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SECURITIES REGULATIONS IN CHINA AND THEIR CORPORATE FINANCE IMPLICATIONS ON STATE ENTERPRISE REFORM

K. Matthew Wong*

INTRODUCTION

When the Communist Party took control in China in 1949, it decided to implement a centrally controlled economic system. Under this system, the government abolished free markets and nationalized most private companies into state enterprises. Further, annual production targets were set by planning committees in various levels of the government. Chinese Marxists theorized that a planned economy would better maximize productivity and efficiency because it would avoid economic fluctuations such as unemployment and depressions that frequently occur in a free market economy.\(^1\) In practice, however, this planned economic system proved all but unmanageable because there was no incentive to pursue operational efficiency. Field managers in the system were not held accountable for any profit or loss of their businesses. As a result, the industrial sector generated massive waste and losses.\(^2\) To correct this trend, China embarked on its latest reform movement in the late 1970s and the economy has since been remarkably transformed.

As a result of its reform program which began with the promulgation of the joint venture law in 1979,\(^3\) China has been very successful in attracting foreign investment. China now ranks second only to the United States in terms of foreign direct investment inflows.\(^4\) From

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2. Id.; see also David Eu, Note, Financial Reforms and Corporate Governance in China, 34 Colum. J. Transnat'l L. 469, 470 (1996) ("These inefficient state enterprises are the result of decades of central planning, during which they faced distorted incentives and few, if any, financial constraints.") (footnote omitted); infra part I (discussing the condition of the state sector).
3. Law of the PRC on Sino-Foreign Joint Equity Enterprises, as amended, China L. Foreign Bus. (CCH) ¶ 6-500 (1979). This was the first commercial law enacted as part of China's modern economic reform program.
4. Richard Brecher, Considering the Options, China Bus. Rev., May-June 1995, at 10, 10. In general, there are three types of foreign-invested enterprises ("FIE"s), the equity joint ventures ("EJV"s), contractual joint ventures ("CJV"s), and wholly foreign owned enterprises. The difference between EJVs and CJVs is that whereas partners in EJVs are entitled to the profits according to their respective proportion of capital contributions, in a CJV the partners would simply stipulate their profit shares regardless of their actual capital contributions. Approximately SUS34 billion in foreign capital were injected into investment projects in 1993 alone. Id. By June 1994, China had more than 200,000 foreign-invested enterprises and over 24,000 foreign representative offices. Id. at 10-11; see also Vivienne Bath, Introducing the "Limited
1983 to 1989, foreign direct investment in China grew at an annual rate of 34%. This growth rate accelerated to 60% per year from 1989 to 1993. Between 1979 and 1993, China had a real economic growth rate of 9% per year, making it the fastest growing economy in the world during the period.

The rapid pace of China's economic reforms and general economic growth requires the development of a modern financial market to facilitate the efficient exchange of economic resources. In addition to accelerating the development of the credit markets, China experimented with the creation of equity stocks and a public stock market. Beginning in 1986, China allowed limited stock trading in the Over-the-Counter markets in selected cities. In 1990, the first national stock exchange was established in Shanghai ("Shanghai Stock Exchange"). Six months later in 1991, a second national exchange was created in Shenzhen ("Shenzhen Stock Exchange"), a city in southern China. Each of these two national exchanges are regulated by slightly different sets of local regulations that reflect both local conditions and the central government's desire to explore the effects of various securities regulations.

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6. Id.
11. Id.
12. See infra part III (discussing China's securities regulatory regime including the local regulations).
With the enactment of the provisional National Securities Law\(^\text{13}\) in 1993 and the Company Law\(^\text{14}\) in 1994, a preliminary model of China’s securities regulatory regime has emerged. To gain acceptance within the current political environment, however, this regime has incorporated significant socialist characteristics which distort the normal functions of a financial market.\(^\text{15}\) As discussed below, the current regulatory scheme will likely prevent China from achieving its goal of using the equity market to rejuvenate its ailing state industrial sector. The partial free market system that exists today in China simply does not allow the efficient allocation of scarce economic resources.\(^\text{16}\)

China’s economic reforms of the last decade, meanwhile, have also changed the fundamental characteristics of domestic enterprises. In 1980, at the beginning of the modern reform movement, the state sector—as represented by state enterprises—accounted for 76% of the gross industrial output in China.\(^\text{17}\) By 1991, this figure had fallen to 53%.\(^\text{18}\) The state sector today produces less than half of the industrial output in China.\(^\text{19}\) Within the next few years, the state sector’s output share is expected to decline significantly further.\(^\text{20}\) Notwithstanding their declining share of industrial output, state enterprises as a whole

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13. Provisional Regulations on the Administration of the Issuing and Trading of Stocks, China L. Foreign Bus. (CCH) § 13-574 (1993) [hereinafter National Securities Law]. These regulations were approved by the State Council, the highest administrative government body in China, on April 22, 1993. \(\text{Id.}\) These provisional regulations supersede local municipal laws governing securities trading, unless similar local rules are more stringent. Many of the local regulatory laws in Shanghai and Shenzhen are still in effect; in areas where the National Securities Law does not address, the local laws are the primary law.

Meanwhile, China has been working on the comprehensive National Securities Regulations legislation for a number of years. The promulgation of this legislation has been postponed numerous times for undisclosed reasons. \(\text{See}\ Kevin Murphy, Lacking Rules, China Plays Difficult Market Game, Int’l Herald Trib., May 28, 1996, available in LEXIS, Nexis Library, Current News File (noting that “those involved in the drafting process [of the National Securities Regulations] say they cannot even predict when the work might be done”). Presumably, the final legislation would incorporate most of the provisional regulations and regional practices.


15. \(\text{See infra}\) parts III, IV (discussing the securities regulatory regime and its impacts on the pricing of stocks).

16. One alternative to this economic dilemma is to return to the socialist central planning system and simply overhaul the planning process. However, such an alternative would directly contradict the major goal of China’s modern reform movement—breaking away from a rigidly planned economy.

17. Aim{en Chen, Chinese Industrial Structure in Transition: The Emergence of Stock-Offering Firms, 26 Comp. Econ. Stud. 1, 9 (Winter 1994).}

18. \(\text{Id.}\)


20. Breaking the Taboo, Euromoney, Feb. 1996, at 80, 80 (remarking that “China’s state statistical bureau expects the state’s [industrial production] share to shrink to 25% by the end of the century”).
are still critical to China, given that they are the largest employer in the country. In 1993, this sector employed 75% of China’s urban labor force. Therefore, any state sector reform will have a significant impact on the national economy and perhaps social stability.

Viewed broadly, China’s reform movement is a direct response to the gross inefficiency that prevailed within the planned economy. In many ways, China’s current problems with its state sector are similar to those encountered in Russia and Eastern Europe. Years of directives from static state planning and a complete lack of competition have led to bloated bureaucratic management structures and obsolete manufacturing facilities. At the same time, sagging demand for the state sector’s inferior products further aggravates these problems. Consequently, throughout the reform movement, the government has always focused on improving efficiency through introduction of foreign capital, technology transfer from western countries, and exports. Legal reforms and changes in economic institutions are implemented merely to accommodate this overriding national goal of achieving operational efficiency.

This Note examines the proper role of China’s stock market in the state sector reform. It argues that the current securities regulatory regime hinders the true functions of an efficient stock market and has significant corporate finance consequences.


