FOREIGN ACCESS TO SECURITIES MARKETS IN TAIWAN AND THE PEOPLE'S REPUBLIC OF CHINA

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[Securities Markets in the People's Republic of China and the Republic of China on Taiwan have undergone significant liberalization in recent years. The greater sophistication of the Taiwan markets has required approaches with greater complexity than the more basic efforts of the PRC to induce investment in its budding securities markets. Both regions face ideological barriers to complete liberalization of the markets. Yet in both cases, there has been a steady effort to open up the markets to foreign investment. The specific measures taken and the potential implications of these measures reflect the particularities of the two regions, while the broader effort to increase foreign investment reflects certain similarities.]

1. *INTRODUCTION*

While the economic systems of the People's Republic of China and Taiwan display obvious differences, securities law and policy in the PRC has been influenced by the experience of the Republic of China (ROC) on Taiwan.[1] This is consistent with the extent to which the Taiwan experience has shaped PRC thinking about reform generally.[2] In both Taiwan and the PRC, recent developments with potentially far-reaching significance have taken place concerning securities markets. In Taiwan, long expected reforms in the securities regulatory system have been enacted,[3] while in the PRC, securities markets have been re-established for the first time under Communist rule.[4] Of particular interest to the

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1 See *e.g.*, references to the laws on Taiwan on securities regulation in Zhang Xue, *Zhengjuan zhishi shouce* (Handbook on Knowledge About Securities) (Beijing 1990) 496 *et seq.*

2 Indeed the latest reforms in the PRC aimed at building a 'socialist market economy' are reminiscent of the state-directed free economy policies of Taiwan: see *e.g.*, Jiang Zemin, 'Speed Up the Pace of Reform, Opening, and Modernization and Win Greater Victories in the Socialist Cause With Chinese Characteristics' (Final Report to 14th National Congress of the Communist Party of China, 12 October 1992) in *FBIS Daily Report-China Supplement* 21 October 1992, 1, 9 *et seq.*

3 In early 1988 Taiwan substantially amended its Securities and Exchange Law. As of this writing, a bill to amend this legislation is pending which will add new financial instruments to the market.

4 See generally Potter, P.B., 'Recent Developments in Securities Markets Regulation in China: Balancing State Regulation With Investor Confidence' (Fall, 1992) *The China Law Reporter*. The regulations for the Shanghai Securities Exchange are set forth in 'Shanghai zhengquan jiaoyi suo jiaoyi shichang yewu shixing guize' (Trial Regulations of the Shanghai Securities Exchange on the Activities of the Exchange Market) (26 November 1990) in Zhongwai Zhengquan Fa Gui Ziliao Huibian (Compilation of Materials on Chinese and Foreign Securities Law and Regulations (*'Compilation'*)) (Beijing 1993) 214; and 'Shanghai shi zhengquan jiaoyi guanli banfa' (Methods of Shanghai Municipality for administration of securities transactions) in *Jiefang ribao* (Liberation Daily) (Shanghai), 12 December 1990. An English translation appears as 'Shanghai Securities Transaction Regulations' in *FBIS Daily Report-China*, 20 December 1990, 46. The regulations for the Shenzhen exchange are contained in 'Shenzhen zhengquan jiaoyi suo zhangcheng' (Articles of Association for the Shenzhen Securities Exchange) in *Compilation* 160, and 'Shenzhen shi gupiao faxing yu jiaoyi guanli zanxing banfa' (Provisional Methods of Shenzhen Municipality for the Issue and Transferring of

world financial community are the ways in which these changes will affect foreign participation in the Taiwanese and PRC securities markets. This paper addresses these issues with particular attention to regulatory structures and operational issues.

2. *RECENT REFORMS IN TAIWAN SECURITIES REGULATIONS: THE EFFECTS ON FOREIGN PARTICIPATION*

For decades, the financial sector in Taiwan was heavily restricted, reflecting the government's conservative attitude and mistrust of private financial institutions. But as its financial market began to demonstrate both problems and potentials in the 1980s, the ROC government gradually redirected its financial policies toward internationalization and liberalization.

In 1982, the Executive *Yuan* (the cabinet) of the ROC resolved to permit the three-stage internationalization of Taiwan's securities market. The first step, which entails permitting foreign investors to invest indirectly in Taiwan's securities market through mutual funds sponsored by ROC mutual fund management companies, has been accomplished. Drafting of regulations to implement the second stage, giving foreign institutional investors access to direct investment in Taiwan's securities market, was begun in 1986, but was halted owing to concerns over the foreign exchange effects of the policy. The foreign exchange reserves of the ROC were already at a staggering level at that time. However, as discussed below, the second stage began again in earnest in 1991.

The third stage, which is yet to be accomplished, is the all-out internationalization and liberalization of the securities market. It is now well accepted in Taiwan.[5] However, one needs to examine the track record of financial reforms in the ROC and the present structure and activities of its securities market to contemplate the potential for successful completion of this process. Furthermore, a close analysis of the transformation of Taiwan's securities market since early 1988, as presented below, will provide necessary insight for assessing the future opportunity for foreign participation in the ROC securities market.

2.1 *Security Markets And Regulatory Framework*

Under the 'Land to the Tillers' program in the 1950s, the ROC government secured land from land owners for distribution to the tenant farmers; in return, the land owners received from the government its holdings in four major companies and land bonds.[6] The need to regulate trading activities became apparent after an

Shares), 15 May 1991, in *Compilation* 166. Also see 'Guanyu [Shenzhen shi gupiao faxing yu jiaoyi guanli zanxing banfa] he [Shenzhen zhengquan jiaoyi suo zhangcheng] de pifu' (Official Reply Concerning the Provisional Methods of Shenzhen Municipality for the Issue and Transferring of Shares and the Articles of Association for the Shenzhen Securities Exchange), Document Yin Fu [1991] No.154, 11 April 1991, addressed to the People's Bank of China Shenzhen Branch. Also see 'Shenzhen shi fa gui jin chutai' (Statutes and regulations of Shenzhen Municipality Are Tabled Today), *Wenhui bao* (Literary Daily) (Hong Kong), 15 May 1991.

[5] See Liu, L.S., 'Brave New World of Financial Reform in Taiwan, The Republic of China — Three Waves of Internationalization and Liberalization and Beyond' (1988-9) 8 *Chinese Yearbook of International Law And Affairs* 166-7.

[6] See Amsden, A., 'Taiwan's Economic History: A Case of *Etatisme* and a Challenge to Dependency Theory' in (1987) 5 *Modern China* 341.

amorphous and primitive over-the counter (OTC) securities market came into existence. Therefore, following the recommendation by the Task Force to Study the Establishment of a Securities Market, the Security and Exchange Commission (SEC) of the Ministry of Finance (MOF) was established in 1960. The Taiwan Stock Exchange (TSE), a corporation supervised by the SEC, was established in 1961, and in April 1968 the Securities and Exchange Law (SEL) was enacted. The framework for securities regulation in Taiwan was thus formally established. The SEL provides for a comprehensive regulatory framework patterned much after the American securities laws, but requires merit review for new issues and follows a paternalistic regulatory approach.[7]

Before the 1988 SEL amendment, 'securities firms' as defined under the SEL were classified into underwriters, brokers, and dealers. A securities firm engaging in any one of these businesses generally could not engage in other lines of securities business. One exception, which has continued, was financial institutions which could, for example, engage in the underwriting business if they were constituted as a trust company or the trust or savings department of a bank. They could also choose to engage in either the dealer business or the brokerage business. Up to 1988, the SEC had licensed only twenty-two underwriters (only five or six of them being active), ten dealers and twenty-eight brokers (fourteen of which were private companies and the other fourteen of which were the trust or savings departments of government-owned financial institutions).[8]

There had been a moratorium on issuing securities licenses for many years. In fact, until the mid-1980s the securities business in Taiwan was not profitable. With a small number of listed companies and inadequate depth in the market, many securities houses had folded. Prior to the 1988 SEL amendment, the government did not consider permitting foreign ownership in securities firms either.[9] The SEC regulates brokerage commissions pursuant to Article 85 of the SEL, and has set the rate at 0.1425 percent of the transfer price of equity securities. Commission rebates are nevertheless frequent, reflecting keen competition. Furthermore, after the Fair Trade Law (FTL) came into effect in February 1992, the rigid rate structure for brokerage commissions in Taiwan has come under legal, populist and competitive pressures for change to a flexible commission system.

