

# OBSERVATIONS ON CAPITAL MARKET REGULATION: HONG KONG AND THE PEOPLE'S REPUBLIC OF CHINA

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## 1. INTRODUCTION: THE HAND-OVER

For more than 150 years, Hong Kong has been controlled by the British government, and in recent years has become a center of both trade and finance. Hong Kong's economic system has been an expression of market principles. Individuals and enterprises have been able to buy, sell, and invest to a large degree without governmental controls and restraints. Many believe that this market approach has been an important source of the economic energy that has characterized Hong Kong in the last half of the twentieth century.<sup>1</sup>

At midnight on June 30, 1997, the control of Hong Kong will pass from the United Kingdom to the People's Republic of China ("P.R.C."), pursuant to the joint declaration by the two govern-

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The author received assistance on this Article from various sources, notably Cleary, Gottlieb, Steen & Hamilton, Clifford Chance, Freshfields, Johnson Stokes & Master and Kwok & Yih and several colleagues at Salomon Brothers. Larry Kwok's recently published analysis and compilation of Hong Kong securities laws was a valuable guide. LARRY L.K. KWOK & PETER F. AMOUR, CORPORATE SECURITIES LAW (1996) (published in three volumes). Michael Hickman of Cleary, Gottlieb, Steen & Hamilton advised extensively on China issues, and his colleagues Zhang Jun and Elise Harte provided research assistance, as did Tammie Tam of Johnson Stokes & Master. All help is greatly appreciated, but responsibility for the content of this Article, of course, rests solely with the author.

<sup>1</sup> See BRUCE BUENO DE MESQUITA ET AL., RED FLAG OVER HONG KONG 11, 19-21 (1996) (discussing the beneficial effects of limited government and a free market on the Hong Kong economy).

ments in 1984 ("Joint Declaration").<sup>2</sup> While the provisions of the Joint Declaration are designed to assure the maintenance of Hong Kong's social, legal and economic system for fifty years after the hand-over, the new Hong Kong Special Administrative Region ("S.A.R.") will be part of and under the authority of the P.R.C., and governed under the new basic law for the S.A.R. ("Basic Law").<sup>3</sup>

In contrast to Hong Kong, the P.R.C. has been following economic policies involving a high degree of government ownership and control. In the last few years, purely government-controlled, "command" economies — most notably, the Soviet Union — have encountered difficulties or essentially failed. The P.R.C., although it has had some economic problems, has continued its past policies, and at the same time experimented significantly with market processes. This modified program has brought substantial economic progress in the P.R.C.<sup>4</sup>

Hong Kong is already part of the P.R.C.'s market experimentation. Much of the trade and finance now flowing through Hong Kong is in some way related to the P.R.C.<sup>5</sup> Accordingly, there is reason to believe that the P.R.C. will continue to support Hong Kong's market approach. Nevertheless, the role of the P.R.C. government in the economy remains very substantial, and the interrelationship of Hong Kong and the P.R.C. assures interaction between their policies. Indeed, since the hand-over was agreed upon in 1984, government bodies and businesses in Hong Kong have sought to function in harmony with the P.R.C. With the hand-over becoming a reality, the influence of the P.R.C. in Hong Kong's economic affairs will only grow.

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<sup>2</sup> Joint Declaration on the Question of Hong Kong, Dec. 19, 1984, U.K.-P.R.C., 1985 Fr. Brit. T.S. No. 26 (Cmnd. 9543).

<sup>3</sup> Zhonghua Renmin Gongheguo Xianggang Tebie Xingzheng Qu Jiben Fa [The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China], Apr. 4, 1990, ZHONGHUA RENMIN GONGHEGUO FALÜ FAGUI (Huoye) 1-4-0-I•1 [hereinafter FALÜ FAGUI], translated in [1990 - 1994 Special Zones and Cities] China Laws for Foreign Bus. (CCH) ¶ 100-010 [hereinafter Basic Law].

<sup>4</sup> See generally DE MESQUITA ET AL., *supra* note 1, at 36-39 (discussing the history of centralized economic control in the P.R.C. and detailing significant economic improvements in the P.R.C.); FRANK CHING, HONG KONG & CHINA 62 (1985) (describing the mixed system of state-owned enterprises and decentralization).

<sup>5</sup> See discussion *infra* Section 10.

Capital markets are of continuing importance to both Hong Kong and the P.R.C. Economic growth depends upon capital to create the facilities for production and delivery of goods and services. In the P.R.C., the government itself is historically the primary source of capital, but investment funds increasingly come from non-governmental sources. In Hong Kong, non-governmental market sources have provided most of the capital for some time.

In the early high-risk phases of economic development, individual or corporate enterprises tend to obtain capital mainly from internally generated funds and from banks or other financial intermediaries. Ultimately, with expanding demand for capital and the accumulation of savings by individuals and enterprises, funds must be raised directly from the investors controlling these savings. Capital markets perform this key function of raising investment funds.

In addition to raising funds, capital markets allocate funds among enterprises. Investors — the providers of capital — select investments expected to generate the highest levels of profitability consistent with the risks they are willing to assume. If investors perceive a particular enterprise or market more favorably than another, demand for that investment rises. Absent governmental restrictions, capital follows investors' perceptions of relative risk and return.

Capital markets can be national assets. A market may be utilized by, and create revenues from, both domestic and international capital providers and users. Markets themselves create value for the community, and Hong Kong has already reaped such benefits. However, the role and effectiveness of capital markets depend on how they are managed and controlled.

This Article examines certain aspects of the regulation of capital markets in Hong Kong and the P.R.C., in the hope of understanding how they may evolve after the hand-over of Hong Kong to the P.R.C. in mid-1997. It focuses on regulation of capital raising processes, with limited reference to private investment and lending, secondary trading of previously-issued securities or derivatives, or financial institutions and market participants as such (and does not address other economic, social or political issues). The subjects covered by such a review are inevitably arbitrary, and these observations are too abbreviated to support predictions, but it may be possible to discern lines of

future development.

## 2. REGULATORY STRUCTURE

The regulation of capital markets in Hong Kong is under the direction of a single agency separate from governmental organs of economic and fiscal policy. This relatively simple structure is quite different from regulation in the P.R.C., where capital market processes are affected by actions of multiple governmental bodies having various functions in the economy.

The Hong Kong Securities and Futures Commission ("SFC") is a government regulatory agency with general powers over the securities markets, as well as futures and so-called leveraged foreign exchange markets, including the two exchanges in Hong Kong. The Stock Exchange of Hong Kong Limited ("SEHK"), has a statutory monopoly on stock exchange trading in Hong Kong.<sup>6</sup> Similarly, the Hong Kong Futures Exchange, ("HKFE") is the only licensed futures exchange in Hong Kong.<sup>7</sup>

The Hong Kong structure reflects the replacement of several securities and futures market regulators by the SFC, largely in response to regulatory weaknesses revealed in the 1987 market break. At that time, among other things, stock and stock index futures trading on the exchanges had to be suspended for several

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<sup>6</sup> See Securities Ordinance §§ 20-22, ch. 333 of the Laws of Hong Kong, originally 12 of 1974 - L.N. 56 of 1974, L.N. 140 of 1974, 62 of 1976, 8 of 1978, L.N. 92 of 1980, L.N. 101 of 1980, 47 of 1981, L.N. 377 of 1981, 58 of 1985, R.Ed. 1986, 33 of 1988, 46 of 1988, L.N. 57 of 1988, L.N. 294 of 1988, 10 of 1989, L.N. 259 of 1989, R.Ed. 1989, 62 of 1990, 63 of 1990, 6 of 1991, 24 of 1991, 26 of 1992, 68 of 1992, 27 of 1993, 8 of 1994, 49 of 1995, 62 of 1995, 63 of 1995, 76 of 1996 [hereinafter SO]; Stock Exchanges Unification Ordinance §§ 3, 27, ch. 361 of the Laws of Hong Kong, originally 55 of 1980 - L.N. 259 of 1980, 9 of 1982, 65 of 1982, 59 of 1985, L.N. 61 of 1986, 27 of 1986, R.Ed. 1986, 10 of 1989, R.Ed. 1989, 3 of 1990, 65 of 1990, 104 of 1991, 68 of 1992, 74 of 1994, 49 of 1995 [hereinafter SEUO].