22. In addition to manufacturing, state enterprises provide many critical social services, including the operation of child-care facilities and hospitals. Donald C. Clarke, What’s Law Got To Do With It? Legal Institutions and Economic Reform in China, 10 UCLA Pac. Basin L.J. 1, 44 (1991). Closing down state enterprises therefore carries an enormous social cost. Id. at 54. Currently, state enterprises theoretically have the legal right to dismiss their employees. This right, however, is almost never exercised. Id. at 43.


25. Some commentators observe that the goals of the current reforms are to eliminate economic waste and improve efficiency by implementing three specific measures: (1) decentralization of economic decision making at the micro-level; (2) reliance on market forces and material incentives to alter undesirable economic behaviors; and (3) opening the economy to external competition with foreign investment. Mei Xia et al., The Re-Emerging Securities Market in China 22 (1992); see also Johns, supra note 21, at 912 (noting that “much of the reform . . . focused on solving the efficiency and related problems of state-owned enterprises”).
Part I of this Note discusses the economic difficulties currently facing the state sector. It then examines the government’s efforts to convert state enterprises into publicly listed joint stock companies as well as the government’s intention to utilize the stock market to provide funds for state sector modernization. Part II examines some of the contentious political issues surrounding China’s creation of a stock market to actively trade shares of converted state enterprises.

Part III scrutinizes the current securities regulatory regime. This regime, although relatively limited in its overall reach compared with regimes in fully developed capital markets, contains detailed microfinance provisions in areas that affect the daily operations of state firms. Most importantly, current regulations which separate common stocks into different classes create substantial price distortions in the market, thereby defeating the corporate finance functions of stock trading. This Note points out that in addition to providing a market for fund raising, an equally important role of an efficient stock market is to provide firm managers with a means to fairly estimate the company’s cost of capital in order to make appropriate project investment decisions.

Finally, part IV illustrates the potential corporate finance problems created by the current securities regulatory regime. Grounded in modern finance theory, this part shows that the current securities regulatory regime in China can produce significant mispricing problems for different classes of stocks with the same underlying rights. Consequently, managers in the state sector cannot rely on the market to estimate their own internal cost of capital. Without this cost estimation, there is no reliable guidance for company investment decisions. Indeed, even if most of the approximately 100,000 state enterprises were converted into joint stock companies and were traded publicly, China probably still could not stop the massive economic waste generated by the state sector. This Note concludes that if China hopes to rely on the market to improve the efficiency of its state sector, it must integrate its stock market by collapsing the various stock classes.

I. Economic Reforms and the State Enterprises

To provide a background for this study, this part describes modern China’s economic reforms and briefly surveys the condition of the state sector in China. Generally, the industrial infrastructure in China consists of state enterprises, collectively owned enterprises—principally in rural areas and in agriculture—and private enterprises.

26. See infra part III (examining the securities regulatory regime).
27. See Chanda, supra note 24, at 48 (remarking that “China has a whopping 108,000 state enterprises”).
28. See infra notes 74-75 and accompanying text (defining joint stock company).
As noted above, state enterprises remain the most important sector in the Chinese economy because the finished goods manufactured by these firms are critical to the economy and the sector employs a large percentage of the population. In China, state enterprises pervade every sector of the economy, but they are especially prevalent in heavy industries that require substantial capital investment. Accordingly, the government has focused its attention on improving efficiency in this sector. Notwithstanding the current interest in increasing private participation in the state enterprise modernization process, it is clear from the Chinese Constitution and other laws that the government will not relinquish all of its ownership interest in this sector.

At its inception, the Communist government in China established a centralized economic system based on socialist ideals. Following the Soviet model, the State Planning Committee would decide the economic priorities and incorporate them in the country’s five-year plans. Economic growth under this system was achieved by blunt increases in material inputs and labor rather than through attempts to efficiently allocate resources. As a result, by the mid-1970s, China’s economic growth lagged far behind that of other industrialized nations. It became increasingly clear to the Chinese leadership that China needed to open its doors to foreign investments. In December 1978, at the Third Plenum of the 11th Central Committee of the Communist Party of China, the government announced a shift in its focus from class struggle to economic development. This shift marked the beginning of China’s modern economic reforms.

China’s senior leader Deng Xiao Ping described the new policy of openness to foreign capital and entrepreneurs as “socialism with Chinese characteristics.” According to one commentator,

The reforms were prompted by dissatisfaction with the results of the traditional system of collectivized agriculture and planned industry.

29. A typical state enterprise is controlled by one or more government units. It is basically situated at the bottom of the hierarchy of state planning. At the top of this system of planning is the State Planning Commission (“SPC”) which determines the initial output targets. SPC then modifies these targets according to the various needs of ministries and provinces. The individual targets are then disaggregated to individual state enterprises. Clarke, supra note 22, at 5.
30. See supra note 21.
31. See infra note 54 (indicating that the Chinese Constitution and various statutes stipulate the supremacy of state ownership).
32. See Xia et al., supra note 25, at 19-22 (describing the pre-reform economic structure in China).
33. Id.
34. Id.
35. Clarke, supra note 22, at 4; see also Cantor & Kraus, supra note 23, at 489 (noting that the Third Plenary Session in 1978 “marked the start of the privatization movement and the re-emergence of forms of private property ownership”).
and commerce. Their essential aim was the devolution of economic decision making power from higher to lower level governmental bodies and, in some cases, the transfer of such power out of the bureaucratic hierarchy altogether.37

Before the reforms, state enterprises simply obtained investment funds from the state and produced whatever output quota that was required by the state. Any additional profits were remitted to the state. Under this system, there was no incentive to seek growth or change to meet market demand. Further, because it was impossible for a firm under a state plan to precisely estimate the actual operating costs, state enterprise managers' concern about cost overrun was miniscule. Whenever there was a budget shortfall, the manager could simply plead for a larger budget. In effect, the enterprises were operating under a "soft budget constraint" wherein economic waste was irrelevant.38

As an early part of its economic reform, the government introduced a profit retention system in 1980 that allowed state enterprises to retain a portion of their profits.39 The new system held managers responsible for the performance of the enterprises.40 At the same time, the government significantly reduced direct allocation of state funds to state enterprises.41 Firms were forced to obtain project finance capital from a variety of sources including the traditional state funding, interest bearing loans from banks, and even equity or bond issuances.42 The net result of these reforms is that today an enterprise must compare its own cost of capital with the rate of return from the project.

The problem with this new arrangement between government and local enterprises is that determining profits or losses in the state industrial sector can be a very difficult and irrational exercise. Most goods used by the industry in China still have fixed prices. Thus, as one commentator argues, "until the price system is reformed, therefore,

37. Clarke, supra note 22, at 3. The government began the reform by first replacing the commune system in rural farms with a responsibility system where a single family unit—rather than a commune which typically combines several villages—is responsible for fulfilling government quotas. Output exceeding the quotas could be sold to the public and the family unit could retain the profits. After the initial success of the rural reforms, the reform movement expanded to include the urban industrial sectors. Instead of providing rigid planning, the reformed state planning system now merely regulated the markets and let market forces determine the flow of goods and capital. See generally China Int'l Econ. Consultants, Inc., The China Investment Guide 23 (4th ed. 1989) (describing China's economic system). As discussed in this part, it is in the industrial sector where China's reforms are currently having the most difficulties.