The entire mutual fund industry was created by stage one of the three-stage plan. Four mutual fund management companies, all of which are international joint ventures licensed by the SEC as securities investment trust enterprises (SITE), were authorized to establish mutual funds based upon securities investment trust contracts between themselves, the custodian banks and the beneficial owners of units in the funds. In 1992 the SEC allowed eleven more such companies to be set up. The total foreign ownership in each SITE company is restricted

[7] See *e.g.*, SEL articles 20 (anti-fraud), 22 (registration requirement), 30 (statutory prospectus), 31 (prospectus delivery requirement), 32 (prospectus accuracy requirement), 155 (prohibition of wash sales and other market manipulations), 157 (short swing profit disgorgement) and 157-1 (insider trading sanctions).

[8] Such statistics were cumulative. Several different lines of the securities businesses could be engaged in by the same entity. See SEC, *1986 Annual Report* (1987) 17.

[9] The only 'exception' at that time was Citibank, which had a 40 percent holding in Taiwan First

to no more than 49 percent.[10] It is amazing that this trust arrangement was accomplished under a framework covered only by a single statutory provision, article 18-1 of the SEL. Since Taiwan does not have a comprehensive trust law, the detailed regulations were drafted by the SEC from scratch. Each of the four original SITE companies now sponsors a 'foreign fund' (that is, country fund) traded abroad, as well as other funds.

Despite the participation of new institutional investors such as the funds, the TSE is still overwhelmingly dominated by individual investors, whose herd mentality partially explains the volatility of the market. Unlike in other markets, pension funds rarely invest in the Taiwan securities market because of the Basic Labor Standards Law and conservative government policies on the safety of such funds. There are changes in the wind. In January 1993 the Offshore Futures Trading Act came into effect. The SEC is also studying proposals to create a domestic futures trading market.

There are about three dozen SEC-licensed Securities Investment Consulting Enterprises (SICE companies). The ROC government has always permitted complete foreign ownership in such SICE companies. However, this business was unprofitable until the SEC promulgated the Guidelines Governing the Operations of Securities Investment Consulting Enterprises in Providing Foreign Securities-Related Advice (Foreign Securities Advice Regulations) in late 1987 to permit SICE companies to advise on foreign securities, particularly foreign mutual funds under certain circumstances.[11] In fact, such permission amounts to permitting such SICE companies to promote and distribute foreign securities although they still may not handle discretionary investments for their clients. However, a strong lobby by the association of SICE companies for such authorization has resulted in its inclusion in the SEL amendment bill of 1992.

Today the public securities market in Taiwan can be divided into the Taiwan Stock Exchange (TSE) and the OTC trading system of the Taipei Securities Firms Association. The TSE is the most active market while there is also a small OTC debt market and an emerging OTC market for equities.[12] At the end of 1991 there were 221 companies with securities listed on the TSE.[13] The growth of trading in the securities market, particularly between 1986 and 1989, whet the appetite of unlisted companies to come to the market and reduce long-term borrowing from banks. However, initial and subsequent public offerings are subject to the 'merit review' of the TSE and SEC.[14] The SEC has also exercised indirect regulation over the price of offerings by stipulating that they be priced pursuant to its formula.[15]

Investment Trust Co. Ltd., a local trust company authorized to engage in securities business under art.101 of the Banking Law and art.45 of the SEL.

[10] Rules for the Administration of Securities Investment Trust Enterprises, art.4. Actual foreign holdings are smaller, reflecting the SEC's discouragement when the SITE enterprises were formed and the subsequent sale of some of these holdings to recognize returns on original investment.

[11] There are requirements on the rating, listing, size, and track record of the fund or fund management companies. Foreign Securities Advice Regulation Articles 2, 3, 4, 6, and 7.

[12] At the end of 1991, there were 9 companies whose shares were quoted under this OTC system.

[13] At the end of 1991, there were in fact a total of 234 securities listed on the TSE.

[14] This review process is sequential (that is, the SEC will review the results of the prior review by the TSE), instead of concurrent.

[15] Public offerings in Taiwan therefore are on a best-efforts basis.

2.2 *Exchange Control Liberalization*

The internationalization of a security market requires free movement of funds and capital. However, since the inception of its economic development, Taiwan was required to practice rigid foreign exchange control under the Statute for the Administration of Foreign Exchange (SAFE)[16] due to concerns over the possibility of capital flight and the need to meet international payment obligations. But after the early 1970s it was evident that foreign exchange control had to be relaxed because of Taiwan's substantial trade surplus, the accumulation of foreign exchange reserves, and the expectation of the New Taiwan (NT) Dollar's appreciation.

The ROC government responded in 1987 by liberalizing foreign exchange control. Specifically, its Legislative *Yuan* (the Parliament) added Article 26–1 to the SAFE, authorizing the Executive *Yuan* to suspend the application of core provisions of the SAFE in whole or in part under certain circumstances.[17] The CBC then suspended these core provisions and adopted eight regulations to replace the previous regulatory framework. The most important regulations are the Regulations for Non-governmental Inward Remittance (Inward Regulations) and the Regulations for Non-governmental Outward Remittance (Outward Regulations). They essentially permit movement of trade payments, but retain control over capital flows.

Under the Inward Regulations, as amended, any resident adult individual now may accept remittances of up to $US5 million each year for conversion into NT dollars. However, inward remittance for the repatriation of capital and profits of an offshore investment or for a foreign investor's investment in Taiwan has to be approved by the CBC.[18] Under the Outward Regulations, Taiwan entities and residents may make outward remittances in foreign exchange up to $US5 million per year, except that each outward remittance exceeding $US1 million is subject to a ten-day waiting period. Inward and outward remittances exceeding these limits on movement of capital not related to international trade transactions require a special approval by the CBC.[19]

In order to prevent the influx of hot money in pursuit of arbitrage gains as a result of financial liberalization, the ROC government has implemented a containment policy for regulating capital inflows, restricting the ability of foreigners to make portfolio investment in Taiwan. To this end, the SEC instructed the TSE and Taiwan securities firms not to permit foreigners to open brokerage accounts except for the purpose of selling their holdings. Similarly, the MOF directed ROC financial institutions not to take NT dollar deposits from non-resident aliens or foreign corporations.

However, this containment policy has not worked very well. Hot monies are believed to have come freely into Taiwan's financial system nonetheless, making

[16] Under SAFE, foreign exchange earnings resulting from exports of goods and services generally had to be sold to the Central Bank of China (CBC) or 'appointed banks', that is, banks authorized by the CBC to engage in foreign exchange business.

[17] See Liu, L.S., 'Republic of China's Deregulation of Foreign Exchange Control' (1986-7) 6 *Chinese Yearbook of International Law and Affairs* 298.

[18] Inward Regulations art.4. This quota has been increased several times from the original amount of $US50,000.

[19] Outward Regulations art.5.

waves in the securities market;[20] and with the initiation of the second stage of the plan to open Taiwan's securities market in 1991, this policy was to an extent relaxed after the CBC agreed with the SEC that qualified foreign institutional investors (FII's) could make portfolio investments in TSE-listed companies under certain conditions.[21] However, to prevent concentration of foreign ownership, investment ceilings have been set.[22]

Lest there be excess liquidity, the CBC has allowed an aggregate quota of $US2.5 billion, with each FII generally entitled to a quota ranging from $US5 million to $US50 million. Moreover, the new plan is not an invitation to all FIIs. Generally, only three types of foreign institutions — banks,[23] insurance companies[24] and fund management companies[25] — are qualified.[26] Each such investor must meet size and ranking standards specified by the SEC. To control capital flows, there are also 'lock up' requirements on remitting the investment principal, dividend and capital gains.[27]

Despite such restrictions, there has been a favorable response to this program.[28] However, the restrictions have made Taiwan's FII program less competitive internationally, especially in view of the fiduciary mandate of international investors that their fund managers maintain liquidity, convertibility and flexibility. In late 1991 the CBC indicated that it would impose a temporary moratorium in the FII program as part of its exchange rate policy but retreated from this stance after an international outcry against it. This incident not only bruised the reputation of the CBC, but also revealed the vagaries in the market-opening programs in Taiwan.

2.3 *Securities Market Reforms*

The 1988 SEL amendment and ensuing regulatory changes have transformed Taiwan's securities market. They sought to modernize the structure of Taiwan's securities industry and intensify market regulation.[29] They also permitted foreign securities firms to have limited access to Taiwan's securities market, and for the

[20] See Hsu, P.S.P. and Liu, L.S., 'The Transformation of the Securities Market in Taiwan, the Republic of China' (1988) 27 *Columbia Journal of Transnational Law* 169, 179-80.