<sup>7</sup> See Commodities Trading Ordinance § 13, ch. 250 of the Laws of Hong Kong, originally 59 of 1976 - 79 of 1976, L.N. 268 of 1979, L.N. 65 of 1980, 54 of 1980, 9 of 1982, 35 of 1982, 61 of 1985, L.N. 313 of 1985, R.Ed. 1985, L.N. 111 of 1986, 27 of 1986, 40 of 1987, L.N. 387 of 1987, 10 of 1989, L.N. 259 of 1989, R.Ed. 1989, L.N. 415 of 1989, 3 of 1990, 62 of 1990, 63 of 1990, 64 of 1990, 9 of 1991, L.N. 253 of 1991, 25 of 1992, L.N. 399 of 1992, 27 of 1993, 7 of 1994, L.N. 564 of 1994, 49 of 1995, 62 of 1995, 76 of 1996 [hereinafter CTO]; Commodity Exchanges (Prohibition) Ordinance, ch. 82 of the Laws of Hong Kong, originally 54 of 1973 - L.N. 163 of 1973, 59 of 1976, L.N. 269 of 1979, R.Ed. 1980, 10 of 1986, 8 of 1991, L.N. (C) 14 of 1996 (Chinese authentic version).

days and was resumed only with a financial back-stop provided by Hong Kong banks to the HKFE.<sup>8</sup> Following this crisis, there was a study, resulting in May 1988 in a report<sup>9</sup> the recommendations of which were implemented principally through 1989 legislation establishing the SFC.<sup>10</sup>

The SFC is a separate corporate body, distinct from the executive branch of government; the SFC's ten directors, who are appointed and serve at the pleasure of the Governor of Hong Kong, include the SFC Chairman (currently Anthony Neoh, a distinguished lawyer in Hong Kong) and its four operating division heads, plus five persons who are not executives of the SFC.<sup>11</sup> After the hand-over, the Chief Executive of the S.A.R. will make determinations regarding the directors of the SFC, possibly after consultations with P.R.C. officials.<sup>12</sup>

The two exchanges are limited liability companies governed by their members which are their shareholders.<sup>13</sup> However, the exchanges exercise self-regulatory responsibilities under the supervision of the SFC.<sup>14</sup>

The Hong Kong Monetary Authority ("HKMA") also has an impact on capital markets. It administers Hong Kong government debt issues in the capital markets and supervises banks in Hong Kong. The HKMA's exercise of banking powers affects the availability of credit and liquidity in capital markets, and so-called exempt dealers subject to only limited regulation by the SFC consist mainly of banks or other depository institutions under the supervision of the HKMA.<sup>15</sup>

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<sup>8</sup> See KEVIN RAFFERTY, CITY ON THE ROCKS 239-40 (1989).

<sup>9</sup> See SECURITIES REVIEW COMMITTEE OF HONG KONG, THE OPERATION AND REGULATION OF THE HONG KONG SECURITIES INDUSTRY (1988) (sometimes referred to as the "Hay Davison Report" after Committee Chairman Ian Hay Davison).

<sup>10</sup> See Securities and Futures Commission Ordinance, ch. 24 of the Laws of Hong Kong, originally 10 of 1989 - L.N. 259 of 1989, R.Ed. 1989, 62 of 1990, 63 of 1990, 66 of 1990, 67 of 1991, 77 of 1991, 24 of 1992, 68 of 1992, 82 of 1992, 87 of 1992, L.N. 96 of 1993, 53 of 1994, 73 of 1994, 7 of 1995, 49 of 1995, 62 of 1995, 68 of 1995, 9 of 1996, 66 of 1996, 76 of 1996 [hereinafter SFCO].

<sup>11</sup> See *id.* §§ 3, 5.

<sup>12</sup> See Basic Law, *supra* note 3, art. 48, para. (7).

<sup>13</sup> See SEUO, *supra* note 6, §§ 3-4; CTO, *supra* note 7, § 13.

<sup>14</sup> See SFCO, *supra* note 10, §§ 4(1) (d), (f), (k), 47-51; SO, *supra* note 6, §§ 23-29; SEUO, *supra* note 6, §§ 10A, 15, 34-37; CTO, *supra* note 7, §§ 13-25.

<sup>15</sup> See generally SO, *supra* note 6, § 60; SFCO, *supra* note 10, § 4; Banking Ordinance, ch. 155 of the Laws of Hong Kong, originally 27 of 1986 - L.N. 246

Regulation of capital markets in the P.R.C. ultimately derives from the National People's Congress ("NPC"), whose members serve for five year periods; the NPC meets annually in full session and more often by its Standing Committee.<sup>16</sup> The NPC appoints the State Council, the principal executive organ of the government, consisting only of ministerial-level government leaders, including Premier Li Peng and Vice Premier Zhu Rongji.<sup>17</sup> The Communist Party of China also has great power in the P.R.C.; senior government officials often have positions in the party.

In late 1992, the State Council took action<sup>18</sup> to authorize the State Council Securities Commission ("SCSC"), currently chaired by P.R.C. Vice Premier Zhu Rongji, to set policy for securities markets, and also the China Securities Regulatory Commission ("CSRC"), currently headed by Zhou Daojiong, to carry out these policies. The SCSC consists of fourteen members appointed by the State Council from interested government departments

of 1986, L.N. 258 of 1986, L.N. 274 of 1986, L.N. 21 of 1987, L.N. 276 of 1987, 64 of 1987, L.N. 373 of 1987, L.N. 412 of 1987, L.N. 413 of 1987, R.Ed. 1987, 26 of 1988, 68 of 1988, L.N. 106 of 1988, L.N. 255 of 1988, L.N. 272 of 1988, L.N. 285 of 1988, L.N. 300 of 1988, L.N. 346 of 1988, L.N. 5 of 1989, L.N. 66 of 1989, L.N. 75 of 1989, 10 of 1989, 14 of 1989, L.N. 283 of 1989, L.N. 333 of 1989, L.N. 397 of 1989, L.N. 412 of 1989, L.N. 413 of 1989, L.N. 30 of 1990, 3 of 1990, L.N. 79 of 1990, 29 of 1990, L.N. 210 of 1990, 43 of 1990, L.N. 63 of 1991, 41 of 1991, 95 of 1991, L.N. 407 of 1991, 67 of 1992, 68 of 1992, 82 of 1992, L.N. 82 of 1993, L.N. 96 of 1993, L.N. 146 of 1993, 77 of 1993, 94 of 1993, L.N. 120 of 1994, L.N. 449 of 1994, L.N. 450 of 1994, 49 of 1995, L.N. 307 of 1995, 62 of 1995, L.N. 70 of 1996, L.N. 336 of 1996, 4 of 1997; Exchange Fund Ordinance, ch. 66 of the Laws of Hong Kong, originally 54 of 1935 (Cap. 66, 1950 Ed.) - 44 of 1936, 57 of 1936, 9 of 1937, 21 of 1939, 12 of 1946, 20 of 1948, 4 of 1951, 54 of 1956, 14 of 1958, 6 of 1964, 31 of 1968, 47 of 1968, 57 of 1970, 90 of 1970, 25 of 1971, L.N. 150 of 1971, L.N. 125 of 1972, 8 of 1975, 7 of 1978, 17 of 1979, L.N. 56 of 1980, L.N. 173 of 1980, L.N. 363 of 1980, L.N. 388 of 1981, 26 of 1983, 16 of 1984, 76 of 1984, 27 of 1986, L.N. 64 of 1987, R.Ed. 1987, L.N. 333 of 1989, 82 of 1992, 58 of 1993, 81 of 1994, L.N. (C) 40 of 1994 (Chinese authentic version), 12 of 1995, § 5A.

<sup>16</sup> See ZHONGHUA RENMIN GONGHEGUO XIANFA [The Constitution of the People's Republic of China] ch. III, arts. 57-61 (1982), translated in [1 Business Regulation] China Laws for Foreign Bus. (CCH) ¶ 4-500 (1982) [hereinafter China Laws].

<sup>17</sup> See *id.* arts. 62, 85-86.