38. Clarke, supra note 22, at 9.

39. See Xia et al., supra note 25, at 31.

40. Id.

41. Id. at 33.

42. Id.
profitability will be a poor indicator of efficiency. If the output price is fixed high relative to the fixed price for inputs, profitability will be high regardless of efficiency." 43

In essence, identifying money-losing businesses in a fixed-price economy is much more complicated than it would be in a free market system. In a fixed-price system, it is difficult to ascertain whether the enterprise losses are attributable to mismanagement or to macroeconomic structural problems for which the enterprise is not at fault. 44 But even if prices on the factors of production 45 are not fixed, as discussed in part IV below, a state enterprise will still have difficulties estimating its own cost of capital and making an informed decision on project investments, because the stock market cannot provide adequate information on the fair market value of the enterprise's stock.

Despite these well-intentioned reforms, the late 1980s saw further deterioration in the state sector. In the first half of 1988, state enterprises incurred operating losses of RMB 6.87 billion yuan, 46 more than the amount for all of 1987. 47 The monetary austerity measures enforced in late 1988 also caused huge amounts of inter-enterprise debt—close to RMB 100 billion yuan by November 1989. 48 By 1993, the average return on investment in the state sector had dropped to 1.9% from 11.8% in 1985. 49 It had become obvious that measures were necessary to address these structural problems in the state sector.

43. Clarke, supra note 22, at 12.

44. China's policy makers are probably aware of this problem. This might explain why bankruptcy of a state enterprise is still a rare event, despite the implementation of bankruptcy legislation in 1988 which allowed money losing enterprises to be closed down. One commentator concludes that the present Bankruptcy Law is mostly ineffective to correct state enterprise behavior without reforming the price system. Id. at 55. In addition, state enterprises can rely on the safe harbor clause in article 3 of the Bankruptcy Law, which provides that enterprises should not be forced into bankruptcy if losses are not due to their own fault. Id. at 53.

45. These factors are commonly identified as land, labor, and capital.

46. Yuan is the dollar unit of Renminbi (RMB), the currency of China. The exchange rate is currently pegged by the Chinese government at approximate $US1 = RMB 8.3 yuan. See Currency Trading, Wall St. J., Nov. 8, 1996, at C18.

47. Clarke, supra note 22, at 52. In the first three quarters of 1994, close to half of the audited 100,000 state enterprises lost money, totaling over RMB 29 billion yuan. Johns, supra note 21, at 915 n.21.

48. See Clarke, supra note 22, at 52 n.234. This is the so-called "triangular debt" problem in China. Enterprises owed money to each other which could not be set off by mutual obligations; no one had the money to payoff its own debt unless the money it was owed was paid first. Id. For example, suppose there were three enterprises A, B, and C. If A owed money to B, B owed money to C, and C, in turn, also had borrowed from A, none of them would be able to clear its own debt unless one of them was paid off first. Id. By 1995, this "triangular debt" had mushroomed to nearly RMB 600 billion yuan which amounted to one third of China's industrial output. Lincoln Kaye, Fire When Ready, Far E. Econ. Rev., Feb. 23, 1995, at 50, 52.

49. Chanda, supra note 24, at 48 (quoting official Chinese statistics).
As a commentator observes, "development of securities markets was intended, amongst other things, to extricate the Peoples Republic of China (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."\(^5\) It is believed that an active stock market will enable state enterprises to utilize the huge personal deposits in China\(^5\) and subject their management to the stimulations and disciplines of market forces.\(^5\)

II. Ideological Issues Concerning the Stock Market

The emergence of stock markets in China symbolizes a significant departure from socialist practice and raises many political issues.\(^5\) Under the traditional socialist system, state ownership of major economic establishments on behalf of the "whole people" is considered an essential socialist attribute and the ideal economic structure.\(^5\) Thus, prior to the 1980s, allowing individuals to acquire an equity interest in a state enterprise was thought to be antithetical to socialist ideology.\(^5\) The notion of individual stock ownership also challenges the ideal of state ownership of the means of production.\(^5\) Indeed, on various occasions the government has stressed that privatization is unacceptable in China.\(^5\)


51. Personal savings in China are estimated to be between SUS200 to SUS300 billion. *Id.*

52. *Id.* (stating that "[a]s part of the process, it was hoped that exposing State enterprises to the rigors of the capital market would improve internal management and raise productivity").

53. Further aggravating the potential political problem is the fact that most of the companies listed on the two exchanges were former state enterprises. See Kou Hai, *Chinese Companies Listed to Develop Modern Enterprises*, Xinhua News Agency, Jan. 20, 1996, *available in* LEXIS, Nexis Library, Current News File.

54. Some commentators observe that "the government [seeks to preserve] the Marxist-Leninist principle of ownership of the means of production by the people, as represented by the state." Art & Gu, *supra* note 1, at 283. Further, article 6 of China's 1982 Constitution states "[t]he basis of the socialist economic system of the People's Republic of China is socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people." *Id.* at n.62 (citation omitted); see also James V. Feinerman, *The Evolving Chinese Enterprise*, 15 Syracuse J. Int'l L. & Com. 203, 204 (1989) (referencing same passage of Chinese Constitution).


57. See, e.g., Andrew X. Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 UCLA Pac. Basin L.J. 62, 83 (1993). Some commentators characterize the current government practices as corporatization rather then privatization. *See generally id.* at 92 (noting that a better description of the process is corporatization); Art & Gu, *supra* note 1, at 282-83 (observing that "China's program is not privatization . . . it is 'corporatization,' a more limited reform"); Johns, *supra* note 21, at 934-36 (same).
Nevertheless, the government in the 1980s needed to find ways to solve the state sector's problems. Following the successful preliminary structural reform in the rural areas, in 1984 China expanded the program into a comprehensive national economic reform and significantly increased the decision-making power of state enterprises. In so doing, the government announced that "the state's right to own and to run businesses 'may be appropriately separated.'" As a result, government efforts were centered on increasing the efficiency of state enterprises by separating management from ownership. In most cases, this meant less micro-management from state planning authorities. Ironically, the classical business-agency problem became apparent soon afterward; with greater autonomy and bonuses tied to profitability of the entities, business managers began to focus solely on short term profitability rather than long term investment decisions. Unlike matured market economies where the financial marketplace would discipline management misbehavior or incompetence, China lacked adequate market mechanisms such as the threat of bankruptcy and a sizable group of experienced investors capable of scrutinizing the company's stock performance and monitoring and disciplining management.

