\$200 million was raised in the initial launches of nine open-ended "B" share funds. These funds were all authorised in Hong Kong, many of them being sub-funds of existing umbrella funds already authorised in Hong Kong and domiciled in Luxembourg, the Channel Islands or Bermuda.

The open-ended funds were authorised by the Securities and Futures Commission (SFC) on the basis of full compliance with existing regulations, including liquidity and diversification requirements, and stringent risk disclosure. The focus of the risk disclosure was on PRC market capitalisation and liquidity, the then undeveloped nature of the legal, regulatory and accounting framework in the PRC, and the more general political risk associated with the PRC's experiment with market mechanisms.

Despite these risk warnings, the enormous demand for "B" shares unleashed by these funds led the SFC to issue an additional risk warning concerning the effect on price volatility of the significant imbalance between supply and demand. And during the early days of the China fund boom, when there were almost as many China funds as there were listed "B" shares, the SFC closely monitored advertising to ensure that funds did not promise more exposure to the "B" share market than was in fact possible.

At present, activity is much quieter on the China fund front. Although some of the open-ended funds are fully invested in "B" shares, most are invested (to varying degrees) in Hong Kong-listed China concept stocks.

Regulation of the Equities Markets

At present, regulation of the PRC equities markets is still very much in the development stage - the new national Securities Commission is still in start-up mode (as are the Provincial Regulators in Shanghai and Shenzhen), demarcation lines between Authorities have not yet been clarified, national laws and regulations are still in the process of being drafted, and there are some uncertainties concerning the framework within which existing regulations have been established.

Regulatory Authorities

Pursuant to a resolution on 12 October 1992 the State Council of China established the CSRC, under the Chairmanship of Professor LIU Hongru, to regulate China's securities markets. The SFC's link to the State Council is via SCSPC chaired by Vice Premier ZHU Rongji. The SCSPC is the macro policy-making body and consists of representatives from Government organisations who have an interest in securities regulation, for example the PBOC and the MOF.

The CSRC shares regulatory responsibilities in respect to the securities industry with other agencies, including the PBOC (which has responsibilities for matters such as approving licences for intermediaries, approving mutual fund managers, and approving issues of mutual funds) and the Provincial Regulatory Commissions.

At the regional level in Shanghai and Shenzhen, municipal Regulatory Authorities (the Shenzhen Securities Regulatory Commission and the Shanghai Securities Regulatory Commission) have recently been established to perform supervisory tasks, especially in relation to Provincial issuers and intermediaries. In Shenzhen, a two-tiered regulatory structure has been established along similar lines to the Beijing model. The Shenzhen Securities Regulatory Commission commenced operations on 1 April 1993 comprising officials from the local PBOC and the Municipal Economic Systems Reform Committee whose functions are to deal with day-to-day operational issues such as supervision of new issues, listing, trading and supervision of intermediaries and professionals. The Shanghai Municipal Securities Regulatory Commission started operations in March 1993 with a brief to regulate the market in Shanghai.

Finally, the Exchanges in Shanghai and Shenzhen undertake the normal functions performed by most other stock exchanges, such as approving securities for listing and regulating the activities of members.

Securities Regulatory Requirements

National level laws (and regulations) are still being developed, a dynamic process which will evolve over a period of years. The main regulatory requirements are being framed in the following documents:

- (i) The Provisional Regulations of the State Council on the Administration of Securities. These Regulations, when promulgated, will provide for the establishment of the SCSPC

and the CSRC and define their respective responsibilities and powers. Other matters include basic requirements and obligations for securities intermediaries and issuers, and requirements concerning trading of securities, management of investment funds and clearing and settlement. It also sets out investigation powers for the CSRC as well as the penalties which might be imposed on those who violate the regulations.

- (ii) The Standard Opinion on joint-stock companies - a document issued by the State Commission for Restructuring the Economic System and which establishes a basic framework of shareholders' rights and corporate governance (it contains some of the types of requirements normally set out in western company law).
- (iii) Provisional Provisions on the Registration of joint-stock companies - to be promulgated by the State Administration of Industries and Commerce (SAIC), and which sets out the requirements for a joint-stock company to be registered as a legal person. The SAIC issues Certificates of registration, evidence that a company has legal status.
- (iv) Provisional Regulations on the Administration of Stock Issuance and Trading. These are requirements issued on 22 April 1993 which currently constitute the national law governing the issuance and trading of "A" shares within the PRC, although this is not the national securities law. The measures contain detailed provisions relating to the issue of shares (prospectus requirements, etc.), trading of shares (listing requirements, etc.), takeovers of listed companies (including requirements to make tender offers once a 30% threshold is reached), the disclosure obligations of listed companies, and offence provisions for market manipulation, etc.
- (v) The Company Law of the People's Republic of China - this is being drafted by the law drafters of the Standing Committee of the National People's Congress and will eventually establish company law in China on a firm footing (it will supersede regulatory requirements (ii) and (iii) above).