<sup>18</sup> See Guowuyuan Guanyu Jinyibu Jiaqiang Zhengjuan Hongguan Guanli de Tongzhi [Notice from the State Council Regarding the Further Strengthening of the Overall Administration of the Securities Market], Dec. 17, 1992, FALÜ FAGUI, *supra* note 3, 2-6-5-IV\*4 [hereinafter Document 68], translated in INTERNATIONAL SECURITIES INSTITUTE LIMITED, THE P.R.C. SECURITIES MARKET HANDBOOK NSCR-1 (1994) [hereinafter ISI HANDBOOK].

including the Ministry of Finance, the State Planning Commission, the Ministry of Foreign Trade and Economic Cooperation and the State Commission for Restructuring the Economic System; the CSRC Chairman also serves as Deputy Director of SCSC.<sup>19</sup>

The Shanghai Stock Exchange ("SHSE") was established in 1990, and the Shenzhen Stock Exchange ("SZSE") in 1991; these exchanges are supervised by the CSRC and, respectively, by the Shanghai and Shenzhen Municipal Securities Administrative Offices, which are agencies of the municipal governments.<sup>20</sup> However, these local agencies also operate under the guidance of the SCSC and CSRC, and in 1996, the State Council acted to strengthen the role of the CSRC, giving it more effective control in supervising the exchanges.<sup>21</sup>

Several other organs of P.R.C. government under the State Council are important to the capital markets.

The State Planning Commission ("SPC") has general authority over economic planning.<sup>22</sup>

The State Commission on Restructuring the Economic System ("SCRES") has responsibility for conversion of government enterprises into joint stock companies.<sup>23</sup>

The State-Owned Assets Administration Bureau ("SAAB") is responsible for state-owned assets, and is a key actor in the reorganization of Chinese companies preparing for an equity offering.<sup>24</sup>

The State Administration of Industry and Commerce ("SAIC") is responsible for administrative supervision of Chinese companies,

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<sup>19</sup> See W. William A. Woods & Susan M. Selwyn, *The Securities Markets of the People's Republic of China*, ISI HANDBOOK, *supra* note 18, at 1, 93-95.

<sup>20</sup> The SHSE and SZSE were established prior to the creation of the SCSC and CSRC pursuant to municipal government authorizations in the two cities. See EUGENE MARANS & MICHAEL HICKMAN, INTERNATIONAL SECURITIES INSTITUTE, CUSTODIAL SERVICES IN ASIA, PRC 56, 58, 60 (1993).

<sup>21</sup> See Document 68, *supra* note 18; Zhengjian Jiaoyisuo Guanli Banfa [Securities Exchange Administration Measures], Aug. 21, 1996, *reprinted in* JINRONG RIBAO [FINANCIAL DAILY], Aug. 30, 1996; *see also* *Stock Exchange Administration Procedures*, CHINA L. & PRAC., Sept. 1996, at 9-10.

<sup>22</sup> See Document 68, *supra* note 18.

<sup>23</sup> See *id.*

<sup>24</sup> See Guoyou Qiye Caichan Jiandu Guanli Tiaoli [Regulation on the Supervision and Administration of the Assets of State-Owned Enterprises], July 24, 1994, FALÜ FAGUI, *supra* note 3, 2-2-0-III•5.

which among other things, includes the issuance of business licenses and the maintenance of on-going business registration records.<sup>25</sup>

The People's Bank of China ("PBOC")<sup>26</sup> licenses all financial institutions including banks and securities firms, regulates financial institutions and — together with the SPC and the State Administration of Foreign Exchange — controls borrowings by P.R.C. entities.<sup>27</sup>

The State Administration of Foreign Exchange ("SAFE") supervises foreign exchange transactions including borrowings in foreign currencies.<sup>28</sup>

The Ministry of Finance ("MOF") is responsible for sovereign borrowings by the P.R.C., including domestic and foreign bond issues.<sup>29</sup>

### 3. LAWS AND RULES

Neither Hong Kong nor the P.R.C. has a unified source of laws and rules for the securities markets. However, with the consolidation of regulatory powers under all the relevant statutes in the SFC, the laws and rules in Hong Kong are reasonably well integrated. In the P.R.C., while the CSRC has the most significant role in the securities markets, other agencies have powers which interact with those of the CSRC, sometimes in complex ways.

The principal laws in Hong Kong pertinent to capital raising

<sup>25</sup> See *Zhonghua Renmin Gongheguo Qiye Faren Dengji Guanli Tiaoli* [Regulations on the Registration of Enterprise Legal Persons], July 22, 1991, FALÜ FAGUI, *supra* note 3, 4-21-0-III•5, translated in [2 Business Regulation] China Laws, *supra* note 16, ¶ 13-542.

<sup>26</sup> See *Zhonghua Renmin Gongheguo Zhongguo Renmin Yinhang Fa* [The People's Bank of China Law], Mar. 18, 1995, translated in [1 Business Regulation] China Laws, *supra* note 16, ¶ 8-450.

<sup>27</sup> See *id.*; Document 68, *supra* note 18; *Zhonghua Renmin Gongheguo Waihui Guanli Tiaoli* [The People's Republic of China Foreign Exchange Administration Regulations], Jan. 29, 1996, FALÜ FAGUI, *supra* note 3, 4-4-2-III•16, translated in [1 Business Regulation] China Laws, *supra* note 16, ¶ 8-540.

<sup>28</sup> See *People's Republic of China Foreign Exchange Administration Regulations*, *supra* note 27.

<sup>29</sup> See *Guowuyuan Guanyu Jinyibu Jiaqiang Jieyong Guoji Shangye Daikuan Hongguan Guanli de Tongzhi* [State Council Notice on the Further Strengthening of Overall Administration of International Commercial Loans], Sept. 27, 1995, art. 2, FALÜ FAGUI, *supra* note 3, 4-4-1-IV•14.



are:

Securities Ordinance ("SO") — sets forth general provisions for registration of securities industry participants, supervision of exchanges and dealers and prevention of improper trading practices;<sup>30</sup>

Protection of Investors Ordinance ("PIO") — prohibits public solicitations of securities transactions except by regulated firms, pursuant to a qualified prospectus or in an exempted transaction;<sup>31</sup>

Securities (Disclosure of Interests) Ordinance ("SDIO") — requires substantial shareholders, directors and chief executives of Hong Kong listed companies to disclose interests in securities of the company;<sup>32</sup>

Securities (Insider Dealing) Ordinance ("SIDO") — prohibits insider trading;<sup>33</sup>

Companies Ordinance ("CO") — prescribes prospectus content and other requirements for company offerings of securities by companies incorporated in and outside of Hong Kong;<sup>34</sup> and

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<sup>30</sup> SO, *supra* note 6.

<sup>31</sup> Protection of Investors Ordinance, ch. 335 of the Laws of Hong Kong, originally 13 of 1974, L.N. 38 of 1974, L.N. 56 of 1974, 9 of 1983, R.Ed. 1983, 10 of 1989, 44 of 1989, R.Ed. 1989, 7 of 1991, 82 of 1992, 77 of 1993, 94 of 1993, 54 of 1994 [hereinafter PIO].

<sup>32</sup> Securities (Disclosure of Interests) Ordinance, ch. 396 of the Laws of Hong Kong, originally 63 of 1988 - R.Ed. 1988, 10 of 1989, 45 of 1990, 68 of 1991, 68 of 1992, 82 of 1992, 49 of 1995, 62 of 1995 [hereinafter SDIO].

<sup>33</sup> Securities (Insider Dealing) Ordinance, ch. 395 of the Laws of Hong Kong, originally 62 of 1990 - 69 of 1991, 68 of 1992, 29 of 1994, 61 of 1995, 62 of 1995, L.N. 391 of 1996 [hereinafter SIDO].