Currently, the Chinese government appears to be sidestepping the sensitive issue of ownership by instead focusing discussion on the property rights that stock represents. Indeed, the concept of a narrowly defined property right in stock is theoretically appealing in a transitional socialist economy. From a finance theory standpoint, the fair market price of a share of stock today is nothing more than the present value of the aggregate future income that the owner of the share can reasonably expect, taking into account the expected risk. This future income is commonly represented in finance literature by the stock dividends. Thus, owning a share of a company's stock would not have to be viewed as entitling the shareholder to a piece of

58. See supra part I.
59. Zheng, supra note 9, at 604 (citation omitted); see also Qian, supra note 57, at 72-85 (discussing the theoretical debates in China regarding private ownership).
60. See generally Torbert, supra note 21 (discussing the evolutionary company legislation in China).
61. Before reform, the state acted as owner-manager. Thus, there was no separation of interest between principal and agent. Qian, supra note 57, at 75.
63. See, e.g., Qian, supra note 57, at 77-80 (debating the separation of ownership from property rights); Johns, supra note 21, at 934-36 (discussing the property right relationship between the state and the state enterprise).
64. In most finance textbooks, the idea is presented mathematically as:
\[ P = \frac{S}{D/(1+K_t)}; \]
where \( t \) denotes the time periods which run from 1 to infinity; \( P \) is the fair market value of the share today; \( D \) denotes dividends; and \( K \) is the risk-adjusted discount rate demanded by the investor. See, e.g, Van Horne, supra note 62, at 29-34 (discussing the valuation model).
the enterprise itself. Rather, the shareholder is seen merely as participating in profit sharing of the enterprise's future income stream.\textsuperscript{65} Absent legislative characterization of the exact ownership nature of an equity share,\textsuperscript{66} holding equity would be considered fundamentally equivalent to holding debt—which is clearly devoid of ownership. It follows that shareholding would not challenge the notion of state ownership of assets in China.

However, this is not the only problem the introduction of a stock market in China creates for the government. The purchase of equity stocks by firms diverts money from the bond market and traditional bank saving deposits. Major state planning remains dependent upon these two sources for capital and control. In addition, new projects supported through the raising of equity capital often conflict with state plans and create bottlenecks in material supplies in the economy.\textsuperscript{67}

Further complicating the issue is that, from 1949 to 1978, prior to the current reforms, the Chinese government invested about RMB 600 billion yuan in the fixed assets of state enterprises. If these state-owned enterprises were converted into privately-owned enterprises, it would be impossible for private enterprises and individual investors to absorb this large amount of assets. It has been argued that setting up joint stock companies is the most effective way to convert a state ownership system into a share system because a joint stock company theoretically combines the interests of all involved parties—the government, the state enterprises, employees, and other individual investors.\textsuperscript{68}

These various considerations help explain the numerous conflicting provisions in the current securities regulatory regime. Part III examines the significant features of the regime.

\textsuperscript{65} In other words, the shareholder merely possesses the right to future profits. She does not presently own any physical property (the underlying assets of the company). In essence, the shareholder is paid a rent periodically on the company's use of her capital in project investments.

\textsuperscript{66} See supra note 63 and accompanying text.

\textsuperscript{67} Zheng, supra note 9, at 606.

\textsuperscript{68} Some authors observe,

Technically, the fixed assets invested by the government in an enterprise would be priced and converted into shares and owned by the government. The accumulated retained earnings of the enterprise, although difficult to calculate, would be converted into shares owned by the enterprise itself. The enterprise could also issue shares to its own employees or to other enterprises and individual investors. The board of directors, consisting of the representatives of all interested parties, would decide the management issues of the enterprise. The state would not withdraw its shares from the enterprise but would be able to transfer or sell them to other state entities. Xia et al., supra note 25, at 94.

Because the government still maintains the largest shares, the demand of capital infusion from the private sector will be more limited.
III. Securities Regulatory Regime

China's current securities regulatory regime primarily consists of two sets of laws: the newly enacted Company Law\(^6\) and the "securities laws." The securities laws at present are comprised of the provisional National Securities Law\(^7\) and local securities regulations. China has yet to pass a permanent national securities law regulating stock trading.\(^7\)

Although patterned on western schemes, China's existing securities regulatory regime distinctly reflects the various competing political and economic considerations within the country.\(^7\) China's central government undoubtedly hopes that the regulatory regime will help transform the state enterprises as a whole into a modernized sector. Many provisions under the regime clearly envision state enterprise conversions. Nonetheless, the regime contains numerous operational restrictions for both the individual firms and the market as a whole. These restrictions nullify many of the benefits of a free stock market and a private enterprise system.

This part first surveys the salient provisions of the Company Law, which explicitly allows joint stock companies to be listed publicly in the stock market. The part then examines the current securities laws and contrasts the local regulations with the provisional national law. As seen below, the current securities regulatory regime in China specifically classify stocks based on the nature of the owners. This peculiar classification system results in significant distortion in stock pricing. The classification system is analyzed in this part as well.

A. Company Law

Before 1994, even with active equity stock trading on the two national exchanges, China lacked any national corporate legal scheme that clearly established the rights and responsibilities of the shareholders and management of publicly traded companies. On July 1, 1994, China's national Company Law became effective. It uniformly applies to both domestic and foreign investment enterprises. One of the main purposes of the Company Law is to reform existing state enterprises and to allow foreign investment in these enterprises.\(^7\) The Company Law governs two types of corporate entities: "limited liability companies" and "companies limited by shares." The latter are commonly referred to as "joint stock companies."\(^7\) The basic difference be-

\(^6\) Company Law, supra note 14.
\(^7\) National Securities Law, supra note 13.
\(^7\) See Murphy, supra note 13 (stating that the drafting of the permanent national securities law has been delayed numerous times).
\(^7\) See Qian, supra note 57, at 91-92.
\(^7\) Torbert, supra note 21, at 2.
\(^7\) See generally Company Law, supra note 14 (detailing articles governing limited liability companies and companies limited by shares). Conceptually, the limited
between them is that shares of joint stock companies can be publicly traded while shares of limited liability companies cannot.\textsuperscript{75} Also, through provisions such as those defining the powers of management and stockholders, the Company Law provides a clear legal basis for joint stock companies to participate in China’s expanding “securitization” program.\textsuperscript{76}

Significantly, the Company Law gives state enterprises an opportunity to follow a stipulated procedure to reincorporate and reorganize as a joint stock company with widely held shares.\textsuperscript{77} Converted state enterprises may also raise needed capital in the stock market when they meet the listing requirements and regulations of the exchanges.\textsuperscript{78} Under the Company Law, a joint stock company may be established by promotion or by subscription.\textsuperscript{79} The majority of the five or more promoters or sponsors must be domiciliaries of China.\textsuperscript{80} These two requirements are probably motivated by the need to develop China’s infant domestic underwriting industry and to prevent well financed and experienced international securities firms from monopolizing the underwriting process. Reflecting China’s desire for foreign capital and the business reality of a sizable foreign participation in the stock market before the promulgation of the Company Law, there is no nationality requirement for the shareholder of a joint stock company.\textsuperscript{81} Foreign nationals, however, are not allowed to purchase the “A shares” which are common stocks issued to Chinese residents for domestic trading only.\textsuperscript{82} If the company is formed by subscription, the promoters must undertake to buy at least 35% of the shares and keep them for three years to provide a measure of stability for the new company.\textsuperscript{83} A significant result of this provision is that the manage-

\textsuperscript{75} See Company Law, supra note 14, art. 144 (“The assignment of shares by a shareholder shall be conducted at legally established stock exchanges.”).

\textsuperscript{76} It is also referred to as the corporatization program. See supra note 57.

\textsuperscript{77} See Company Law of the PRC, China Bus. L. Guide (CCH) § 14-120 (1995). The law, however, does not specifically deal with the issue of pre-existing debts found in most state enterprises. Presumably this question will be answered at the valuation stage when shares are issued. That is, the final initial public offering stock price will take into account the size of the enterprise’s debt.

\textsuperscript{78} The state enterprise must also be first approved by the government for listing. See Company Law, supra note 14, arts. 151, 153.