- (vi) The Securities Law of the People's Republic of China - being drafted by the law drafters of the Standing Committee of the National People's Congress - and which will eventually absorb the share issuance and trading requirements mentioned above. The draft securities law sets out provisions concerning powers of the new national regulatory bodies, the issuance of securities (including qualifications of issuers and documentary requirements), disclosure of important events (news dissemination), securities trading, disclosure of interests, insider dealing and other market malpractices, the licensing of securities intermediaries, takeovers and mergers, investment funds, securities exchanges and OTC markets, and a mechanism for the arbitration of disputes and penalties for contravention of such provisions.

Because trading of equities in Shanghai and Shenzhen has preceded the implementation of national companies and securities laws, various regulatory requirements have had to be developed at the regional level. For example, the Shanghai PBOC, the Shanghai Municipal People's Government and the Shanghai Branch of the State Administration of Foreign Exchange Control have promulgated requirements such as:

- Operating Rules for the Trading Market of the Shanghai Securities Exchange (1 December 1990);
- Procedures on the Administration of "B" shares (22 November 1991);
- Implementing Rules for the Administration of "B" shares (25 November 1991); and
- Provisional Regulations Relating to Companies Limited by Shares (18 May 1992).

Similar requirements have been introduced in Shenzhen to underpin the development of its market.

Listing of China Enterprises in Hong Kong

For some years now, Hong Kong has been the focal point for listing what have become known as "China concept" stocks - i.e. companies incorporated in Hong Kong, Bermuda or some other English common law jurisdiction but whose assets are predominantly (if not all) located in China. Notable among the China concept stocks are companies such as China Travel Service, Guangdong Investment, Guangzhou Investment, China Oversea Land & Investment and Denway Investment which were incorporated and listed on the Stock Exchange of Hong Kong (SEHK) under control of PRC interests.

The China concept stocks have obviously added a further dimension to the Hong Kong market, but in some respects, and more importantly, they have provided the basis for an evolutionary move to list, on a primary listing basis, PRC-incorporated enterprises in Hong Kong. This market development initiative, which has been in progress for about 12 months, involves major path-breaking work for both the SEHK and the SFC in terms of devising an appropriate *investor protection framework* and *efficient market structures* to enable the listings to proceed.

Investor Protection Framework

The underlying philosophy of the current SEHK listing rules is that an overseas issuer seeking a listing on the Exchange must be established in a jurisdiction where the standards of shareholder protection are at least "equivalent" to those provided in Hong Kong. Given the particular nature and stage of development of the PRC securities markets, the legal and accounting systems, the regulatory structures and the business and governmental framework, it became clear that the concept of "equivalence" could not apply. As a substitute, the various regulatory authorities have developed the concept that there should be a "sufficient" level of shareholder protection.

In order to establish a "sufficient level" of shareholder protection, the important issues which have been addressed include:

- Developing a package of "shareholder corporate rights" (Package 1).
- Developing a package of "shareholder securities market rights" (Package 2).
- Developing procedures to ensure that the investor protection requirements work in an operational sense (Package 3).

Package 1 "Shareholder Corporate Rights" - PRC state-owned enterprises which intend to apply for listing in Hong Kong will be converted into joint-stock companies. They may issue two types of shares which will rank *pari passu*: one type denominated in RMB, listed and traded only on PRC exchanges and available only to Chinese citizens and domestic entities (the "A" shares), and a second type, also denominated in RMB, but listed and traded in Hong Kong dollars on the SEHK and available only to overseas investors (the "H" shares). The "H" shares are not the same as "B" shares (which are US\$-denominated shares listed and also available only to overseas investors) in that "B" shares are traded on a Chinese exchange and do not provide the corporate and securities market investor protection aspects which are a feature of the package discussed below. It is envisaged that enterprises with "H" shares will not issue or list "B" shares on any PRC exchanges but that they will most likely have concurrent offerings of "A" shares in China and "H" shares in Hong Kong.