<sup>34</sup> Companies Ordinance, ch. 32 of the Laws of Hong Kong, originally 39 of 1932 (Cap.32, 1950) - 29 of 1933, 24 of 1935, 15 of 1936, 20 of 1948, 1 of 1949, 9 of 1950, 22 of 1950, 24 of 1950, 23 of 1952, 15 of 1955, 25 of 1958, 4 of 1963, 30 of 1964, 22 of 1965, L.N. 100 of 1968, L.N. 151 of 1969, 21 of 1970, 24 of 1970, 41 of 1970, 49 of 1970, L.N. 72 of 1971, 27 of 1971, 71 of 1971, L.N. 183 of 1972, 68 of 1972, 78 of 1972, 14 of 1973, 20 of 1973, 12 of 1974, 14 of 1974, 55 of 1974, 57 of 1974, 68 of 1974, 74 of 1974, 80 of 1974, L.N. 58 of 1975, 26 of 1975, 49 of 1975, 74 of 1975, 80 of 1975, 92 of 1975, 4 of 1976, L.N. 223 of 1976, 81 of 1976, L.N. 16 of 1977, 4 of 1977, 36 of 1977, L.N. 149 of 1977, L.N. 48 of 1978, 24 of 1978, 51 of 1978, 69 of 1979, 31 of 1981, L.N. 55 of 1983, 6 of 1983, 20 of 1983, 6 of 1984, 46 of 1984, R.Ed. 1984, L.N. 67 of 1985, 12 of 1985, 25 of 1985, 77 of 1985, 27 of 1986, 10 of 1987, 38 of 1987, 48 of 1987, 52 of 1987, 12 of 1988, 55 of 1988, 79 of 1988, 38 of 1989, 41 of 1989, L.N. 242 of 1989, 7 of 1990, 17 of 1990, 28 of 1990, 32 of 1990, 59 of 1990, 60 of 1990, 54 of 1991, 77 of 1991, 68 of 1992, 75 of 1992, 86 of 1992, 88 of 1992,

SEHK Rules Governing the Listing of Securities ("SEHK Listing Rules") — establish disclosure and governance requirements in relation to issuers of securities listed on the SEHK.<sup>35</sup>

The principal laws and rules in the P.R.C. pertinent to capital raising are:

Company Law of the People's Republic of China ("Company Law") — general corporate formation and governance rules, some of which expressly apply to listed companies and the issuance of debt or equity securities;<sup>36</sup>

Regulations of the State Council on Foreign Capital Shares Listed in China by Companies Limited by Shares,<sup>37</sup> and Implementing Rules of the State Council on Foreign Capital Shares Listed in China by Companies Limited by Shares<sup>38</sup> — requirements for B share offerings;

Notice from the State Council Regarding the Further Strengthening of the Overall Administration of the Securities Market — policy guidelines regarding the strict implementation of securities regulations;<sup>39</sup>

Interim Regulations on Share Issuing and Trading — regulations on the listing and offering process and certain

8 of 1993, 10 of 1993, L.N. 187 of 1993, L.N. 188 of 1993, L.N. 231 of 1993, 75 of 1993, 94 of 1993, L.N. 187 of 1994, 30 of 1994, L.N. 371 of 1994, 72 of 1994, L.N. 570 of 1994, 13 of 1995, 49 of 1995, L.N. (C) 52 of 1995 (Chinese authentic version), 62 of 1995, 68 of 1995, 83 of 1995, L.N. 11 of 1996, L.N. 135 of 1996, L.N. 235 of 1996, L.N. 306 of 1996, 68 of 1996, 76 of 1996, 3 of 1997 [hereinafter CO].

<sup>35</sup> Stock Exchange of Hong Kong Limited, Rules Governing the Listing of Securities, Third Edition December 1989, as amended by Update Nos. 1 (issued January 1990) to 31 (issued January 1997) [hereinafter SEHK Listing Rules].

<sup>36</sup> Zhonghua Renmin Gongheguo Gongsifa, Dec. 29, 1993, [The Company Law of the People's Republic of China], FALŪ FAGUI, *supra* note 3, 2-6-1-I-2 [hereinafter Company Law], translated in [2 Business Regulation] China Laws, *supra* note 16, ¶ 13-518.

<sup>37</sup> Guowuyuan Guanyu Gufen Youxian Gongsijingnei Shangshi Waizigude Guiding [State Council Regulations Regarding the Domestic Listing of Foreign Invested Shares of Companies Limited by Shares], Dec. 25, 1995, FALŪ FAGUI, *supra* note 3, 2-6-5-III•5 [hereinafter State Council B Share Regulations], translated in CHINA L. & PRAC., Apr. 1996, at 20-27.

<sup>38</sup> Gufen Youxian Gongsijingnei Shangshi Waizigude Shishi Xize [Implementing Rules for the Regulations for the Domestic Listing of Foreign Invested Shares of Companies Limited by Shares], Dec. 25, 1995, FALŪ FAGUI, *supra* note 3, 2-6-5-III•6, translated in CHINA L. & PRAC., Sept. 1996, at 26-35.

<sup>39</sup> Document 68, *supra* note 18.

secondary market activities;<sup>40</sup>

Securities Exchange Administration Measures — provisions on the establishment and administration of exchanges in China;<sup>41</sup>

Interim Measures on the Prevention of Securities Fraud — prohibits insider trading, market manipulation and general fraud;<sup>42</sup>

Detailed Implementing Rules on the Disclosure of Information by Companies Making Public Offerings of Shares (Trial Implementation),<sup>43</sup> and Standard Form and Content of Information for Disclosure by Companies Making Public Issues, Form No. 1 and Prospectus Contents (Trial Implementation)<sup>44</sup> — disclosure requirements generally, including periodic reporting requirements and obligations to announce and publish material events;

Special Provisions of the State Council on Overseas Share Offers and Listings of Companies Limited by Shares — general requirements for the issuance of H or N shares;<sup>45</sup>

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<sup>40</sup> Gupiao Faxing yu Jiaoyi Guanli Zanzing Tiaoli [Provisional Regulations on the Administration of Share Issuance and Trading], Apr. 22, 1993, [hereinafter Provisional Regulations], FALÜ FAGUI, *supra* note 3, 2-6-5-III•1, translated in [2 Business Regulation] China Laws, *supra* note 16, ¶ 13-574.

<sup>41</sup> Securities Exchange Administration Measures, *supra* note 21, replacing Zhengjuan Jiaoyisuo Guanli Zanzing Banfa, [Provisional Measures for the Administration of Securities Exchanges], July 7, 1993, translated in [2 Business Regulation] China Laws, *supra* note 16.

<sup>42</sup> Jinzhi Zhengjuan Qizha Xingwei Zanzing Banfa [Provisional Measures for the Prohibition of Securities Fraud], Sept. 2, 1993, FALÜ FAGUI, *supra* note 3, 2-6-5-III•3, translated in [2 Business Regulation] China Laws, *supra* note 16, ¶ 13-558 [hereinafter Measures to Prohibit Fraud].

<sup>43</sup> Gongkai Faxing Gupiao Gongsì Xinxì Pilu Shìshì Xìze [Detailed Implementing Rules for Disclosure of Information by Companies which Publicly Issue Shares], July 10, 1993, translated in ISI HANDBOOK, *supra* note 18, NSR-1.

<sup>44</sup> Zhaogu Shuomingshu de Neirong yu Geshì Gongkai Faxing Gupiao Gongsì Xinxì Pilu de Neirong yu Geshì Zhunze Diyi Hao [Prospectus Form and Content, Principles for the Content and Form of Disclosure of Information by Companies which Publicly Issue Shares No. 1], June 3, 1993 [hereinafter Standards for Disclosure by Companies Issuing Shares], translated in ISI HANDBOOK, *supra* note 18, NSR-1.

<sup>45</sup> Guowuyuan Guanyu Gufen Youxian Gongsì Jingwai Muji Gufen jì Shangshì de Tebie Guiding [Special Regulations of the State Council Regarding Offerings and Listings Outside China by Companies Limited by Shares], Aug. 4, 1994 [hereinafter State Council Special Regulation on Foreign Share Offerings], FALÜ FAGUI, *supra* note 3, 2-6-5-III•4, translated in [2 Business Regulation] China Laws, *supra* note 16, ¶ 13-552.

Notice Regarding the Provision of Guidance for Companies which Issue Shares to the Public — requires underwriters to assist issuers with initial public offerings and post-offering compliance matters;<sup>46</sup>

Shanghai Securities Exchange Trial Implementation Rules for Trading Market Operations — includes listing application requirements;<sup>47</sup>

Shenzhen Interim Measures for the Supervision and Administration of Listed Companies — periodic reporting and other post-offering disclosure requirements;<sup>48</sup>

Shenzhen Interim Measures for the Administration of the Issue and Trading of Shares — regulations on the listing and offering process and certain secondary market activities;<sup>49</sup> and

Operating Rules of the Shenzhen Stock Exchange — includes listing application requirements.<sup>50</sup>

The SFC has recently proposed a consolidation and clarification of eight of the statutes it currently administers.<sup>51</sup> No major changes are contemplated, and simplification is the main goal. The SFC's objective is to have this recodification enacted before

<sup>46</sup> Guangyu dui Faxing Gupiao Gongsi Jinxing Fudao de Tongzhi [Notice Regarding Providing Guidance for Companies which Issue Shares], Sept. 11, 1995, *translated in* ISI HANDBOOK, *supra* note 18, NSR-1.