[21] They could also invest in listed closed-end funds, government bonds, bank debt instruments, corporate bonds and other securities approved by the SEC.

[22] The aggregate FII investment in a listed company is ten percent, and each FII's investment in a listed company may not exceed five percent.

[23] Foreign banks (not including investment banks) must rank among the largest 500 banking institutions in the free world, measured by total assets. They must also have securities holdings with a total value of $US500 million.

[24] Qualified foreign insurance companies must have been in the insurance business for ten years. They must have securities holdings with a total value of $US500 million.

[25] Qualified foreign fund management companies must have established for more than five years, and the total assets managed must exceed $US500 million.

[26] When this program began, the SEC indicated that it could permit other institutional investors (such as foreign pension funds) to apply. However, none has done so.

[27] The original capital has to be remitted into Taiwan within six months of the approval, and may not be remitted out of Taiwan within three months after the initial inward remittance. Capital gains and dividend income may be remitted out of Taiwan only after the end of the FII's accounting year.

[28] Investors such as Jardine Fleming, Nippon Life, G.T. Management, S.G. Warburg, Thornton, Citicorp, Morgan Stanley, Barclays and Barings have applied for a total of $US850 million by the end of 1991.

[29] See Hsu and Liu, *op.cit.* n.20, 169.

first time created integrated securities houses (ISH), that is, securities intermediaries that can hold the underwriter, broker and dealer licenses all at the same time.

Following the 1988 SEL amendment, the Criteria for the Establishment of Securities Firms (Establishment Criteria) were adopted quickly, and the SEC began accepting applications.[30] The result was a Taiwanese version of the 'Big Bang'; the number of brokerage firms in Taiwan has increased to over 300, with about 40 ISH operations. The securities market cannot sustain so many intermediaries: a quiet shake-out has begun since the market underwent a down turn in 1990.

Access to this new market was provided to foreign securities firms in three ways. First, any foreign investor may invest in a securities operation entering a joint venture with Taiwanese investors. Second, foreign securities firms may set up a branch operation. Third, foreign banks' Taiwan branches may set up a securities operation, which the 1989 Banking Law amendment has now made more feasible. Thus far, however, no such foreign bank branch has been licensed. The SEC has discretion to limit the number and business scope of foreign securities firms setting up a branch operation or foreign banks' Taiwan branches setting up a securities operation. Foreign securities firms must meet certain requirements in order to set up a Taiwan branch and, once set up, they will be subject to the same requirements as Taiwan securities firms, except that they have to choose to engage in only certain securities operations.

Foreign nationals may invest in a securities company to engage in securities operation, but a prior approval of the SEC is also required. Such investment also has to undergo the review process pursuant to the Statute for Investment by Foreign Nationals (1954) ('SIFN'). However, the total amount of foreign ownership in a securities business entity may not exceed 40 percent of its paid-up capital, and each foreign investor may only invest in not more than 10 percent of the total paid-up capital of the entity.[31] Moreover, once a foreign investor invests in a securities entity, it may not invest in any other securities entity.

In June 1989 the SEC issued Regulations for Foreign Securities Firms Establishing Brokerage Branches (Brokerage Branch Regulations) to permit foreign securities firms to set up a Taiwanese brokerage branch. A condition of such permission is that the home country of these foreign securities firms grant reciprocity. Initially only three foreign securities firms were to be permitted to set up such a branch, with the number in future to be subject to the conditions of Taiwan's economy and its financial and securities markets. The paid-up capital of such foreign securities firms must exceed $US2 billion, and their total asset value must exceed $US20 billion. The foreign securities firm or one of its subsidiaries must be a member of the New York Stock Exchange, Tokyo Stock Exchange and the London Stock Exchange. In addition, it must have information transmission facilities linking it with these three stock exchanges.[32] Thus far, only Merrill Lynch and Shearson Lehman have each set up such a branch.

30 The minimum paid-up capital for the underwriting, dealing, and brokerage operations is $NT400 million, $NT400 million, and $NT200 million, respectively. Therefore, an ISH operation will require a total paid-up capital of $NT1 billion: Establishment Criteria Articles 3, 7.

31 Establishment Criteria Articles 36, 37.

32 Brokerage Branch Regulations Article 3.

2.4 *Mutual Funds Market Liberalization*

Another pilot program in the early 1980s that became an oligopoly over time, the mutual fund business, has come under pressure for market liberalization. In early 1991, the SEC announced a plan to permit more SITE companies to be set up. By the first annual deadline of 2 March 1992, fourteen groups had already applied to the SEC, and eleven groups now have received approval to proceed with the incorporation of SITE companies.[33] Adopting the foreign shareholder requirements of the four existing SITE companies, at least one fourth of the shareholders in the new SITE companies must be eligible foreign banks or international fund management institutions.[34] In addition, the SEC requires that each new SITE company complete a domestic offering of $NT4 billion to 5 billion for capital market investment within three months after their licenses are granted. This is a path-breaking experiment in which not only is the status of qualifying shareholders specifically set forth, but the new companies are to forfeit their licenses if they cannot meet the initial performance target of the SEC.

This is a bold — and bald — attempt to kill several birds with one stone. First, the 'shot gun marriage' requirement that foreign institutions participate is intended in part to prevent violations of regulations by otherwise purely local firms. Foreign institutions meeting the SEC requirements are all regulated abroad and presumably will protect their reputation jealously, thereby reducing the oversight burden. Second, foreign institutions will not enjoy majority control, reducing the concern with foreign domination. Third, part of the *quid pro quo* for foreign institutions seeking to access the market is a contractual commitment to transfer technology in fund management. Fourth, assuming that no industrial groups will lightly apply unless they can launch the first fund as mandated by the SEC, the new SITE companies should siphon off some excess liquidity in the financial system, and create tremendous buying pressure on the TSE.[35]

2.5 *'New' Instruments And Market Stability*

To enhance market stability and growth, Taiwan's SEC has to be receptive to developing 'new' securities and other instruments. A case in point is the convertible bond, a new arrival in Taiwan's market. The SEC first adopted regulations on convertible bonds in 1983, but no convertible bond could be issued at the time because of practical difficulties arising from Company Law rigidity and share listing. It was not until 1988 that Yuen Foong Yu Paper Mfg Co. (YFY) issued domestic exchangeable bonds, that is, bonds that could be exchanged into the shares of another listed company held by YFY to retire the repayment obligations. In late 1989, YFY floated the first Eurobonds by a Taiwan company for a total face amount of $US100 million at the coupon rate of two percent per annum for funding plant facilities to be identified outside Taiwan.

The YFY Eurobonds were able to fetch a low coupon rate because the market

33 The minimum paid-up capital was increased from $NT100 million to $NT300 million.

34 Eligible foreign banks must have assets ranking among the top 150 banks in the free world. International fund management institutions must have $US10 billion under management by them or their affiliates, of which $US5 billion must be represented by securities.

35 See Liu, L.S., 'The Republic of China's Aspirations to Become A Regional Financial Center: A Legal and Policy Analysis' in *Conference on Law and Practice in International Banking* (1992) 23.

in Taiwan has been quite restrictive to foreign investors. An undertaking to convert such bonds into equities 'when and if' permitted by the government of the ROC, backed up by a put option to bond holders to cash them out after a lock-up period provided the extra attraction for investors. Five other Taiwan companies raised funds through Eurobonds in 1991,[36] but they were not able to catch the favorable market window and received more scrutiny by the SEC and other government agencies, the equity conversion and foreign exchange conversion being the key issues.

This use of convertible Eurobonds merits continued examination because it will increase the globalization of the TSE as foreign portfolio investors convert to become shareholders of TSE-listed companies. Furthermore, foreign participation in syndicating these bond offerings seems to be permitted. Although some local securities firms participated in the syndicate, the lead underwriters were all foreign securities institutions not technically authorized to engage in securities business in Taiwan.[37]

Another 'new' instrument that gained recent popularity in Taiwan is the global depositary receipt (GDR). The GDR is a means by which foreign investors can invest in public listed securities. Usually, the shares of the publicly listed company are held by a custodian, which then issues depository receipts which can be traded outside the country in which securities of the publicly listed company are traded. One example of the GDR is the American Depository Receipt (ADR), by which US investors can indirectly trade the shares of companies listed on foreign exchanges if the companies involved sponsor the issuance of ADRs in the US by a custodian.