The basic building block of Package 1 is the "Standard Opinion" promulgated by the PRC State Commission for Restructuring the Economic System and which sets out the rules for establishing a joint-stock company. Because the Opinion does not coincide with Hong Kong company law (there are gaps, overlaps and conflicts) it has been necessary to develop mechanisms to "reconcile" the Opinion

with Hong Kong company law with regard to corporate governance matters. This has been done by a combination of methods, including:

- A mandatory standard set of Articles of Association which enshrines into the Articles of the PRC State Enterprise and establishes as a matter of contract many rights which are contained in Hong Kong corporate law, but which are not contained in the Standard Opinion. For example, they contain such matters as rights of shareholders, directors' fiduciary duties, the rights of one class of shareholders *vis-à-vis* another, financial disclosure matters and an arbitration mechanism for resolving disputes in relation to the affairs of the company. Of particular importance is the provision which gives each shareholder a direct cause of action against any director who is in breach of his duties as a director where normally it would be the company rather than the shareholder who will have the right of action. There are also provisions which, with one exception, require the passing of a special resolution by a specific class of shareholders before the rights of that class can be changed.
- An "Addendum" and an "Explanatory Note" to the Standard Opinion which, for those PRC state enterprises wishing to list in Hong Kong, bring the Standard Opinion into line with Hong Kong practice and provides authoritative interpretation of the Standard Opinion.

Package 2 "Shareholder Securities Market Rights" - PRC state-owned enterprises offering the "H" shares will be required to comply with the prospectus requirements of the Hong Kong Companies Ordinance and with the listing requirements of the SEHK, and once listed on the SEHK, a PRC issuer will be subject to all relevant laws and non-statutory requirements in Hong Kong, such as the Securities Ordinance, the Securities (Insider Dealing) Ordinance, the Securities (Disclosure of Interests) Ordinance, the Companies Ordinance insofar as it is applicable to a Part XI overseas company, the Protection of

Investors Ordinance and the Codes on Takeovers and Mergers and Share Repurchases.

As would be expected, it has been necessary to make some amendments to the *SEHK Listing Rules*, in particular there are modifications to the Listing Agreement and the enterprises' memorandum and articles of association, which are specified in a new section in the Listing Rules in a similar manner to that provided for companies incorporated in Bermuda and the Cayman Islands (approximately 50% of all companies currently listed on the SEHK are incorporated in Bermuda and the Cayman Islands). Specific amendments to the Listing Rules include a requirement that a PRC issuer retain for a minimum period of three years, a sponsor or an acceptable professional firm in Hong Kong to advise it on compliance with the Listing Rules, a requirement to have two independent non-executive directors, a requirement that the public float of "A" plus "H" shares represents at least 25% of the company's share capital (and that "H" shares represent the higher of HK\$50 million or 10% of the company's share capital, and that all "H" shares must be held by the public).

A particularly important component of Package 2 relates to the *Accounting Standards* to be used for reporting purposes. The current provisions of the Listing Rules require all companies listed on the SEHK, including overseas companies, to comply with accounting standards approved by the Hong Kong Society of Accountants (HKSA) and laid down in the Statements of Standard Accounting Practice issued periodically by the HKSA, or with International Accounting Standards (IAS), as promulgated periodically by the International Accounting Standards Committee.

In the PRC, state-owned enterprises are currently required to comply with the accounting standards promulgated by the MOF in respect of their particular category. On conversion to joint-stock enterprises they will be required to comply with the "Joint-Stock Company Enterprises Accounting Standards" promulgated by the MOF in 1992. These contain a number of significant departures from IAS,

for example, in such areas as accounting for foreign exchange transactions, depreciation, costs of maintaining plant and machinery and date of commissioning. As these departures could cause significant problems in terms of interpreting reported profits and financial position (with implications for dividend distribution, etc.) it has been necessary to establish a framework which will satisfy both PRC and international investors.

The approach which has now been agreed involves PRC enterprises listed in Hong Kong presenting two sets of accounts - one certified to be in compliance with the PRC Joint-Stock Enterprise Standards and the other certified as "true and fair" in accordance with IAS, normally by an "international" auditing firm. Audits must be conducted in accordance with International Auditing Standards. IAS will be used for initial and on-going disclosure purposes under the Hong Kong Listing Rules and the Hong Kong Takeovers Code. The maximum amount of distributable profit for the corporation will be based on the lower of the profit established by PRC Accounting Standards and IAS.

The other important element of the "securities markets rights" package concerns *disclosure*. Like any other issuer in Hong Kong, a PRC issuer will be subject to the disclosure requirements of the Companies Ordinance and the Listing Rules, including disclosure of certain special factors in the prospectus. The special factors will include a summary of:

- the relevant PRC laws and regulations;
- the political and economic environment/structure of the PRC;
- the foreign exchange control and the exchange rate risk of RMB;
- the untested nature of the regulatory framework being developed for the PRC listing;
- specific risk factors related to the business of the issuer or its products; and
- investor protection mechanisms which are different from that generally available in Hong Kong.

Package 3 "Procedures" - In order to ensure that the investor protection requirements set out in the two packages mentioned above work in an operational sense, we have developed two important sets of procedures.