<sup>47</sup> Shanghai Zhengjuan Jiaoyisuo Jiaoyi Shichang Yewu Shixing Guiding [Shanghai Securities Exchange Trial Regulations on Market Trading Operations], Nov. 26, 1990 [hereinafter Shanghai Regulations], *translated in* ISI HANDBOOK, *supra* note 18, SHSER-1.

<sup>48</sup> Shenzhenshi Shangshi Gongsi Jianguan Zanxing Banfa [Shenzhen Municipality Provisional Measures for the Supervision and Administration of Listed Companies], Apr. 4, 1992 [hereinafter Shenzhen Provisional Measures for Listed Companies], *translated in* ISI HANDBOOK, *supra* note 18, SZC-1.

<sup>49</sup> Shenzhenshi Gupiao Faxing yu Jiaoyi Guanli Zanxing Banfa [Shenzhen Municipality Provisional Measures on the Administration of the Issuance and Trading of Shares], May 15, 1991 [hereinafter Shenzhen Provisional Measures on Issuance and Trading of Shares], *translated in* ISI HANDBOOK, *supra* note 18, SZSR-1.

<sup>50</sup> Shenzhen Zhengjuan Jiaoyisuo Yewu Guizhi [Shenzhen Securities Exchange Operating Rules], June 22, 1991 [hereinafter Shenzhen Operating Rules], *translated in* ISI HANDBOOK, *supra* note 18, SZSER-1.

<sup>51</sup> SECURITIES AND FUTURES COMMISSION, A DRAFT FOR A COMPOSITE SECURITIES AND FUTURES BILL (1996) [hereinafter SFC DRAFT COMPOSITE BILL]; SECURITIES AND FUTURES COMMISSION, A CONSULTATION PAPER ON A DRAFT FOR A COMPOSITE SECURITIES AND FUTURES BILL (1996) [hereinafter SFC CONSULTATION PAPER]; SECURITIES AND FUTURES COMMISSION, MAIN PROPOSED REVISIONS TO A DRAFT FOR A COMPOSITE SECURITIES AND FUTURES BILL (1996) [hereinafter SFC REVISIONS TO DRAFT COMPOSITE BILL].

the hand-over — it is unclear whether that will be achieved. In the P.R.C., a national securities law has been drafted and under review and revision for several years.<sup>52</sup> The P.R.C. market would benefit from the clarifications and improvements such a law might provide. However, the law's progress may be impaired by political struggles over the allocation of authority with respect to securities and other financial markets, or concern that the P.R.C.'s market experiment might have gone too far. The P.R.C. seems to be continuing an incremental approach to improving financial market regulation, rather than a major reform, and the future of the draft securities law is uncertain.

#### 4. CONTROL OF ACCESS TO CAPITAL MARKETS

The most evident difference between Hong Kong and P.R.C. capital markets lies in the degree of regulatory control over access to the capital raising process, in particular for the raising of new equity for enterprises. Hong Kong has essentially no formal controls, though certain listing and disclosure rules may have some impact on access. In the P.R.C., there is an elaborate process for a company to obtain government approval to raise capital by issuing securities.

An offering of stock listed on the SEHK is the primary means of equity capital raising in Hong Kong. Not only does the SEHK have a statutory monopoly on stock exchange activity, but Hong Kong law prohibits a dealer from trading a listed stock on an exchange other than the SEHK, and also prohibits such trading, whether or not on an exchange, for other than immediate delivery<sup>53</sup>; these provisions have tended to impair development in Hong Kong (though not offshore) of trading in Hong Kong stocks other than on the SEHK.

The SEHK's Listing Rules set forth preconditions of a new listing, including requirements that the company have had profitable operations in the past three years under essentially the same management, and that it maintain a sufficient management presence in Hong Kong, normally at least two of its executive directors.<sup>54</sup> In addition, both the issuer and its business must, in

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<sup>52</sup> See *China Regulations: Securities Law Now in 14th Draft*, EIU ViewsWire, Apr. 11, 1996, available in LEXIS, News Library, Wires File.

<sup>53</sup> See SO, *supra* note 6, §§ 22, 76(1)(b).

<sup>54</sup> See SEHK Listing Rules, *supra* note 35, §§ 8.05, 8.12.

the SEHK's opinion, be suitable for listing — for example, not subject to conflicts with business conducted by a controlling shareholder.<sup>55</sup> Based on its authority to determine suitability for listing, the SEHK has the ability to restrict access to capital through the listing process.

Prospectuses for offerings in Hong Kong must be approved under the CO by the Registrar of Companies based on review of compliance with disclosure requirements; while review of a prospectus once rested with the Registrar, that responsibility moved to the SFC, and then to the SEHK for listed issuers.<sup>56</sup> The review process, while not directly addressed to the merits of the offering, can be exacting, and exchange personnel may take an active role in defining and developing disclosures including disclosures not specified by the rules. The SEHK's role in interpreting and applying disclosure standards also therefore can have an indirect but potentially significant effect on an issuer's access to the market.

Once a company is listed, it may issue additional stock without stringent prospectus disclosure or detailed regulatory review, as in a placing to institutional investors.<sup>57</sup> Further, for immediate access to large amounts of equity capital, issuers can arrange for a major shareholder to sell a block, and then replenish the shareholder's ownership through a new issue of shares to that shareholder.<sup>58</sup> This two-step approach — sometimes referred to as a placing and top-up — effectively assures that the company obtains current market pricing for the entire block. In addition, rights offerings, where a company grants existing shareholders the right to buy additional shares, may be accomplished under SEHK Listing Rules with minimal burden (provided the company is already listed). SEHK Listing Rules do require shareholder approval for issuance of shares, except in situations where

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<sup>55</sup> See *id.* §§ 8.04, 8.10.

<sup>56</sup> See CO, *supra* note 34, §§ 38D, 342C; SFCO, *supra* note 10, § 47; Securities and Futures Commission (Transfer of Functions) Order, Feb. 1, L.N. 15 of 1993.

<sup>57</sup> See SEHK Listing Rules, *supra* note 35, §§ 7.09-12 & app. 6 (Placing Guidelines for Equity Securities); CO, *supra* note 34, §§ 38(3), 48A, 343(2).

<sup>58</sup> These transactions generally follow principles for placing stock of a class previously listed, and the rules on transactions with connected persons apply, requiring board approval and disclosure. See SEHK Listing Rules, *supra* note 35, ch. 14 (Equity Securities — Notifiable Transactions).

shareholders have already granted a general mandate to directors of the company to authorize issuance of new shares not exceeding in the aggregate twenty percent of the company's issued capital.<sup>59</sup>

Access to equity capital in the P.R.C. is intimately related to the introduction of market economics and the reform of the state sector, a gradual process which is proceeding with some difficulty. To date, the most challenging part of this process is the first step of creating a company limited by shares out of assets and economic activities previously part of the command economy. If securities are to be issued following a successful reorganization, the opportunity for a public issue is itself allocated by government, and the terms of the securities and the markets in which they are offered or listed are also controlled. The process is complex and involves local, regional, and national political issues in addition to business and economic factors.

The reorganization of state activities into corporate structures in the P.R.C. is guided by SCRES, which has power to approve the establishment of companies limited by shares, particularly in the context of preparing for a public offering of securities.<sup>60</sup> A number of other state agencies must pass on various aspects of the reorganization process. Significant among these is the governmental agency with regulatory authority over the industrial sector in which the enterprise operates. Such agencies often play a substantial role in determining which enterprises are reorganized and their policies for those enterprises and the industry as a whole may directly affect the success of a potential offering. Agencies with broader responsibilities are also directly involved in reorganizing enterprises. The SAAB is responsible for ensuring that state assets are valued fairly in the reorganization process; this is accomplished by appraisal, conducted by a firm licensed by the SAAB.<sup>61</sup> Valuation of land and buildings for this purpose

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<sup>59</sup> See *id.* app. 7 (Listing Agreement), pt. A, ¶ 19(b)(2), pt. B, ¶ 19(b)(2); CO, *supra* note 34, § 57B.

<sup>60</sup> Prior to the enactment of the Company Law, SCRES was one of the primary regulators involved in the creation of companies limited by shares, and it continues to play a role today. See Document 68, *supra* note 18; Company Law, *supra* note 36.