\textsuperscript{79} Id. art. 74 (stating that “[a] company limited by shares may adopt the promotion method or share float method [i.e. subscription] for its establishment”). Under the promotion method, the promoters are required to purchase all the company shares and can then resell them at retail. Under the subscription method, individual outside investors would be able to purchase the residual shares after the promoters bought a portion of the available company shares. Id.

\textsuperscript{80} Id. art. 75.

\textsuperscript{81} See Company Law, supra note 14.

\textsuperscript{82} See infra part III.C.

\textsuperscript{83} See Company Law, supra note 14, art. 83.
ment of converted state enterprises will be subject to monitoring by shareholders with a significant holding of the company's shares for a fairly lengthy period of time.

Another provision of the Company Law is the requirement that the company set aside a portion of its profits in a reserve fund until the fund equals 50% of the company's capital. This seemingly paternalistic restriction is apparently designed to protect China's predominantly inexperienced shareholders. Although the requirement probably has the effect of stabilizing dividends and reducing the chance of bankruptcy, it significantly reduces management's flexibility in reinvesting the company's profits. It also infringes upon the management's right to deploy its own financial resources. Because state enterprises tend to have a relatively large capital base, a consequence of the reserve fund requirement is that dividend payout from converted state enterprises would be extremely limited at least in the first few years. Their stocks, therefore, may not be very appealing to overseas stock investors who often expect to receive stock dividends.

Under the Company Law, companies are also required to "consider the opinions of the company's trade union or employees when discussing and determining matters related to the employee's immediate or vital interests." It is not known how much protection this provision will provide the workers, however, because of the Company Law's deliberately vague language. There is also a rather unique provision in the Company Law that mandates establishment of a supervisory board elected by workers to protect their interests, as well as shareholders' rights. Such a board might be important in China because of the large number of small and powerless shareholders. Nonetheless, this provision further limits management's freedom.

The Company Law permits converted state enterprises to issue corporate bonds, increasing the financing flexibility of management through the use of debt. All bond issuances, however, must be approved by the relevant authorities—presumably the central bank—and the total amount of bonds is limited to a maximum of 40% of total assets. With these provisions, the policy makers evidently intend to prevent private corporate debt financing from competing with state plan-funding requirements which are substantially financed by the issuance of government bonds and direct borrowing from state banks.

84. Id. art. 177.
85. Id. art. 121.
86. Id. art. 124.
87. The People's Bank of China is the central bank in China.
89. This provision can also be viewed as another attempt by the government to prevent enterprises from taking excessive risk.
Ideally, to effectuate its state enterprise restructuring, China should implement legislation that provides broad guidelines to safeguard public interests. Meanwhile, the law should leave adequate room for management to optimize operations. In contrast to this ideal, the current Company Law contains some surprisingly intrusive restrictions at the management level, as noted above, thereby hindering the process of modernization.

B. Securities Laws

Stock issuance and trading in China are regulated under a provisional national legislation (i.e. the National Securities Law) and local municipal laws enacted in Shanghai and Shenzhen, where the two national stock exchanges are located. These securities laws delineate the basic listing requirements, the regulations of the securities market, and the disclosure provisions for listed companies. The basic purposes of the securities laws are to protect investors from fraud and market manipulation.

The National Securities Law was first promulgated by the central government in mid-1993. Residual regulations governing listings and trading of shares were enacted by the Shanghai Securities Exchange ("Shanghai Regulations") and the Shenzhen Stock Exchange ("Shenzhen Regulations"). Through the enactment of the National Securities Law, China's central government attempted to reconcile and standardize the local laws and regulations in the two securities exchanges.91

Before the enactment of the National Securities Law which defined the roles of the different administrative agencies, various government units, both at the central government level and at the provincial level, competed for control over the emerging financial markets.92 These agencies imposed many confusing and sometimes contradicting tem-

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90. The Shanghai Exchange, formed in 1990, is governed primarily by the Administrative Measures of Shanghai Municipality Governing Securities Trading, China L. Foreign Bus. (CCH) ¶ 91-038 (1992) [hereinafter Shanghai Regulations]. Its counterpart in Shenzhen is the Provisional Measures of Shenzhen Municipality on Share Issuing and Trading, China L. Foreign Bus. (CCH) ¶ 73-553 (1992) [hereinafter Shenzhen Regulations]. Before the enactment of the provisional National Securities Law in 1993, these local municipal laws were the principal governing laws. Afterward, these laws supplement the National Securities Law.


92. For example, before the enactment of the National Securities Law, the central bank (the People's Bank of China) issued provisional rules from time to time to regulate the stock market. Simultaneously, a multitude of other agencies also claimed similar authority and issued regulating measures.
temporary regulatory measures. The National Securities Law stipulates that the Securities Committee of the State Council ("SCSC") is the national authority responsible for the overall control of China's securities markets.\(^9\) The China Securities Regulatory Commission ("CSRC"), the administrative arm of the SCSC, is responsible for drafting and implementing policies and regulations regarding market supervision.\(^9\) In addition, the State Commission for Restructuring the Economic System directly oversees the reorganization of state enterprises into joint stock companies.\(^9\) The National Securities Law thus greatly clarifies the previously confusing channels of administration.

Although the National Securities Law adopted most of the pre-existing local regulations and administrative measures utilized in Shanghai and Shenzhen, thereby giving investors legal certainties in their equity investments, it also modified some of the local rules. For example, the National Securities Law raised the minimum number of individual shareholders for a publicly listed company from 800 in the Shenzhen Regulations and from 500 in the Shanghai Regulations.\(^9\) This increase in the minimum number of shareholders presumably reflects the government's concern about the appearance of "privatization," where control of companies lies in the hands of a few individuals.\(^9\) To ensure market liquidity and maintain widespread share ownership, the National Securities Law also stipulates that if the total share capital to be issued is less than RMB 400 million yuan (a minimum of RMB 50 million yuan in capital is required to satisfy the listing requirement), at least 25% of the shares must be issued to the public.\(^9\) This requirement is more stringent than the previous local regulations.

To reorganize state enterprises, the National Securities Law specifically requires the government unit administering the state-owned assets to give approval for the asset transfers.\(^9\) The State Council, or its delegates, is responsible for determining the proportion of state own-

93. National Securities Law, supra note 13, art. 5.
94. Id. Note that although Commerce Clearing House ("CCH") has translated this executive branch as the China Securities Supervision and Management Committee, the more common translation is China Securities Regulatory Commission ("CSRC"). See, e.g., Yi-Chen Zhang & Da Yu, China's Emerging Securities Market, Colum. J. World Bus., Summer 1994, at 112, 118 (referring to the committee as the China Securities Regulatory Commission (CSRC)).
96. National Securities Law, supra note 13, art. 30.
97. See supra note 54 (noting Chinese Constitution and statutes which extol the virtues of socialist ownership).
98. National Securities Law, supra note 13, art. 8.
99. Id. arts. 9, 36. The highest level agency in this regard is the State Commission for Restructuring the Economic System. See supra note 95 and accompanying text.
Of particular concern are two additional conditions in the National Securities Law. First, the enterprise's net assets must be at least 30% of the total gross assets, and the enterprise's intangible assets must constitute no more than 20% of the total assets. Second, the enterprise must have been profitable for three years prior to the new share offering. The local Shenzhen Regulations further require that a company listed on that exchange must show a return on investment of at least 10% before going public. The combined net effect of these requirements is that only profitable enterprises with significant book value can be reorganized into joint stock companies. While the current securities laws seek to protect market integrity at this embryonic stage of market development by ensuring that only relatively healthy state companies are traded on the exchanges, the laws also may have inadvertently contravened the original economic intent of state sector reorganization. These minimum profitability and asset value requirements prevent the most inefficient or near bankrupt state enterprises—those most in need of additional equity capital—from entering the market and getting the capital they desperately need to improve their operations.