The SEC promulgated regulations governing the issuance of GDRs in April 1992. The first beneficiary in this program was the state-owned China Steel Corporation (CSC), which has been designated by the ROC government as among the first batch of state-owned companies to be privatized through secondary offerings.[38] CSC's principal shareholders — the ROC government and affiliates — placed 150 million shares of its common stock through a Rule 144A offering in the United States for future trading under the PORTAL system of the National Association of Securities Dealers in the United States, and another 210 million shares through the GDRs for trading through the SEAQ International system of the London Stock Exchange.[39] Over $US330 million was fetched for this offering.

[36] These are: Acer Inc. (a computer company), Tung Ho Steel, Microtech (a computer and scanner company), Far Eastern Textiles, and Pacific Cable and Wire.

[37] The SEC does not seem to be bothered that underwriting for Taiwan companies and maintaining frequent contacts with these companies in Taiwan could constitute engagement in securities business in Taiwan. Although Bankers Trust originated the Eurobond concept for YFY, which was at the time a partner with Bankers Trust in an ISH in Taiwan, Nomura took on more lead underwriting business in following issues. Other international securities firms participating in these syndicates include Jardine Fleming, Barclays, Morgan Stanley, Barings, Dresdner Bank, Solomon Brothers, Gartmore-Banque Indosuez, S. G. Warburg, Yamaichi, Shearson Lehmen, Goldman Sachs, and Merrill Lynch.

[38] The Executive *Yuan* has determined that banks owned by the central and provincial governments will also be privatized.

[39] China Steel Corporation Preliminary Offering Circular dated 20 April 1992. PORTAL is an acronym for 'Private Offerings, Resales and Trading through Automated Linkages', which is a system for automated quotations for shares privately placed. This system is used by the U.S. National

Although the definition of 'privatization' is far from clear,[40] this program often requires placement of securities offshore because the selling pressure on the TSE generated by the size of the offering would otherwise reduce the proceeds of such privatization offerings substantially. However, this in turn raises foreign exchange issues. ROC Treasury restrictions would require the proceeds, estimated to be over $US900 million, to be converted into New Taiwan Dollars, whereas the CBC has resisted this proposal for fear of fuelling further appreciating pressure on the currency. Although such proceeds could remain in the US Dollar denomination and be expensed for future government procurement, neither the CBC nor the National Treasury Department is willing to bear the currency exchange risks of this.

The mirror image of the GDR, the Taiwan Depositary Receipt (TDR), has been proposed since 1988. This proposal entails placing securities of sponsoring foreign blue chip companies under custody and issuing TDRs in Taiwan which will be listed on the TSE. However, the same foreign exchange considerations have prevented the proposal from being implemented. If implemented, this would be a great leap forward for Taiwan, which until now has not permitted offshore companies to be listed on the TSE.[41]

2.6 *Prospects For Further Internationalization*

In an attempt to develop a more concrete plan for internationalization of the financial markets, the National Securities Conference (NSC), along with the National Financial Conference and National Insurance Conference, were convened in 1991.[42] The NSC was organized by the SEC, MOF and CBC. Their intention was to complete an overhaul of the deficiencies in Taiwan's securities market and to recommend measures for the future. Although the NSC focused on the long-term capital market, market opening — that is, liberalization and internationalization — was likewise the focus of that conference.

The Fourth Working Group of the NSC focused on internationalization issues concerning the primary market, secondary market, securities firms, and laws and regulations that require modifications to meet this need. Its findings under each of these headings are set out below.

2.6.1 *Promoting the Internationalization and Liberalization of the Market*

The Fourth Working Group first recommended that foreign public entities be permitted to issue securities in Taiwan, which has not been contemplated under

Association of Securities Dealers (NASD). SEAQ ('Stock Exchange Automated Quotations') is a comparable system used by the International Stock Exchange of London.

[40] Theoretically, privatization would minimize government ownership, at least to a point below fifty percent of the outstanding shares. However, politicians in the Provincial Council, the assembly for the Province of Taiwan, have shown adamant resistance to relinquishing majority control.

[41] The general sense of the practitioners also suggests that even a local company that has more offshore operations than in Taiwan could encounter difficulties in seeking initial public offerings on the TSE. It and the SEC have adopted an important, although unwritten, policy of not permitting holding companies to be listed.

[42] See *Proceedings of the National Securities Conference* (1991, Taipei) Vol. 2, 537-77. The discussion of the NSC that follows is taken from this document.

the securities laws and regulations. It also argued that the purchase of foreign securities specifically offered in Taiwan should not be subject to the annual quota of the Outward Remittance Regulations. In addition, it supported the much studied proposal of the SEC and TSE to permit foreign listed companies to come to Taiwan to sponsor the issuance of TDRs, although it cautioned that market forces should be permitted to work lest this new instrument lose its effectiveness as a means for Taiwan investors to invest abroad.

The Fourth Working Group argued that present laws and regulations are not clear on the treatment of private placements of foreign securities by non-resident persons, and recommended that such placements be permitted. Likewise, it argued that laws and regulations for Taiwan residents offering securities offshore should be liberalized. To this end, in connection with funds raised by ROC financial institutions for use offshore, it suggested that interest payments should not be subject to withholding taxes, even though such funds were raised in the name of the home office.

The Group also counseled the expeditious passage of regulations governing GDRs, and argued that the Company Law's pre-emptive subscription restrictions on the issuance of new shares be liberalized. It was argued that issuers should be permitted to remit foreign currency proceeds raised through the GDRs into the New Taiwan Dollar notwithstanding the annual quota under the Inward Remittance Regulations. In the same vein, a recommendation was made to permit Eurobonds issued by Taiwan companies to be converted into listed shares of the issuers, and for foreign currency proceeds raised through such issues to be converted into the local currency.

Concerning the trading market, this working group argued that the ten percent aggregate ownership limitation by qualified foreign institutional investors in each listed company be gradually increased. Similarly, foreign exchange forward contracts, futures and options should be permitted so that these institutional investors would be better able to hedge currency risks. Another related proposal called for permitting general foreign investors to place orders through brokerage firms in Taiwan, who could enter into agency relations with foreign brokerage firms, to invest in securities in Taiwan.

ROC securities firms should, it was argued, be permitted to employ experienced foreigners to assist their international business. Foreign securities firms should also be permitted to set up subsidiaries in Taiwan, and more foreign stock exchanges or public markets should be available to Taiwan investors.

Where foreign securities were bought through the Taipei branch of the two foreign securities brokerage firms, it was argued that ROC customers should be able to use foreign currency assets outside Taiwan for payment, rather than being required to use New Taiwan dollars for such purchases. Where the local currency is used for payment, the branches should be able to negotiate currency rates and, in addition, should be permitted to offer margin lending for such purchases.

The Fourth Working Group also recommended that listing and OTC regulations be amended to permit the listing and free trading of foreign securities in Taiwan. It recommended that the general price movement limitations for ROC securities be liberalized for trading in foreign securities so as to reduce arbitrage activities.

In the long term, foreign exchange controls should also be removed. Accordingly, the Group suggested that the TSE commence a program to seek gradual linkage with foreign stock exchanges and markets.

2.6.2 *Promoting the Internationalization and Liberalization of Securities Firms*

As noted previously, two foreign securities firms have so far set up branches in Taiwan. The Fourth Working Group recommended that criteria for setting up such branches be relaxed, and that the branches be granted more powers, along the lines of the powers of the ISHs. In addition, it counseled that these branches be permitted to engage in offshore transactions in ways permitted by the offshore markets so as to avoid dual, and sometimes conflicting, practices or requirements.

ROC securities firms are recommended to have their senior employees take examinations so as to qualify abroad. In addition, they should be encouraged to enter into technical co-operation with foreign securities firms or invest in them. Meanwhile, ROC securities firms should be encouraged to participate in offshore offerings by ROC companies and to hire foreign managers.

The Fourth Working Group argued that after the passage of the draft Foreign Futures Trading Law, foreign trading in both commodities futures and financial futures should be liberalized. Likewise, it argued that securities firms should be permitted to engage in such business.

2.6.3 *Overhaul of Laws and Regulations toward Internationalization and Liberalization*

The Fourth Working Group expressed the view that regulatory laws and regulations have become the road blocks to market liberalization and internationalization. For example, it argued that the mandatory shareholders' pre-emptive subscription right for the issuance of new shares under the Company Law has made it difficult for companies to structure new issues and price them. Similarly, provisions of the Company Law requiring the registration of paid-up capital has made it difficult to reserve shares for, say, future conversions or the exercise of warrants.

Yet another example is the inability of companies to buy back their shares to be held as treasury shares, except in extreme circumstances. Also, the requirement of parity of treatment — the same consideration having to be paid for shares enjoying the same rights and privileges — has made it difficult for issuers to offer employee incentive stock or warrants.