<sup>61</sup> See Congshi Zhengjuan Yewu Zichan Pinggu Jigou Zige Queren de Guiding [Provision on Confirmation of Qualifications of Assets Valuation Organizations Engaging in Securities Business], Mar. 20, 1993, translated in ISI HANDBOOK, *supra* note 18, NSR-1.

implicates an additional body, the State Owned Land Administration Bureau ("SLAB"), and each local branch of the SLAB where any relevant real property interests are located.<sup>62</sup> Regional or municipal government agencies for areas where the stated-owned assets or activities are located also may have roles in the process.<sup>63</sup> Once valued and approved for reorganization, the newly constituted company must register with the SAIC, and formal existence of the company commences with the issuance by the SAIC of a business license.<sup>64</sup>

The creation of a company limited by shares in the P.R.C. may result in several different types of ownership. The P.R.C. government normally retains for itself a substantial (usually majority) ownership of the company through securities referred to as "State shares," which do not trade. In addition, state owned enterprises or companies under government control may hold shares, known as "legal person" shares; these shares may be transferred to a limited degree in the P.R.C. outside exchanges. Shares listed on the SHSE and SZSE and owned or traded by P.R.C. persons are generally referred to as "A" shares. Certain Chinese companies have also issued so-called "B" shares, which are — like A shares — denominated in P.R.C. currency — called renminbi or yuan — but settle in U.S. or Hong Kong dollars in trading on the SHSE and on the SZSE, respectively. Certain P.R.C. companies have been allowed to issue shares which are publicly traded outside the P.R.C. These shares are essentially of the same sort as B shares, and are usually traded in Hong Kong dollars and listed on the SEHK ("H" shares) or sometimes in the form of American Depository Receipts on the New York Stock Exchange ("N" shares). Similar offerings may also be allowed in the future on other non-P.R.C. exchanges. For example, an understanding has been reached on listings of P.R.C. enterprises

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<sup>62</sup> See Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zanxing Tiaolie [Provisional Regulations of the People's Republic of China Regarding the Grant and Assignment of the Right to Use State Land in Urban Areas], May 24, 1990, FALÜ FAGUI, *supra* note 3, 2-2-0-III•3, translated in [2 Business Regulation] China Laws, *supra* note 16, ¶ 14-716.

<sup>63</sup> For example, labor and pension matters are as a practical matter regulated locally, as is environmental compliance.

<sup>64</sup> See Regulations on the Registration of Enterprise Legal Persons, *supra* note 29.



on the London Stock Exchange.<sup>65</sup> A shares are available only to P.R.C. persons, and B, H and N shares may be sold only to non-P.R.C. persons.<sup>66</sup>

Once an enterprise has been reorganized, the principal control over whether it may issue stock under current regulations is exercised by the SCSC and the CSRC, although various other agencies are consulted.<sup>67</sup> Further, as in Hong Kong, the exchanges on which stocks are listed, SHSE and SZSE, have rules requiring, as a precondition to listing, that issuers meet certain standards of financial size and profitability.<sup>68</sup> Under national rules, a company in the P.R.C. seeking a listing for its public offering must meet a minimum share capital test, have three years of profitable operations, and not have committed a violation of law or had false financial statements in the past three years.<sup>69</sup>

## 5. DISCLOSURE REQUIREMENTS

The availability of information is important for investors to evaluate the relative merits of investments in different companies. Some investors may not use company-specific information in such a way — a general judgment that a country, market or industry sector is growing or shrinking may be a sufficient basis for purchase or sale of affected securities. But many investors do make company-specific judgments, requiring assessment of the relative values of different securities. These judgments are the means through which capital is allocated among companies based on their return/risk characteristics and the supply of and demand for capital. In addition, disclosure requirements may provide a

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<sup>65</sup> See THE CHINA SECURITIES REGULATORY COMMISSION — HER MAJESTY'S TREASURY AND THE SECURITIES AND INVESTMENTS BOARD, MEMORANDUM OF UNDERSTANDING ON MUTUAL ASSISTANCE AND THE EXCHANGE OF INFORMATION CONCERNING REGULATORY COOPERATION IN SECURITIES AND FUTURES MATTERS (1996).

<sup>66</sup> See State Council B Shares Regulations, *supra* note 37, art. 4; State Council Special Regulation on Foreign Share Offerings, *supra* note 45., art. 2.

<sup>67</sup> See Document 68, *supra* note 18; Company Law, *supra* note 36; State Council B Share Regulations, *supra* note 37, art. 7; Provisional Regulations, *supra* note 40, arts. 5, 12; State Council Special Regulation on Foreign Share Offerings, *supra* note 45, art. 2.

<sup>68</sup> See Shanghai Regulations, *supra* note 47, art. 33; Shenzhen Provisional Measures on Issuance and Trading of Shares, *supra* note 49, arts. 15, 37.

<sup>69</sup> See Provisional Regulations, *supra* note 40, arts 8-9, 30; Company Law, *supra* note 36, art. 152

degree of protection against fraud and misrepresentation simply by demanding greater discipline and effort by companies and their advisors in making information available.

Both Hong Kong and the P.R.C. authorities have adopted requirements that a company seeking to obtain a listing for its stock, or to offer shares to the public, must publicly disclose information about the businesses, properties, material contracts, financial condition and results, management, controlling persons and other matters, either in the form of listing documents or prospectus or offering memoranda; and for offerings of securities, the rules generally require disclosures of additional matters including the use of proceeds of such an offering.<sup>70</sup> Listed companies in both Hong Kong and the P.R.C. have obligations to report material events when they occur, and financial results at least every six months; material events include such matters as significant losses, contracts, litigation, or acquisitions.<sup>71</sup> These requirements are based largely on similar requirements in established markets, especially the United States (for the P.R.C.) and the United Kingdom (for Hong Kong). As adopted in both Hong Kong and the P.R.C., these rules are thorough and demanding.

Hong Kong and the P.R.C. thus accept the proposition that companies, for securities offerings and for secondary market trading, should disclose information sufficient to allow investors to make reasoned decisions about investments. The principal issue is one of implementation. Hong Kong has higher standards and enforces better adherence to the rules than the P.R.C.

The most important disclosures are financial. Financial statements are the universal language and common denominator for evaluation of investments, an area where, as yet, the P.R.C., does not conform to international standards. Examples of

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<sup>70</sup> See CO, *supra* note 34, §§ 38, 342 & Third Schedule (Matters to be Specified in Prospectus and Reports to be Set Out Therein); SEHK Listing Rules, *supra* note 35, app. 1 (Contents of Listing Documents); Provisional Regulations, *supra* note 40, art. 15; Standards for Disclosure by Companies Issuing Shares, *supra* note 44.

<sup>71</sup> See SEHK Listing Rules, *supra* note 35, app. 7 (listing agreement), pt. A, ¶¶ 2-11, pt. B, ¶¶ 2-11; Provisional Regulations, *supra* note 40, arts. 57-60; Detailed Implementing Rules for Disclosure of Information by Companies which Publicly Issue Shares, *supra* note 43; see also Shanghai Regulations, *supra* note 47, arts. 40-41; Shenzhen Provisional Measures for Listed Companies, *supra* note 48, ch. 3.

weaknesses in the P.R.C.'s accounting rules include carrying of assets at cost when write-down to market value would be the international norm, and fixing reserves against bad debts at arbitrarily low levels, when higher reserving or write-off would be required if the real likelihood of repayment were considered.<sup>72</sup> These examples may tend to overstate the results of P.R.C. enterprises; other accounting differences, such as use of official rather than market rates for currency translation, may simply result in non-comparability, and difficulties for international participants in making reasoned investment judgments.

There are indications that the P.R.C. is taking disclosure matters more seriously, at least with respect to fraud. A 1995 decision of the NPC Standing Committee set standards for crimes mentioned in the Company Law, including preparation of a false prospectus, share subscription application, or corporate bond offer.<sup>73</sup> To improve the standards for disclosure by listed companies, the CSRC recently issued new rules which enable it or its designated representatives to conduct periodic examinations of listed companies.<sup>74</sup> In addition the SHSE has established requirements that company secretaries for listed companies be designated as disclosure officers and assume direct personal responsibility for disclosure by their companies.<sup>75</sup>

In one aspect of disclosure, Hong Kong and the P.R.C. are perhaps more progressive than developed markets. Both SEHK and P.R.C. regulations contemplate the inclusion of profit

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<sup>72</sup> See Peter Wang & Tang Qing Liang, *The Current Status of Accounting in the People's Republic of China*, in ISI HANDBOOK, *supra* note 18; K. M. Wong, *The History of Accounting Development in the P.R.C.*, in ISI HANDBOOK, *supra* note 18; Wilfred Wong & Paul Yeung, *Recent Accounting and Auditing Developments in the People's Republic of China*, in ISI HANDBOOK, *supra* note 18.