Similar to the Company Law, the National Securities Law requires the promoter to subscribe at least 35% of the total shares with a minimum value of RMB 30 million yuan. Further, only one class of

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100. National Securities Law, supra note 13, art. 9. The regulatory regime does not specify exactly how to determine the government's portion of the share. Presumably it is subject to negotiation. As a starting point for the negotiation, the government appears to be using the book value of the enterprise. The government has also established a state asset administration agency to monitor and value state assets in the converted state enterprises. See China Bus. L. Guide (CCH) ¶ 38-315 (1993).

101. National Securities Law, supra note 13, art. 9(1). How to compute the net asset value (i.e., gross asset value net of accumulated depreciation) in China is still an open question. Many accounting rules in China are archaic. For example, contrary to international accounting standard ("IAS"), China still applies straight line depreciation to calculate the book value of its assets. Julia W. Sze, The Allure of B Shares, China Bus. Rev. (Jan.-Feb. 1993), at 42, 47 (listing the major differences between the positions of IAS and those in China).

102. National Securities Law, supra note 13, art. 9(2). These requirements are more stringent and specific than the local laws in Shanghai and Shenzhen; see Shanghai Regulations, supra note 90, art. 11 (requiring that company must be profitable for the last two years). Contra Shenzhen Regulations, supra note 90, Ch. III (no specific requirements on company profitability). It should also be noted that net income or profit is calculated differently in China compared to other western economies. See Sze, supra note 101.


104. One advantage of these requirements is that they prevent investors from buying into bankrupt enterprises for the sake of speculating in land value. Many state enterprises currently occupy prime land in major cities. It is possible for investors to take control of the bankrupt company and proceed to strip its valuable assets—in this case, the land. In fact, this is a fairly common speculating tactic used in developing countries. Investors seek control of a company with no intention to run the business. Rather, the intent is to sell the company's highly valuable properties.

105. National Securities Law, supra note 13, art. 8.
common shares may be issued per year, which again limits management's operational flexibility.106

C. Share Classifications

One of the most problematic aspects of China's current securities regulatory regime is that stocks are separated into different classes based upon the nature of the shareholders. These classes include: state shares, legal person shares, individual shares, and foreign investment shares.107 This distinctive classification scheme reflects the ideological debates concerning stock issuance, especially the sensitive question of socialist ownership, and represents the government's attempt to be pragmatic in its market development.108

State shares are shares held by state-owned units designated by the government109 and may be sold or transferred only with the approval of the respective state asset administrative departments.110 These shares are not publicly traded. Legal person shares are shares held by a company, usually another state enterprise, or legal entity other than the state or a natural person.111 As with state shares, the transfer of legal person shares requires approval by the relevant authorities.112 Together, state shares and legal person shares account for approximately 75% of the total number of all common shares issued.113

Individual shares are those held by either the staff and workers of the company or individual investors.114 These shares are authorized to trade publicly on the national exchanges and are referred to as "A shares." Only Chinese nationals may purchase these shares.115

Foreign investment shares (special RMB shares) are issued to persons outside China and are used to attract foreign investment and to

106. Id. arts. 8, 10.
107. See, e.g., Shenzhen Regulations, supra note 90, art. 33 (stating that depending on the owner, shares shall be divided into four different categories).
108. See supra part II; see also Chen, supra note 17, at 5 (noting that “maintaining the dominant position of [state] ownership to preserve socialism is . . . a virtual pre-condition for China's stock market to emerge”).
109. See Zhang & Yu, supra note 94, at 119. It is not known exactly what a state-owned unit is. The term is deliberately vague and should be broadly defined. Presumably, any government agency would fall into this category.
110. See National Securities Law, supra note 13, art. 36.
111. See Zhang & Yu, supra note 94, at 119.
112. See Mark O'Neill, China Leaders Seen Divided Over State Share Sales, Reuter Asia-Pac. Bus. Rep., Jan. 26, 1996, available in LEXIS, Nexis Library, Current News File ("State shares are directly held by the state and legal-person shares are held by institutions, most of them state-owned. Neither can be traded.").
113. See Securities Regulation Climate Improves, But Obstacles Remain, 9 Int'l Sec. Reg. Rep., No. 7, Mar. 14, 1996, at 11 (noting that “[o]nly about 25 percent of issued shares can circulate and the rest are restricted by being classified as state or legal-person shares”).
114. See Zhang & Yu, supra note 94, at 119.
115. Id.
assist the development of securities markets.\textsuperscript{116} These shares, which are listed in the two national exchanges, are called "B shares" and are denominated, traded, and settled in US dollars.\textsuperscript{117} B share owners possess identical rights and obligations as A share owners.\textsuperscript{118}

State enterprises that reincorporate as joint stock companies and intend to apply for listing in Hong Kong may also issue shares denominated in RMB.\textsuperscript{119} These shares, however, are only listed and traded in Hong Kong dollars on the Hong Kong Stock Exchange.\textsuperscript{120} These shares are made available only to overseas investors and are referred to as "H shares."\textsuperscript{121} Enterprises with H shares may not issue or list B shares in China, but they can have concurrent listings of A shares in China and H shares in Hong Kong.\textsuperscript{122}

Apparently, these multiple categories of shares serve the government's overriding goal of preserving a controlling stake of the state sector. With only about 25% of all shares permitted to trade publicly under the current securities regulatory regime, the government effectively maintains a controlling stake in virtually every publicly traded state enterprise.\textsuperscript{123} State ownership and control of enterprises are thus ensured. As one commentator states, "[t]he remaining question is how to integrate the participation rights of shareholders into the existing managerial system without undermining the state's control as the largest shareholder while allowing other shareholders to have a reasonable opportunity to influence the management."\textsuperscript{124} The issuance of B shares and H shares then serves merely to attract the foreign capital needed to modernize operations in the state sector.\textsuperscript{125}

\textsuperscript{116} Nottle, \textit{supra} note 10, at 505. Apparently, the government also hopes that more sophisticated trading in the foreign investment share markets will serve as a guidepost for domestic investors. Unfortunately, domestic investors have virtually ignored these markets and simply focused on short-term speculations in the A share market.

\textsuperscript{117} \textit{Id.} Originally, B shares were denominated in RMB. \textit{Id.}

\textsuperscript{118} \textit{Id.; see also National Securities Law, supra note 13, art. 8 (stating that "only one type of common stock shall be issued with equal rights for equal shares").}

\textsuperscript{119} See Nottle, \textit{supra} note 10, at 516.

\textsuperscript{120} \textit{Id.} The price settlement method is similar to that of the American Depository Receipts ("ADRs") in the U.S. exchanges. For a discussion of the ADRs, see Charles P. Jones, \textit{Investments} 419-20 (1996). The currency conversion rate is determined by the average exchange rates at China's currency swap centers.