The Group also cautioned that the current requirements compelling companies to make public disclosures and diversify their shareholdings are too stringent. It suggested that, instead of relying only on the amount of the paid-up capital, the rules should be modified and, much like Section 12(g) of the American Securities Act of 1934, reliance should be placed on factors such as assets and the number of shareholders to determine whether companies should have public reporting obligations.

With respect to several regulations at present prohibiting securities firms from

hiring foreign nationals as employees, the Fourth Working Group suggested that this prohibition be removed, and that ambiguities in the legal treatment of foreign securities and private placement of foreign securities be clarified.

2.6.4 *Improvement of the Program Allowing Qualified Foreign Investment in Listed Securities*

The fourth working group commended the authorities on the qualified foreign institutional investment program that began in 1991. However, it argued that the qualifications of foreign institutions and custodians should be relaxed, the application process should be streamlined, and the three-month inward remittance deadline and the annual outward remittance requirements should be liberalized. In addition, qualified foreign institutional investors should be permitted to invest in instruments other than listed shares, such as bonds, and should be able to hedge risks through foreign exchange forward contracts, bond options and bond futures.

3. *FOREIGN ACCESS TO CHINA'S SECURITIES MARKETS*

The extent to which the Chinese securities markets will attract foreign capital requires first that policy decisions be made to permit and encourage foreign participation. The potential for foreign participation in China's securities markets has long been a matter of great interest,[43] although Chinese policy and regulation has been somewhat mixed. After lengthy delays, new regulations have been issued supporting foreign participation in the Shanghai and Shenzhen securities markets. The effect of these measures will depend on the policy background from which they have emerged.

3.1 *Policy Background*

In March, 1990, a work conference of the State Commission for Restructuring the Economy held that, in developing the shareholding system, the right to sell stock should be extended to foreign investors in China.[44] The Securities Exchange Executive Council, charged with legislative drafting and long term planning concerning China's securities policies, has been particularly eager to open the doors to foreign investment and hosted a conference on this question in late September 1991.[45] Others have been less supportive. In a speech to the Central Party School in May 1991, Li Peng indicated that foreign investment in Chinese securities markets might be permitted, but only on an experimental basis.[46] Later,

[43] For example, the first transfer of ownership of shares in a Sino-foreign joint venture was made in June, 1988. See 'Panyang gongsi gouru zhong fang gufen' (Panyang Company Acquires a Chinese Party's Shares), in *Da Gong Bao* (Great Public Daily) (Hong Kong), 29 June 1988.

[44] See statement dated 11 March 1990 of the State Commission on Restructuring the Economic System (*ti gai wei*), in *Shenzhen Zhengquan Shichang Nianbao 1990* (Annual Report on the Shenzhen Securities Market 1990) 220.

[45] Interview with officials of Securities Exchange Executive Council, Beijing, 31 August 1991. Interview notes on file with the author.

[46] Interview with highly placed legal specialist closely involved in the Shenzhen securities market. Interview notes on file with the author. For published reports on Li's speech, see 'Li Peng Discusses Economic Situation', Beijing *Xinhua* English Service, 29 May 1991, reprinted in *FBIS Daily Report-China*, 30 May 1991, 33-4; and 'Li Peng, Song Ping at Party School Discussion', Beijing *Xinhua* Domestic Service, 29 May 1991, in *FBIS Daily Report-China*, 31 May 1991, 13-4.

in his June speech to the Fourth Session of the Seventh National People's Congress, Li omitted mention of securities markets in his discussion of the need to better utilize foreign funds.[47] These remarks were consistent with Li's earlier expressions of caution concerning the original establishment of securities exchanges in China.[48]

The uneven approach to foreign participation was evident in Shanghai as well. The Shanghai securities market regulations did not expressly permit foreigners to act as issuers, purchasers or brokers of securities, and also failed to address directly such obstacles as foreign exchange restrictions which effectively prohibited issuance of stocks denominated in foreign currencies or distribution of foreign currency dividends. Officials at the Shanghai Stock Exchange (SSE) expressed the view that foreign participation should be restricted because it would distort the market, foreclose opportunities for Chinese investors, and be difficult to regulate generally.[49] And in contrast to the favourable coverage given in such national publications as Financial News to discussions of foreign participation at the 'International Symposium on the Development of the Securities Business in China' held in Beijing in early September 1991,[50] the Shanghai Securities Weekly offered no coverage of the conference's opening day.[51]

There were supportive voices, however. At the time of the opening of the Shanghai Exchange, Jing Shuping, Chair of the China Stock Exchange Research and Planning Office and also a permanent director of China International Trust and Investment Corporation (CITIC), indicated that foreign investment would be an important aspect of the developing securities market in China.[52] This view was shared by Shanghai Mayor Zhu Rongji and others at the time.[53] Regulations for Shanghai's Pudong development area permit foreign and joint venture financial institutions to trade in foreign currency securities.[54] Ultimately, the SSE and the

[47] See Li Peng, 'Report on the Outline of the Ten-year Programme and of the Eighth Five-Year Plan for National Economic and Social Development', *FBIS Daily Report-China*, 14 June 1991, 1, 14.

[48] See, *e.g.*, Li Peng, 'Continue to work for stable political economic and social development in China — report on the work of the government' in *Beijing Review*, 16-22 April 1990, Documents-I. In his 24 November 1991 visit to the SSE, Li expressed concern that the exchange continue to emphasize bonds over stocks, which Li indicated entailed risk and the potential for speculation. Li's conservative approach was evident in his calligraphic notation that 'the securities market should serve socialist economic construction'. See 'Zongli zai Shanghai zhengquan jiaoyisuo' (The Premier at the Shanghai Securities Market) in *Jingji ribao* (Economy Daily), 25 November 1991.

[49] Interview with official of Shanghai Securities Exchange, 3 September 1991. Notes on file with the author.

[50] See 'Zhongguo zhengquan shichang fazhan qianjing guangkuo' (The Prospects are Broad for Development of Chinese Securities Markets) in *Jinrong shibao* (Financial News) (Beijing), 2 September 1991.

[51] See 'Zhongguo zhengquan ye xiehui zai jing chengli' (The China Securities Business Association is Established in Beijing), in *Shanghai zhengquan* (Shanghai Securities Weekly), 2 September 1991. No mention is made elsewhere in the issue of the 'International Symposium'.

[52] See Zhou Jianmin, 'Economy Under the Shareholding System and Introduction of Foreign Capital — Interview with Jing Shuping, Board Chairman of the China Stock Exchange's Research and Planning Joint Office', Beijing *Zhongguo Xinwen She* (Chinese News Agency), 21 December 1990, translated in *FBIS Daily Report-China*, 27 December 1990, 52.

[53] See 'Securities bonfire ablaze', in *China Daily Business Weekly* (Beijing), 2 December 1990, 2, in which Liu Hongru, Vice Chair of the State Commission for Restructuring the Economy, indicated that the securities markets were 'another important alternative for luring foreign capital'. Also see comments at the opening of the Shanghai exchange made by Shanghai Mayor Zhu Rongji and Zhou Zhengqing, deputy governor of the People's Bank of China, supporting the role of securities markets as vehicles for foreign investment, in 'Zhu Rongji at Shanghai Securities Exchange Opening', Beijing *Xinhua* English Service, 19 December 1990, reprinted in *FBIS Daily Report-China*, 20 December 1990, 46.

[54] See 'Shanghai waizi jinrong jigou, zhongwai hezi jinrong jigou guanli banfa' (Methods for

People's Bank of China Shanghai Branch (PBOC/Shanghai) formally approved the issuance of so-called 'Class B' foreign currency shares in order to resolve the foreign exchange problem.[55] The first enterprise to issue 'Class B' stocks in Shanghai was the Shanghai Vacuum Electronic Device Corporation, which issued one million shares in convertible 'Class B' stock in November 1991,[56] after resolving a number of troubling questions over accounting standards and other matters that threatened to unhinge the deal.[57]

In contrast to the hesitancy evident in Shanghai, foreign participation in the Shenzhen securities market received policy and regulatory support early on. The 1986 Guangdong regulations on foreign enterprises specifically permit Sino-foreign joint stock companies to issue stock, and permit transactions in their shares.[58] At its first meeting, the Shenzhen Securities Market Leading Small Group expressly approved foreign investment in the Shenzhen market.[59] Moreover, the 1991 Shenzhen Stock Transaction Regulations defined stock so as to include Sino-foreign joint stock company issues, thus in principle permitting these securities to be traded on the Shenzhen exchange.[60] The Shenzhen Stock Transaction Regulations also made specific reference to foreign purchasers of securities, although their participation in the exchange remained subject to approval by PBOC.[61] Thus, in Shenzhen, the level of policy support for foreign participation was greater than in Shanghai, signalling perhaps Shenzhen's greater level of comfort with foreign investment generally.

administration of foreign owned and Sino-foreign jointly owned financial institutions in Shanghai), 10 September 1990, Article 21.5.