<sup>73</sup> See Quanguo Renmin Daibiao Dahui Changwei Huiyuan Hui Guanyu Chengzhi Weifan Gongsi Fa de Fanzui de Jueding [Decision of Standing Committee of the National People's Congress on Punishment of Crimes Violating the Company Law], 8th Cong., Standing Committee 12th Sess. (1995).

<sup>74</sup> See Shangshi Gongsi Jiancha Zhidu Shishi Banfa [Implementing Measures for the Examination System of Listed Companies], Jan. 20, 1997, ZHONGGUO ZHENGJUAN BAO [CHINA SECURITIES], Jan. 20, 1997.

<sup>75</sup> See Foo Choy Peng, *New Rules Put Company Secretaries on Information Frontline at A-Share Firms*, S. CHINA MORNING POST, Aug. 14, 1996, at B3.

forecasts in official disclosure documents.<sup>76</sup> Because of fears of liability for forecasts which do not come true, and concerns that forecasts would have to be updated, companies in the United States and other international markets tend not to disclose forecasts in official disclosure documents. However, in both Hong Kong and the P.R.C., disclosures of projections are common. This is a sound recognition that forecasts are critical to valuation; a danger for investors would arise only if the forecasts were not prepared with sufficient analysis and review.<sup>77</sup>

Many Hong Kong companies have experience with the information demands of international investors or lending banks, and are willing and able to respond with adequate reporting. P.R.C. companies listing H shares on the SEHK are also required to meet these standards. Similarly, Hong Kong companies have developed consistent accounting policies and effective audit practices, providing some assurance of the integrity of the disclosures which are disseminated. These factors are as yet present to a lower degree in the P.R.C., generating more concerns about the quality of the data informing capital commitment decisions.

## 6. OFFERING PRACTICES

Offerings of equity securities are conducted differently in the Hong Kong and P.R.C. markets. In Hong Kong, the SEHK Listing Rules allow several alternatives for listing and commencement of trading, but an underwritten subscription offering is usual.<sup>78</sup> A company usually arranges for a new stock issue through a group of brokers/dealers acting as underwriters, at least

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<sup>76</sup> See SEHK Listing Rules, *supra* note 35, app. 1 (Contents of Listing Documents), part A (Equity Securities — Not Yet Listed), para. 34 - (1)(b)2), part B (Equity Securities — Already Listed), para. 29(1)(b)2), part C (Debt Securities), para. 41(2)-(3); Standards for Disclosure by Companies Issuing Shares, *supra* note 44, § 19.

<sup>77</sup> In the United States, the Congress by amendment in 1996 to the Securities Act of 1933, and previously the Securities and Exchange Commission by rule, have sought to encourage use of forecasts in disclosure documents by providing protection against liability. See Securities Act of 1933, as amended, § 27A, 15 U.S.C. § 77z-2 (1996); Rule 175 under the Securities Act of 1933, 17 C.F.R. § 230.175 (1996).

<sup>78</sup> See SEHK Listing Rules, *supra* note 35, ch. 7 (Equity Securities, Methods of Listing).

one of which acts as "sponsor" for the issue.<sup>79</sup> The allocation of shares to interested investors is administered by the underwriters. Offerings of B shares to non-P.R.C. investors are likewise accomplished through groups of underwriters.<sup>80</sup> Share offerings of A shares have generally been conducted through a subscription and lottery process,<sup>81</sup> although rules have recently been adopted with respect to underwriters of A shares,<sup>82</sup> and underwriting may become more common.

In August 1992, there was excess demand for subscriptions to A shares being offered in Shenzhen. While citizens throughout the P.R.C. were eligible, subscriptions were physically available only for a short period at locations only in Shenzhen. Crowds gathered there, many were disappointed, and riots ensued. This incident was widely reported,<sup>83</sup> and contributed to adoption of new national securities regulations in late 1992 and 1993.

Regulations in the P.R.C., as in Hong Kong, require that, when an offering of shares is made and shares are listed, a minimum amount must be distributed to the public. In the P.R.C., the minimum is twenty-five percent of the shares being offered, subject to grant of exception down to ten percent for larger companies.<sup>84</sup> For H shares on the SEHK, at all times all must be held by the public; H shares held by the public must be at least ten percent of issued capital; and the sum of H shares and other shares held by the public (if any) must be at least twenty-five percent of issued capital.<sup>85</sup> For other listings in Hong Kong, twenty-five percent of the issued capital must be held by the public, subject to grant of exceptions down to ten percent for larger companies if such a lower percentage is not considered to

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<sup>79</sup> See *id.* § 3.01, app. 9 (Model Code for Sponsors).

<sup>80</sup> See *China Law-B-Share Rules*, CHINA ECON. REV., Jan. 9, 1996, at 32.

<sup>81</sup> See Provisional Regulations, *supra* note 40, arts. 20-28.

<sup>82</sup> See *China: Law-B-Share Rules*, *supra* note 80, at 32.

<sup>83</sup> See *China's Stockmarkets, Open Outcry*, ECONOMIST, Aug. 15, 1992, at 50; *Inquiry on Shenzhen Chaos, Vice-Premier Steps in Over Share Sales*, S. CHINA MORNING POST, Aug. 12, 1992, at 12; *Stock Trading Suspended in South China After Riots*, Reuters N. Am. Wire, Aug. 11, 1992, available in LEXIS, News Library, Wires File.

<sup>84</sup> See Provisional Regulations, *supra* note 40, art. 8(5); see also Shanghai Regulations, *supra* note 47, art. 33(3); Shenzhen Provisional Measures on Issuance and Trading of Shares, *supra* note 49, art. 37(5).

<sup>85</sup> See SEHK Listing Rules, *supra* note 35, § 19A.14(2).

compromise liquidity.<sup>86</sup> A broad distribution is required at listing, at least 100 investors (more for larger companies) in Hong Kong,<sup>87</sup> 1,000 in the P.R.C.<sup>88</sup> These requirements are designed to assure a minimum level of liquidity and trading interest for investors.

Hong Kong has an additional requirement for offerings made in both Hong Kong and other markets listed in the SEHK — an adequate number of shareholders from Hong Kong.<sup>89</sup> This goal has been achieved partly by restricting the number of shares in an offering allocated to prospective purchasers outside Hong Kong, while allowing reallocation of shares from Hong Kong to non-Hong Kong investors if the offering is not fully subscribed. This approach may add to liquidity in Hong Kong trading, and may give Hong Kong purchasers and securities firms larger shares of the offering than supply and demand would suggest. However, to the extent non-Hong Kong investors account for much of the trading in Hong Kong, requiring allocation to Hong Kong investors might tend to decrease liquidity, and disadvantage international investors to the detriment of Hong Kong as an international marketplace.

In underwritten offerings, underwriters may seek to stabilize the market price. Although in some circumstances such activity could be viewed as manipulation, major markets have rules expressly allowing stabilization in connection with a distribution.<sup>90</sup> Both Hong Kong and the P.R.C. have general prohibi-

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<sup>86</sup> See *id.* § 808(1).

<sup>87</sup> See *id.* § 8.08(2).

<sup>88</sup> See Provisional Regulations, *supra* note 40, art. 30(3). To the extent prior exchange standards are different, they are presumably superseded by the more recent national rule. See Shanghai Regulations, *supra* note 47, art. 33(4); Shenzhen Provisional Measures on Issuance and Trading of Shares, *supra* note 49, arts. 15(7), 37(5).

<sup>89</sup> See Joint Policy Statement on Offering Mechanisms, The Stock Exchange of Hong Kong Limited - Securities and Futures Commission, Nov. 4, 1994 [hereinafter Joint Policy Statement]; Global Offering Mechanism, Securities and Futures Commission - The Stock Exchange of Hong Kong Limited, July 1, 1996.