First, we have prepared a *Memorandum of Regulatory Co-operation* (MORC) between the SFC, the SEHK, the CSRC and the two China Exchanges which establishes a framework for mutual cooperation in regulatory matters and sets out the issues and principles to be taken into account in coordinating regulatory efforts. The basic principles underlying the MORC are the protection of investors, the maintenance of fair, orderly and efficient markets, and ensuring compliance with each other's laws and rules. The scope of the MORC therefore covers not only PRC enterprises listed in Hong Kong, but also issuers of securities, directors, officers, shareholders and professional advisers of all companies listed in the PRC or Hong Kong; dealers and investment advisers operating in the PRC or Hong Kong; trading, clearing and settlement activities; insider dealing, market manipulation and other fraudulent practices on any stock market in the PRC or Hong Kong; as well as training and exchange of personnel and other markets agreed by the parties. Specific areas of cooperation, and detailed mechanisms for that purpose, cover company news dissemination, suspension of trading, takeovers and mergers, regulation of intermediaries and standardisation of securities terms. The list may be revised as and when the need arises.

Like other Memoranda of Understanding entered into by the SFC, the MORC contains a statement of intent which does not impose legally binding obligations on the signatories. As such, it has no power to override domestic laws and regulations, nor does it affect other channels of cooperation.

Second, a mechanism has been established to facilitate the resolution of disputes. It has been agreed that disputes concerning the affairs of the company involving Hong Kong or international "H" shareholders and other parties will be resolved by arbitration in accordance with the law of the enterprises' jurisdiction of incorporation

(i.e. PRC law, which will include the Standard Opinion and the Addendum). Arbitration may take place either at the China International Economic and Trade Arbitration Centre (CIETAC) or the Hong Kong International Arbitration Centre (HKIAC), at the election of the claimant. Hong Kong has nominated six members to the panel of CIETAC while the PRC has nominated six members to the panel of HKIAC. Arbitral awards by CIETAC and HKIAC, both of which are parties to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, will be enforceable in both jurisdictions.

The arbitration provisions do not apply to such matters as claims arising from investor protection laws regulating the marketing, sale, purchase, trading or other activities in the securities of the company. Hong Kong courts will have jurisdiction over all such claims.

Efficient Market Structures

As I have mentioned previously, trading of the "A" shares will take place on PRC Exchanges and trading in the "H" shares will take place in Hong Kong, and possibly elsewhere. Because of the foreign exchange constraints, the two sets of markets will be influenced by somewhat different demand and supply conditions, so that prices are likely to diverge (just as they do at present for "A" and "B" shares). There do not appear to be any special problems from a trading point of view, although a number of issues relating to dividend payments and registration have had to be considered.

Trading of "H" shares on the SEHK will be conducted using the same facilities and will be subject to the same trading rules that apply to all other SEHK listed companies. Clearance and settlement of "H" shares will be effected through Hong Kong's central clearing system (CCASS) on a fully netted and guaranteed basis.

Dividend payments for holders of "H" shares will be based on the exchange rate quoted by the Shenzhen Foreign Exchange Adjustment Centre. Any loss of dividend value due to the conversion of RMB to Hong Kong dollars will be made up by the company, so

that the holders of "H" shares will be paid the same amount of dividend as the "A" shareholders.

A register of shareholders will be maintained in Shanghai or Shenzhen for "A" shareholders and another register will be kept in Hong Kong for all holders of "H" shares. The Hong Kong registrar will provide, on a monthly basis, a copy of the register of shareholders to the registrar in China, to enable the company to have up-to-date knowledge of both its "A" and "H" shareholders. The Hong Kong Securities Clearing Company has set up a company to act as the Hong Kong registrar for the China issues to be listed on the SEHK. The registration process for "H" shares will be the same as any other shares in Hong Kong, except that at the time registration is requested, the transferee will have to agree in writing to submit to arbitration in order to pursue an action against the company or a director as required by the mandatory provision. This process will be accomplished via the insertion of a statement into the document required to be signed by the transferee and issued to the registrar in order for shares to be transferred into his or its name.

Closing Remarks

The experiments currently underway in developing securities markets in China have met with initial successes, although, as we have mentioned throughout this paper, there are a considerable number of issues still to be addressed over time. Many of the issues will probably be resolved by trial and error as various participants in the market - the regulators, the exchanges, the intermediaries, the issuers and the investors - develop more experience. There is little doubt that in some instances the learning process will be painful - history tell us that all securities markets in the world have undergone such processes. Having said this, there is also little doubt that, given the size of China's economy (according to recent IMF statistics, it is now the third largest

in the world) and China's high propensity to save, there is enormous potential for the growth of its securities markets. If China's current economic policies continue, it is not beyond the realms of possibilities that by the year 2000 its equities markets will rank in the top 15 in the world.