55 See *e.g.*, 'Wai bi guli qiye zhuanxing' (Enterprise transformation through foreign currency dividends), in *Wenhui bao* (Literary Daily) (Hong Kong), 23 February 1991. Also see 'Wai bi gupiao B gu ke shangshi' (B Share foreign currency stocks can be issued), in *Wenhui bao* (Literary Daily) (Hong Kong), 9 May 1991.

56 'Shanghai to Issue Special Stocks to Foreigners', Beijing *Xinhua* English Service, 22 November 1991, in *FBIS Daily Report-China*, 22 November 1991, 44.

57 See 'Timetable for Shanghai offer sparks dispute', in *South China Morning Post*, 27 October 1981.

58 See 'Guangdong sheng jingji tequ shewai gongsi tiaoli' (Regulations for Foreign Companies in the Special Economic Zones of Guangdong Province), 28 September 1986, in *Compilation*, *op. cit.* n.4, 250; Chapter Three, in Sun Yonghui, Zhang Shu, Wang Wei, and Li Feng (eds.), *Gupiao, zhengquan zhishi shouce* (Handbook of Knowledge on Stocks and Bonds) (Nanjing, Nanjing University Press, 1991) 219 *et seq.* The role of stocks and bonds as transferable securities instruments had earlier been approved for the Guangzhou Economic and Technology Development Zone. See 'Guangzhou jingji jichu kaifaqu zanxing tiaoli' (Provisional Regulations for the Guangzhou Economic and Technology Development Zone), 6 March 1985, Art.3, in *Zhongguo jingji tequ kaifaqu falu fa gui xuanbian* (Compilation of Laws and Statutes and Regulations in China's Special Economic Zones and Development Zones) (Beijing 1987) 8.

59 See 'Shenzhen shi zhengquan shichang lingdao xiaozu huiyi jiyao (xuan deng yi)' (Summary of minutes of meetings of the Leading Small Group of the Shenzhen Securities Market — selection one) in *Shenzhen Zhengquan Shichang Nianbao 1990* (Annual Report on the Shenzhen Securities Market 1990) 211.

60 See Provisional Methods of Shenzhen Munincipality for the Issue and Transfer of Shares ('Shenzhen Stock Transaction Regulations') Art.5 in *Compilation*, *op. cit.* n.4, 166.

61 See Shenzhen Stock Transaction Regulations Art.29 in *Compilation*, *op. cit.* n.4, 166. Although proposed revisions to these regulations would have specified that the approval must come from PBOC head office, the final text does not specify whether the central or provincial branches of PBOC have the authority to approve foreign purchasers participating in the exchange. See handwritten notations suggesting revisions to the Shenzhen Exchange Articles on Zhongguo renmin yinhang, 'Guanyu [Shenzhen shi gupiao faxing yu jiaoyi guanli zanxing banfa] he [Shenzhen zhengquan jiaoyi suo zhangcheng] de pifu' (Official Reply Concerning the Provisional Methods of Shenzhen Municipality for the Issue and Transferring of Shares and the Articles of Association for the Shenzhen Securities Exchange), Document Yin Fu [1991] No.154, 11 April 1991, addressed to PBOC Shenzhen Branch (copy on file with the author).

3.2 *Regulatory Framework*

As with most aspects of law in the PRC, regulatory provisions on foreign participation in the PRC securities markets follow closely the contours of policy. Once the decision had been made by PBOC to permit foreign involvement, regulatory provisions were enacted quickly thereafter. Both Shanghai and Shenzhen enacted regulations and implementing rules governing the 'Class B' shares.

3.2.1 *Shanghai*

In November, 1991, PBOC, PBOC/Shanghai and the Shanghai municipal government issued administrative measures and implementing rules for 'Class B' shares. The Shanghai Administrative Measures[62] comprise twenty six articles in five chapters, addressing general provisions, administration of issuance, administration of trading, administration of securities houses, and supplementary provisions. The Shanghai Implementing Rules[63] are much more detailed, comprising fifty-four articles in twenty chapters addressing a wider range of issues including conversion rates; exchange accounts; securities dealers inside and outside China; issues and trading; clearance procedures; and taxation, fees, and penalties. In addition, the Shanghai exchange issued in February 1992 a set of Supplementary Operating Rules governing transactions in 'Class B' shares.[64]

Under the Administrative Measures, 'Class B' shares are denominated in Renminbi but can yield dividends and profits that may be remitted abroad.[65] Investors in 'Class B' shares are limited to natural and legal persons from Hong Kong, Taiwan, and Macao; foreign natural and legal persons; and others with special approval.[66] Issuers of 'Class B' shares must be joint stock companies with specific government approval and demonstrated authority and capacity to engage in foreign exchange transactions.[67] In addition to the standard documentary requirements under the 'Measures for Administration of Securities Transactions in Shanghai Municipality',[68] companies seeking to issue 'Class B' shares must also submit to the approval authorities feasibility studies, plans for foreign exchange revenue, profit forecasts, and other supplementary documents.[69] The Administrative Measures reify the supervisory authority of PBOC, by requiring PBOC approval for all 'Class B' share issuances;[70] by requiring all 'Class B' Share transactions to be done at the Shanghai exchange through securities houses approved by PBOC;[71] and by requiring purchases of more than 5 percent of a company's total shares to be reported to PBOC.[72]

62 'Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares' ('Shanghai Administrative Measures') (22 November 1991) in *Compilation, op. cit.* n.4, 236.
63 'Detailed Implementing Rules for the Measures of Shanghai Municipality for the Administration of Special Renminbi-Denominated Shares' ('Shanghai Implementing Rules') (25 November 1991) in *Compilation, op. cit.* n.4 238.
64 'Supplementary Operating Rules for the Trading Market (Special Renminbi-Denominated Shares) of the Shanghai Securities Exchange' (18 February 1992).
65 Shanghai Administrative Measures Articles 2 and 5.
66 Shanghai Administrative Measures Art.14.
67 Shanghai Administrative Measures Articles 8 and 9.
68 'Shanghai shi zhengquan jiaoyi guanli banfa', *supra* n.4.
69 Shanghai Administrative Measures Art.10.
70 Shanghai Administrative Measures Art.7.
71 Shanghai Administrative Measures Articles 18 and 20.
72 Shanghai Administrative Measures Art.16.

While the Administrative Measures provide the general regulatory outlines for issuance and trading of 'Class B' shares, the Implementing Rules concern more specific issues. For example, conversion rates for share values, dividends and profits are specified in the Implementing Rules as set according to the average RMB:US Dollar exchange rate of the Shanghai Swap Market for the previous week.[73] The Implementing Rules also establish the mechanics by which 'Class B' shares are purchased and traded, and the mechanics for the foreign exchange conversion processes.[74] The Implementing Rules devote extensive attention to the regulation of securities houses within China, and their cooperative agents for sales of 'Class B' shares outside China, thus strengthening PBOC supervisory control over the establishment, approval and operation of these institutions.[75] The basic structure involves the registered and approved Chinese securities brokers selecting foreign securities agents to trade in 'Class B' shares abroad on behalf of the Chinese brokers. Foreign financial institutions which have not been selected to be agents for Chinese securities firms may apply independently for approval to act as sub-distributors of 'Class B' shares.[76]

The Implementing Rules also contain detailed provisions on the issue of securities that augment the provisions of the Administrative Measures, and build upon the distribution structure discussed above. Of critical interest are the procedures by which the foreign securities agents or sub-distributors remit the foreign exchange proceeds from the sale abroad of 'Class B' shares. Members of distribution syndicates must remit the whole of their foreign exchange proceeds into the PBOC account of the Chinese securities distributor within five days of the close of the period approved by PBOC/Shanghai for the distribution of shares, with interest charged on late payments at the London Inter-Bank Office Rate (LIBOR) plus 0.5 percent on the amount of foreign exchange deposited late for each day of delay.[77] The Chinese main distributor must then deposit the whole of the foreign exchange proceeds into the account for the issuing company within two days (i.e. seven days from the end of the period approved for distributions of shares), with the same LIBOR + 0.5 percent interest on late deposits. The Chinese main distributor must then report to PBOC within an additional three days.[78] This tight remittance and reporting schedule admits to little variation and is designed to ensure that the 'Class B' share system operates effectively as a source of foreign exchange.