\textsuperscript{121} See Nottle, \textit{supra} note 10, at 516.

\textsuperscript{122} \textit{Id.} Thus, state enterprises that wish to issue foreign investment shares have a basic choice between B or H shares. Of course, they can also issue A shares. H shares in the form of ADRs for some state enterprises are also listed on the New York Stock Exchange, and they are sometimes referred to as "N shares." \textit{See World Bank Report Urges Restraint in Regulating Capital Markets, 9 Int'l Sec. Reg. Rep., No. 6, Feb. 29, 1996, at 11.}

\textsuperscript{123} See supra note 113 and accompanying text.

\textsuperscript{124} Zheng, \textit{supra} note 9, at 608.

\textsuperscript{125} That China is not interested in wholesale privatization and the associated changes in organizational structure can be seen from comments of investment bankers. \textit{See Breaking the Taboo, supra} note 20, at 83 ("It's [merely] a cash-raising exer-
Perhaps the most egregious flaw in this system, however, is the manner in which it distorts the fair pricing function of an efficient stock market. As one author states, "[a]n efficient market (EM) is one in which the prices of all securities quickly and fully reflect all available information about the assets. This concept postulates that investors will assimilate all relevant information into prices in making their buy and sell decisions." Theoretically, assuming that the conditions for an efficient market apply, if one categorizes stock classes according to the fundamental characteristics of the underlying stocks, as with common and preferred stocks, the market is said to be efficient with respect to the particular class of stocks. As such, the market price of the stock fairly reflects the value of the company. Given this "efficient price," one can apply a standard model to estimate the company's implied cost of equity capital.

China's current securities regulatory scheme subdivides one class of stocks (i.e. common stocks) with the same basic characteristics into four groups according to the nature of the stockholders. Under this arrangement, it is not clear whether the traditional efficient market concept still applies. Even if the concept applies, there would be four "efficient prices" for essentially the same securities. Further, there is no theoretical basis to prefer one price over the other in computing the implied cost of equity. The potential economic and financial problems caused by China's regulatory regime are discussed in detail in the following part.

IV. CORPORATE FINANCE IMPLICATIONS OF THE CURRENT SECURITIES REGULATORY REGIME

One of the principal motivations behind the government's drive to create an equity market was the establishment of a major source of capital to revitalize the country's ailing state enterprises. These enterprises are critical to China's economic health because many of them produce important intermediate goods (raw materials, chemicals, etc.) necessary for China's booming economy. China also hopes that the new equity market will channel the country's huge private savings base into capital investment and lessen the pressure of inflation by dampening consumer spending. In addition, competition for investment funds in the open market is expected to discipline state-sector managers to raise productivity and profits. Therefore, the develop-

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126. Jones, supra note 120, at 269.
127. See infra note 140; see also infra part IV (detailing the pricing problems created by the current securities regulatory regime in China).
128. See Johns, supra note 21, at 916 n.23 (observing that state enterprises dominate important industries in China); see also supra part I (discussing the significance and problems of China's state sector).
129. Sze, supra note 101, at 42.
ment of a modern financial market in China serves the dual goals of China's economic reform plan: improving production efficiency and stimulating economic growth. The securities regulatory regime can be viewed as a statutory attempt to ensure the success of the economic modernization process. Paradoxically, rather than enhancing market development, the current securities regulatory regime may actually stifle the potential effectiveness of the financial marketplace.

As noted earlier, there are many idiosyncratic provisions under the current securities regulatory regime in China. For instance, the new Company Law stipulates that a joint stock company must limit the issuance of bonds to at most 40% of its total assets. The securities regulatory regime thus artificially constrains the joint stock company's capital structure by requiring that a company be at least 60% equity financed. This requirement places an unduly large premium on the importance of the equity stock market.

An even more serious problem exists in stock classifications. By separately classifying A, B, and H shares, China's securities regulatory regime essentially bifurcates the stock market into the A shares domestic fund market, and the B and H shares foreign fund market. In effect, the domestic and the foreign fund markets are affected by totally separate supply and demand forces. This bifurcation results in divergent pricing for shares with the same rights in a given company.

In the domestic fund stock market, with relatively few stocks listed on the two national exchanges, there is simply too much money chasing too limited a supply of shares. As a result, the A shares are grossly overvalued relative to B or H shares. In 1992, price earnings multiples ("P/Es") for the A shares market were estimated at 120 times for stocks on the Shenzhen Stock Exchange and 135 times for those on the Shanghai exchange. In contrast, foreign investors were much more cautious towards the prospect of the reorganized state enterprises. The average company's B shares traded at a 60-70% dis-

130. See supra note 88 and accompanying text.
131. See supra part III.
132. An added source of price fluctuations in the foreign fund market is currency fluctuation. Foreign investors will thus also factor this currency risk into their pricing of the stock.
133. At the end of 1995, there were 13 million investors for 361 listed stocks. Bo Ning, Stock Investors Reach 13 Million in China, Xinhua News Agency, June 26, 1996, available in LEXIS, Nexis Library, Current News File.
134. Chen, supra note 17, at 11-12; see also Qian, supra note 57, at 71 (stating that "market is too small to supply demand").
135. See Nottle, supra note 10, at 510-12. The P/E ratio is a popular measure of the stock market price level. In essence, it measures how much money investors are willing to pay for $1 per period of future earnings. As a comparison, the average market P/Es in the United States typically fall between 15 to 22.
count to the A share price. Therefore, segregating and classifying separate portions of the stock market under the securities regulatory regime greatly distorts share prices. As discussed later, this price distortion causes significant problems in internal cost of capital estimation for state enterprises.

In terms of wealth distribution, the current regime also creates unearned windfall profits for the few investors fortunate enough to own individual shares that can be legally traded on the stock exchanges. These profits stem directly from the non-transferability of state and legal person shares. Because of the trading restriction, the state is transferring part of its possible earnings in price appreciation to a few individuals. Ironically, the securities regulatory regime—which seeks to further the socialist purpose of state ownership—is supposed to prevent precisely this uneven, and sometimes unfair, wealth distribution from occurring.

Perhaps more importantly for China at this juncture is that the stock market should function as an assessor of each state enterprise’s internal cost of capital. The legislative drafters and regulatory officials, however, are apparently too preoccupied with the investment function of a stock market—attracting capital to joint stock companies. The more fundamental economic function of a stock market—facilitating the efficient allocation of scarce resources—is ignored under the current securities regulatory regime.

At the moment, even after converting a state enterprise into a joint stock company under the Company Law and publicly offering its stocks for trading under the securities laws, the pressure on the state enterprise’s manager to perform well remains minimal. The state still maintains effective public ownership, and private investors have very limited influence on management. Additionally, profitability alone is

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136. Id. at 513. Thus, in Shenzhen, a typical B share would have a P/E ratio of approximately between 34 to 36, similar to that of a growth stock in the United States. Even at this more modest level, the P/E still appears to be high by international standards. As a comparison, U.S. stocks with premium international brandnames such as Coca Cola and McDonald’s are presently commanding a P/E of 37 and 21, respectively. Robert McGough & Eleena De Lisser, P/E Reaches Stars at Planet Hollywood, Wall St. J., Oct. 2, 1996, at C1. Presently, most H shares (those shares that are listed in New York) are trading at a P/E ratio of below 10, reflecting a more conservative view from U.S. investors. See Breaking the Taboo, supra note 20, at 81.