The Implementing Rules also provide detailed rules on trading of 'Class B' shares and the final clearance and settling of accounts. As discussed above, trading is limited to approved Chinese securities houses and must be conducted at the exchange.[79] Earnest money may be required of the investor to fund the Securities House's purchase of 'Class B' shares on the investor's behalf,[80] or the investor

[73] Shanghai Implementing Rules Art.2.
[74] Shanghai Implementing Rules Chs 3 and 4.
[75] Shanghai Implementing Rules Chs 7, 8 and 9.
[76] Shanghai Implementing Rules Art.16.
[77] Shanghai Implementing Rules Art.22.
[78] Shanghai Implementing Rules Articles 23 and 24.
[79] Shanghai Implementing Rules Articles 27 and 30; *cf.* Shanghai Administrative Measures Articles 18 and 20.
[80] Shanghai Implementing Rules Articles 31 and 32.

may simply keep an account with the Securities House to fund purchases of 'Class B' shares.[81] Clearance of 'Class B' share transactions must be completed by the third business day following the date of the transaction.[82] The order of clearance is first between the Securities Houses and the Exchange, and then between the Securities Houses and agents and investors outside the PRC.[83] To ensure the clearance and settlement of 'Class B' accounts, members of the Exchange conducting business in 'Class B' shares must establish foreign exchange guarantee accounts at the Exchange, as well as risk funds at special 'clearing banks', which also hold the foreign exchange guaranty funds for foreign securities brokers and agents.[84] The 'clearing banks' must be located in Shanghai and licensed to handle foreign exchange business, be well known internationally and experienced in international clearance of securities, and be approved by PBOC.[85]

The Implementing Rules also address a variety of other issues, including fees (calculated in RMB but paid in US Dollars), taxation (*e.g.* dividends subject to withholding tax provisions of PRC Individual Income Tax Law and Income Tax Law on Foreign Invested Enterprises and Foreign Enterprises), governing law (law of China), arbitration (forum subject to PBOC approval) and penalties.

These regulations have great significance for foreign participation in the Shanghai exchange. Foreign businesses will have opportunities to participate as investors, while foreign invested enterprises in China will have the chance to raise capital through issuance of 'Class B' shares. Moreover, foreign securities brokers will have opportunities to act either as agents for Chinese brokers or as sub-distributors of 'Class B' shares. However, despite the support for foreign participation expressed through the Shanghai regulations, foreign access to Chinese securities markets will remain a sensitive issue, as evidenced by the fact that the reporting on Li Peng's visit to the Shanghai Exchange the day before the 'B Shares' regulations were enacted omitted reference to foreign investment.[86]

3.2.2 *Shenzhen*

In December 1991, PBOC, PBOC/Shenzhen and the Shenzhen municipal government issued Interim Procedures[87] and Implementing Rules[88] for the Shenzhen Securities Market. Despite the many differences between the Shanghai and Shenzhen regulations on matters related to market operations and transactions,[89] the

[81] Shanghai Implementing Rules Art.32.
[82] Shanghai Implementing Rules Art.34.
[83] Shanghai Implementing Rules Articles 35 and 37.
[84] Shanghai Impementing Rules Articles 36 and 38.
[85] Shanghai Implementing Regulations Art.40.
[86] See 'Zongli zai Shanghai zhengquan jiaoyisuo' (The Premier at the Shanghai Securities Market), in *Jingji ribao* (Economy Daily), 25 November 1991. This report indicated that in response to Li Peng's specific question as to the kinds of securities traded on the Shanghai Exchange, Director Li Yangrui replied only that there were thirty-nine issues — eight stocks and the rest bonds — with no mention whatever of the B Shares.
[87] 'Interim Procedures on Control of Shenzhen Special (B-Type) RMB Stocks' ('Shenzhen Interim Procedures') in *China Economic News* (Hong Kong), 27 January 1992; also *Compilation, op. cit.* n.4, 175.
[88] 'Rules for the Implementation of the Interim Procedures on Control of Shenzhen Special (B-Type) RMB Stocks' ('Shenzhen Implementing Rules') in *China Economic News* (Hong Kong), 3 February 1992; also in *Compilation, op. cit.* n.4, 178.
[89] See *e.g.*, Potter, P.B., 'The Legal Framework for Securities Markets in China: The Challenge of Maintaining State Control, and Inducing Investor Confidence' (1992) 7 *China Law Reporter* 61.

broad outline of the Shenzhen measures on 'Class B' shares is quite similar to those enacted for Shanghai. Like the Shanghai measures, the Shenzhen Interim Procedures permit legal and natural persons from Hong Kong, Taiwan and Macao, as well as foreign legal and natural persons, to invest in 'Class B' shares.[90] Like the Shanghai regulations, the Interim Procedures require issuers of 'Class B' shares to meet all of the standard requirements for issuance of securities,[91] and also to submit feasibility studies, plans for foreign exchange revenues, profit projections, and other financial reports in order to establish their capacity and authority to engage in foreign exchange transactions.[92] Also in keeping with the Shanghai regulations, Chinese securities firms may select foreign firms to act on their behalf in trading 'Class B' shares to foreign customers.[93] As in Shanghai, trading of 'Class B' shares may take place only between overseas investors.[94] Control by PBOC/Shenzhen over B share transactions in Shenzhen is maintained very much as is the regulatory authority of PBOC/Shanghai over B shares in Shanghai — through requirements that PBOC approve B share issuances;[95] that all 'Class B' share transactions be done at the Shenzhen exchange through securities houses approved by PBOC;[96] and that purchases of more than 5 percent of a company's total shares be reported to PBOC.[97]

Nonetheless, there are several important differences between the Shenzhen and Shanghai regulations relating to 'Class B' shares. First, the RMB:US Dollar conversion rates for share values of Shenzhen 'Class B' shares are set according to the daily rate at the Shenzhen Swap Centre,[98] whereas in Shanghai share values are set according to the weighted weekly average of the RMB:US Dollar swap rates from the previous week.[99] While the disparity is probably due to the greater levels of currency fluctuation in the Shenzhen Swap Centre, the use of a daily exchange rate in Shenzhen means that the converted share values will be more accurate than in Shanghai. Another difference between the Shenzhen and Shanghai rules involves subscription to stock issuances by overseas investors. Whereas the Shanghai regulations require all 'Class B' share transactions to take place through the intermediary of a registered Chinese securities dealer, the Shenzhen measures permit overseas investors to subscribe to newly issued stock either directly or through an intermediary.[100] This probably reflects the recognition in Shenzhen of the close relationship between the Shenzhen exchange and Hong

[90] Shenzhen Interim Procedures Art.2; *cf.* Shanghai Administrative Measures Art.14.

[91] These are set forth in the 'Shenzhen shi gupiao faxing yu jiaoyi guanli zanxing banfa' (Provisional Methods of Shenzhen Municipality for the Issue and Transferring of Shares) 15 May 1991.

[92] Compare Shenzhen Interim Procedures Articles 7-9, with Shanghai Administrative Measures Art.9.

[93] Compare Shenzhen Interim Procedures Art.15, with Shanghai Implementing Rules Articles 12-6.

[94] Shenzhen Interim Procedures Art.14; *cf.* Shanghai Administrative Measures Art.19.

[95] Compare Shenzhen Interim Procedures Art.6 with Shanghai Administrative Measures Art.7.

[96] Shenzhen Interim Procedures Articles 5, 9, and 16; *cf* Shanghai Administrative Measures Articles 18 and 20.

[97] Shenzhen Interim Procedures Art.20; *cf.* Shanghai Administrative Measures Art.16.

[98] Shenzhen Interim Procedures Art.21.

[99] Shanghai Implementing Rules Art.2. The Shanghai and Shenzhen provisions are alike on the conversion rates for dividends and profits — both are set according to the previous weekly average RMB:US Dollar rate. Compare Shenzhen Interim Procedures Art.23 with Shanghai Implementing Rules Art.2.

[100] Shenzhen Interim Procedures Art.12; *cf.* Shanghai Administration Measures Art.15.

Kong investors, who may be ready and able to subscribe to large blocks of stock without the use of intermediary services, and who might well be reluctant to involve intermediaries.

The Shenzhen regulations also appear less concerned with ensuring timely remittance of foreign exchange proceeds. None of the strict remittance deadlines set forth in the Shanghai regulations are evident in the Shenzhen measures.[101] This may be a function of different attitudes toward 'Class B' shares in Shenzhen and Shanghai — Shenzhen appears more willing to allow the interests of transacting parties and the requirements of the market to determine matters of remittance, while the Shanghai Exchange is more concerned with using 'Class B' shares as a vehicle for generating foreign exchange.[102] In yet another point of departure, the Shenzhen regulations on the use of approved clearing banks to handle the finances for B shares transactions are much less restrictive than those in Shanghai, and say little about required foreign exchange guarantee or risk accounts by securities dealers.[103] Moreover, the Shenzhen regulations specifically permit foreign owned banks to serve as clearing banks, while no such provision is contained in the Shanghai regulations.[104] Finally, in a potentially far-reaching development urged by Shenzhen, the State Council approved the Shenzhen Exchange adding foreign securities firms as members.[105]

Thus, the Shenzhen 'Class B' shares provisions contain several important departures from the Shanghai scheme, while staying broadly within the framework of the Shanghai regulations. While there is no formal requirement that the Shanghai and Shenzhen exchanges have identical regulations, the fact that both are subject to PBOC control means that they proceed from the same institutional and policy starting point. Thus the differences in final result suggest different levels of influence and different attitudes on the part of the local authorities — particularly the municipal governments. Whereas the Shanghai municipal government appears concerned that the activities of the Shanghai exchange be coordinated properly with the national economy, the Shenzhen regulators appear a bit more parochial and more attentive to issues of local performance.

By the end of 1991, both Shanghai and Shenzhen had in place a regulatory framework permitting foreign investment in the local securities exchanges. While significant hesitancy was evident in the initial Shanghai regulations and practices, these gradually gave way to a slightly more supportive position in keeping with the thrust of national policy. In Shenzhen, on the other hand, support for foreign

[101] Compare Shenzhen Implementing Rules Art.10, with Shanghai Implementing Rules Articles 22 and 23.

[102] Shanghai's perception that securities markets should be tied closely to national economic goals (such as foreign exchange generation) may have been summarized by Li Peng, when he visited the SSE in November 1991 and inscribed calligraphy stating that the exchange served socialist economic construction. See 'Zongli zai Shanghai zhengquan jiaoyisuo' (The Premier at the Shanghai Securities Market) *supra* n.48; also see 'Chinese Vice Premier Zhu Rongji Steps Up the Fight for Reform', in *South China Morning Post*, 26 March 1992, in which former Shanghai Mayor Zhu Rongji criticized the 'short-sighted' view taken in Shanghai toward the role of securities markets.

[103] Compare Shenzhen Implementing Rules Articles 16 and 20 *ff.* with Shanghai Implementing Rules Articles 36, 38, and 40 *ff.*

[104] Shenzhen Implementing Rules Art.16. Compare with Shanghai Implementing Rules Art.40.

[105] 'China Gives Shenzhen Stock Exchange More Power' in *China News Digest* (News Global — an electronic database) reprinted in a Reuter News Agency report, 10 April 1992.

participation was evident over a much longer period of time. While the Shenzhen 'Class B' regulations came out after those issued for Shanghai, Shenzhen was far ahead of Shanghai in basic policies and outlook. While the 'Class B' regulations in Shanghai and Shenzhen represent a conversion of basic approaches to the matter of foreign participation in Chinese securities markets, the differences in the regulations suggest that fundamental differences of interest and outlook remain. Additional regulations issued during 1992 and 1993 built upon but did not significantly alter this initial pattern. Even as additional regulations bring the Shenzhen and Shanghai exchanges within the purview of national regulations[106] with a view toward facilitating listing of Chinese companies on foreign exchanges,[107] regulatory and philosophical differences will continue to affect the content and application of regulations on foreign participation in the PRC's financial markets.

4. *Conclusion*

There are both striking similarities and dissimilarities between the securities regulation systems and foreign access of the two Chinas. To be sure, Taiwan's TSE and OTC markets are much more mature and sophisticated. On the other hand, mainland authorities have proven that they can be quick studies, too. One could even trace some similarity between the two systems that is based on a deliberate intention by mainland China to emulate island China. Certainly, the level of exchange and contact between related professionals of the securities industry in the two Chinas has increased rapidly.[108]

The emergence of securities markets in both Chinas reflects the same phenomenon: the transformation of the economy to one that is driven by market forces. Land reform is part of the rationale behind Taiwan's policy of market development. The privatization of state-owned enterprise is also part of the rationale behind the PRC's policy of market development. Similarity in this structural reform aside, one sees a bottom-up approach in Taiwan; in mainland China, the top-down approach still prevails in the manner in which policies are effected.

The two Chinese governments share the same mentality: paternalism, distrust of private financial institutions and reluctance to tolerate speculation, which is almost a necessary component in each mature market.

[106] See *e.g.*, Potter, P.B., 'Securities Regulation: A National System Begins to Emerge' (1993) 15(8) *East Asian Executive Reports* 9. Also see 'Interim Procedures on the Management of Stock Exchanges' (7 July 1993); *China Economic News* (Hong Kong), 9 August 1993; *China Economic News* (Hong Kong), 16 August 1993; and 'Proposals of Securities Committee of the State Council on Procedures of Issuing, Selling, and Subscribing Stocks for 1993' (18 August 1992), *China Economic News* (Hong Kong), 13 September 1993.

[107] Following enactment of the State Council's 'Interim Regulations on the Issue and Trading of Shares' and other national regulations in mid-1993, the Hong Kong Stock Exchange's Listing Rules were amended to permit Chinese domestic firms to list on the Hong Kong Stock Exchange. See 'New rules governing mainland listings in HK', *South China Morning Post*, 20 June 1993, Money 9. The Qingdao Brewery became the first Chinese entity to list on the Hong Kong stock market.

[108] For example, in 1993 alone two major cooperative conferences were held that brought these groups together. These were (1) 'The First Symposium on Securities and Futures Regulations in China and Taiwan', held in Taipei, 21-23 June 1993 and sponsored by Fujen Catholic University, Masterlink Securities, and the Commercial Daily News; and (2) the 'Regional Conference on the Development and Interactions of Futures, Options, Warrants and Stock Markets in Hong Kong, the Chinese Mainland and Taiwan', held in Hong Kong 30-31 August 1993 and sponsored by Hong Kong University of Science and Technology, National Sun Yat-sen University (Taiwan), and the Stock Exchange of Hong Kong Ltd.

There are both conservative and liberal camps in the two financial regulatory bureaucracies. In both cases, foreign exchange control is a very important tool for channeling portfolio investment. Despite the fact that relative foreign exchange holdings are disparate in the two Chinas, regulators in both countries would create special programs, such as B shares and the FII program, to control the inflow and outflow of portfolio foreign securities investment.

Article 1 of Taiwan's SEL sets forth its legislative goals: to promote national economic development and protect investors. One could argue that Taiwan, having the more mature market, has tended to be more interested in investor protection. On the other hand, the desire to chase after funds to finance various projects leads one to argue that, in the PRC, the emphasis is more tilted toward economic development.

The vast differences between the two economies also inform different approaches to market liberalization programs. In Taiwan, there is not much margin for error because, psychologically if not physically, it has a smaller business community and regulatory system. On the other hand, mainland China can afford to experiment at selected localities such as Shanghai and Shanzhen.

There is a greater variety of financial institutions and services in Taiwan: SITE, SICE, GDRs, convertible securities, and so on. While this demonstrates the relative maturity of the capital market in island China, mainland China can be sophisticated enough to play world class financial games, too. In early October 1992, the Brilliance China Automotive Holdings offering on the New York Stock Exchange was overwhelmingly successful, being 40 times oversubscribed. It is a tax-haven holding company owned in part by the People's Bank of China and the Shen Yang city government in China, and it in turn owns a large, state-run automotive and automobile plant.

Indeed, closer financial integration of the mainland, island and colonial Chinas is rapidly emerging. Nine state-run enterprises in China are planning to seek listing on the Stock Exchange of Hong Kong. Taiwan investment in mainland China, estimated to be $US3.5 billion but perhaps much more, provides the necessary link from economic integration to financial integration. Despite political risks and uncertainties in both Chinas, listed companies in Taiwan having sizeable investment in mainland China may wish to float shares there or in Hong Kong. With the reversion of Hong Kong to Beijing in mid-1997, the profile of its listed companies could be quite different.

If financial integration is a corollary of economic integration, then the securities laws of the two Chinas will come into closer contact. There could be both efforts toward harmonization and inevitable clashes of the two regulatory regimes. The potential down-side from such clashes is very great. Therefore this is what the cross channel regulators should try to prevent in the years ahead.