137. To illustrate, if the state decided to publicly trade its shares on the exchanges, the stock price would certainly decline because of the substantial increase in the supply of shares. At present, the government is in effect “cornering” the entire market which artificially increases the general share prices. Because state shares are neither traded nor alienable, all resulting profits are passed to investors who actively trade their shares. This benefits only a few shareholders.

138. See supra part II. Some commentators also suggest that the current process leads to widespread corruption among government officials who control the share distribution process. See Qian, supra note 57, at 72 (observing that “[f]airness, justice, and openness in securities transactions [in China] are not embraced nor sufficiently institutionalized”).
not precise enough to determine efficiency. The key issue is the adequacy of the profit given the risk, because all capital has an opportunity cost that must be recouped before one can estimate the pure economic profit.139

Modern corporate finance theory emphasizes the role of an efficient stock market in determining the cost of equity capital. In the absence of this information, an enterprise cannot achieve efficient allocation of financial resources.140 This estimate of the cost of equity capital, together with information on the company's cost of debt capital, allows the company to derive its overall average cost.141 This overall average cost is the firm's marginal or opportunity cost of capital. For optimal profitability and maximum capital allocation efficiency, a firm should continue to raise and invest money until the rate of return from the last viable project equals the firm's overall cost of capital. In China, therefore, a fully functioning stock market could theoretically provide state enterprise managers with the necessary information to compute the entity's overall cost of capital, thus allowing them to rationally choose efficient project investments. The missing link here, however,

139. For example, instead of investing in a profitable project X, it is more rational to invest in an even more profitable project Y if Y has the same risk as X.

140. Under the assumption that the stock market is efficient, one way for the firm to estimate this "implied" cost of equity capital is to apply the discounted cash flow model. In its simplest form (it is often referred to as the Constant Growth or Gordon Model), this model expresses the cost of equity as the summation of the expected dividend yield and the potential capital gains yield. Mathematically, assuming that the annual dividends of the company will increase at a constant rate of g%, the fair market price of the stock can be calculated as:

\[ P = \frac{D_1}{K_e - g}; \]

where \( K_e \) is the firm's cost of equity capital, \( D_1 \) is the expected dividend one period from now, \( P \) is the current market price of the stock, and \( g \) is the estimated long term earnings or dividend growth rate. Now, if the enterprise wants to estimate its cost of equity, it can convert the above price equation into:

\[ K_e = \frac{D_1}{P} + g. \]

If stock investors are rational, the company can use the prevailing stock price for \( P \) and calculate \( K_e \) directly. The problem in China is that prices for A shares, B shares, and H share prices are all feasible candidates. Lacking \( P \), the company cannot estimate its own cost of equity, \( K_e \). See also Van Horne, supra note 62, at 26-35 (detailing the stock valuation model); cf. supra note 64 (same).

141. This is referred to as the weighted average cost of capital ("WACC") for the firm, it is calculated as:

\[ WACC = \frac{B}{V}(K_d)(1-T) + \frac{S}{V}(K_e); \]

where \( B/V \) is the proportion of debt (B) relative to total asset (V), \( K_d \) is the cost of debt, \( T \) is the tax rate (since interest is tax deductible, the actual cost of debt for the firm is \( (K_d)(1-T) \)), \( S/V \) is the proportion of equity, and \( K_e \) is the cost of equity. See J. Fred Weston et al., Essentials of Managerial Finance 583-84 (1996) (examining the WACC formula). As discussed earlier, the current securities regulatory regime in China prevents the reasonable calculation of \( K_e \). See supra note 140. Lacking the cost of equity, \( K_e \), the enterprise would not be able to estimate its WACC.
is a rationally and efficiently determined share price upon which to base such calculations.\textsuperscript{142}

Presently, China's securities regulatory regime obstructs the calculation of any reasonable estimate of the firm's cost of capital because the regime artificially distorts share prices. Instead of providing information on the firm's future prospects, the current stock prices merely reflect a distorted supply and demand condition for the stock.\textsuperscript{143} Moreover, the regulatory regime's restriction on the company's capital structure also adversely affects the company's cost of capital.\textsuperscript{144} Ironically, for the few publicly traded state enterprises, reliance on modern finance theory to calculate the cost of capital will lead to over-investment, because the implied cost of equity is unrealistically low as calculated from the current share prices.\textsuperscript{145}

In sum, China's prevailing securities regulatory regime has essentially destroyed a crucial function of the stock market—providing the manager with the necessary information to make optimal project investment decisions—and has contravened the original intent of China's experiment in stock markets.\textsuperscript{146}

\textsuperscript{142} One can argue that the enterprise's manager may still come up with a reasonable estimate of capital cost by using the prices of B or H shares (the foreign fund shares). The prices for these shares, however, are greatly distorted. First, there is currency risk for foreign funds. Second, there is political risk for foreign buyers. Third, and most importantly, there is an information gap, in the form of either incomplete information content or additional information arrival time, preventing accurate pricing of the foreign shares. All of these disadvantages create additional uncertainty to stock pricing.

Also, for a non-publicly traded company with no stock market price information, a popular technique in the United States is to use a proxy company that is listed in the market. Unfortunately, one would face the same fundamental problem of a segregated market in China. Perhaps this would explain the obsolete practice of emphasizing accounting book value (gross asset value minus accumulated depreciation) in China's securities regulatory regime. This practice contradicts modern finance theory's focus on the economic value of an asset, i.e., the expected cash flows that can be generated from an asset.

\textsuperscript{143} See supra notes 133-36 and accompanying text.

\textsuperscript{144} The overall cost of capital for the company is a weighted average of the company's cost of debt and cost of equity. See supra note 141. Because the cost of debt is always lower than the cost of equity for the company, an unnecessarily high level of equity in the company's capital structure will raise the company's WACC, i.e., its overall cost of capital.

\textsuperscript{145} Obviously, the higher the price of a company's stock, the lower its cost of equity capital and the lower the overall cost of capital. See supra notes 140-41. With lower capital cost, the company can invest in more projects. However, if the stock price is made artificially high, the company would invest in some projects it should not have originally invested.

\textsuperscript{146} After all, the country's experiments in joint ventures, which rely on private contracting, have been very successful in attracting foreign capital. Arguably, simple modifications in the current joint venture laws could allow domestic private capital to invest in state enterprises. There is no absolute need to rely on stock market to raise funds, even though a stock market can serve as a valuable alternative or complementary means of fund raising. China then would not need to confront the sensitive sub-
Concluding Remarks

China’s current securities regulatory regime reflects a careful political balance between the socialist ideal of state ownership and the capitalist theory of economic efficiency. Although in many respects the securities legislation in China is quite similar to those found in more mature economies and is rather sophisticated, the legislation contains some uniquely socialist characteristics not found in Western markets that are antithetical to traditional market principles.

If the real motivation behind the legislation is to institute market discipline on the many inefficiently run state enterprises, however, the current legislation will most likely fail to achieve this goal. The market, as constructed in China today, cannot reasonably determine the prices of shares. Consequently, managers of state enterprises cannot make rational project investment decisions because they lack information on their own company’s market-determined cost of capital. On the other hand, given the nascent state of the current securities regulatory regime, modifications are bound to be made in the future. Meanwhile, China must deal with a securities market that is not effectuating the basic goal of its policy makers.