<sup>90</sup> See Regulation M under the Securities Exchange Act of 1934, 17 C.F.R. §§ 242.100 - .105 (effective Mar. 4, 1997) (replacing Rules 10b-6, 10b-7 and 10b-8); SECURITIES & FUTURES AUTHORITY, SFA RULEBOOK § 5-47, app. 16 (Stabilization Rules); SECURITIES AND INVESTMENTS BOARD, SIB RULEBOOK, FINANCIAL SERVICES (CONDUCT OF BUSINESS) RULES 1990 pt. 10 (Stabilization Rules) (1990).

tions against manipulation,<sup>91</sup> and the Hong Kong law expressly prohibits stabilization as defined by SFC rule,<sup>92</sup> but neither Hong Kong nor P.R.C. law provides specific exemptive relief for stabilization. SFC's proposed recodification of Hong Kong securities laws would add prohibitions expressly including stabilization of stock markets in and outside Hong Kong, and give the SFC the ability to create exemptions.<sup>93</sup> Yet, the SFC and SEHK have already approved a practice which has a potentially stabilizing effect.<sup>94</sup> Underwriters frequently sell more shares than are available in an offering, thus going "short" in a process called over-allotment; the underwriters then "buy-in" the short position in the market, with such purchases providing demand for and supporting the stock in the period immediately after an offering. The proposed law change could — absent concurrent adoption by the SFC of satisfactory exemption — create uncertainty and be inconsistent with Hong Kong's permissive posture on over-allotments, and could make it less attractive to list international stock offerings in Hong Kong.

Thus, Hong Kong stock offering practices are generally similar to practices in other developed markets, though in certain respects the Hong Kong rules may contain restrictions that could impede international offerings listed in Hong Kong. In the P. R. C., stock offerings rely on high retail demand for scarce supply, allowing direct distribution to investors. As the P.R.C. markets grow, and investors become more discriminating, additional techniques will likely develop to take advantage of the distribution by intermediaries, particularly for sales to institutions.

## 7. CORPORATE GOVERNANCE — PROTECTION OF SHAREHOLDER INTERESTS

Many companies in Hong Kong have controlling or majority shareholders, or are parts of groups of companies under common control or influence. In the P.R.C., the State retains a substantial if not majority ownership, directly or through state owned

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<sup>91</sup> See SO, *supra* note 6, § 35; Measures to Prohibit Fraud, *supra* note 42.

<sup>92</sup> See SO, *supra* note 6, § 146.

<sup>93</sup> See SFC DRAFT COMPOSITE BILL, *supra* note 51, §§ 12.6(1)(c), (2)(c), 12.16; SFC CONSULTATION PAPER, *supra* note 51, ¶ 122; SFC REVISIONS TO DRAFT COMPOSITE BILL, *supra* note 51, ¶ 97.

<sup>94</sup> See Joint Policy Statement, *supra* note 89.

enterprises, in nearly all companies, and some P.R.C. companies may also have other large, influential shareholders. Such patterns of ownership and control are common in developing economies where wealth remains concentrated in the government or a few private holders, and may continue to exist in developed economies.

Hong Kong law recognizes the primacy of the interests of shareholders generally, rather than those of controlling persons. The law in the P.R.C. also purports to recognize shareholder interests generally. Nevertheless, the legitimacy of such interests is not consistently acknowledged in a system that regards private ownership and market processes as experimental.

Protection of shareholder interests enhances the company's ability to raise capital. A stock investor's objective is to participate in the profitability of the company in proportion to that investor's interest in the company's capital, without being disadvantaged by special benefits to controlling persons or other parties. If providers of capital have less than full confidence that their interests will be served by the company, they will tend to pay less for the stock of the company, and the company will tend not to be able to raise as much capital. Regulations are designed to protect investors mainly through requiring disclosure and specific corporate procedures in conflict of interest situations.

For example, in Hong Kong, the SDIO applies to persons who individually or with others (in relationships defined by the law) hold ten percent or more of a company, as well as the directors and chief executive of the company (including shares owned by their family members). Under the SDIO, these persons must make public disclosure of their securities interests in the company and provide updates of disclosed information when there are changes. The enforcement provisions of this law are strong. A company can demand information of an investor, as can the Hong Kong government. If the information is not forthcoming, legal remedies are available, notably, freezing the shares.<sup>95</sup> In addition, if holdings in excess of thirty-five percent of a company are accumulated in the market, an offer to shareholders generally must be made and the Hong Kong rules relating to takeovers come into play.<sup>96</sup>

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<sup>95</sup> See SDIO, *supra* note 32, §§ 41, 44-47.

<sup>96</sup> See discussion *infra* Section 8.



The SEHK Listing Rules require that there be at least two non-executive, independent directors not affiliated with controlling shareholders. The SEHK has issued qualifications for directors, and as a condition of listing, each director must meet those guidelines to the satisfaction of the SEHK; the SEHK also requires directors to conduct themselves consistently with its Code of Best Practice; and a director is obligated to comply with the SEHK's Model Code For Securities Transaction by Directors of Listed Companies, which covers a director's reporting responsibilities under the SDIO and also specifies an obligation not to deal on insider information.<sup>97</sup>

In addition, the SEHK has detailed disclosure and shareholder approval provisions regarding certain transactions of listed companies with connected persons and their associates. These rules require substantial disclosures designed to address concerns regarding transactions which might not be in the interests of shareholders generally. Similar requirements also apply to major asset transactions, corporate acquisitions, and share transactions, whether or not involving connected persons. Where shareholder approvals are called for, these rules generally require that a connected person with an interest abstain from voting.<sup>98</sup>

P.R.C. regulations contain some analogous requirements. When a legal person's direct or indirect holding of outstanding ordinary shares of a listed company equals five percent of the total outstanding ordinary shares, the holder is required to notify the company, the exchange, and the CSRC, and the holder must also make a public announcement; additional increases or decreases of two percent must also be notified and published.<sup>99</sup> In addition, if the holding reaches thirty percent, a tender offer must be made.<sup>100</sup>

There are no regulatory requirements in the P.R.C. for non-executive directors. The general duties of directors are set out in the Company Law.<sup>101</sup> Listed companies in the P.R.C. must, in

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<sup>97</sup> See SEHK Listing Rules, *supra* note 35, at 3.08-3.15, 8.15, app. 10 (Model Code For Securities Transactions by Directors of Listed Companies), app. 14 (Code of Best Practice).

<sup>98</sup> See *id.* ch. 14 (Equity Securities — Notifiable Transactions).

<sup>99</sup> See Provisional Regulations, *supra* note 40, art. 47.

<sup>100</sup> See discussion *infra* Section 8.

<sup>101</sup> See Company Law, *supra* note 36.

addition to a board, have a supervisory committee which is comprised of shareholders and employee representatives and performs an oversight function intended to check the powers of the directors.<sup>102</sup> Certain major actions require shareholder approval under provisions of P.R.C. rules.<sup>103</sup> In addition, there are requirements on the SZSE similar to those in Hong Kong relating to disclosure and shareholder approval of substantial transactions including connected transactions, but the latter are limited to transactions involving individuals — company personnel, their relatives and entities controlled by them — and not other entities controlling the company.<sup>104</sup>

The limited impact of specific rules for disclosure and independent shareholder approval of related party transactions in the P.R.C. is not surprising. With the government essentially in control of both governmental and corporate assets and activities, the potential scope of disclosures could be overwhelming. The issue of related party transactions lies at the core of concerns about investments in P.R.C. companies. Many of the economic relationships within the P.R.C. are not of a market nature, but rather are influenced greatly by the government or entities somehow controlled by the government. Thus, a company's affairs may not be administered in the economic interests of the company or its other shareholders. Availability of supplies for a company, demand for its products and services, and the pricing and other terms of its transactions may be controlled by government-related rather than market forces. In such a situation, the government or other controlling entity may cause the company to act in a manner which is disadvantageous to its non-governmental shareholders in order to serve political or social objectives. There is no resolution of this tension between corporate responsibilities to shareholders generally, and the fact that corporations in the P.R.C. remain, to varying degrees, instruments of the State.

The experience to date with H share companies sheds some light on how this issue might develop. In creating and bringing H share companies to the market, it has sometimes been

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<sup>102</sup> See *id.* arts. 124-128.

<sup>103</sup> See *id.* art. 103; see also Shenzhen Provisional Measures for Listed Companies, *supra* note 48, ch. 6.

<sup>104</sup> See Shenzhen Provisional Measure for Listed Companies, *supra* note 48, arts. 29, 46.

necessary to define, perhaps through new regulations or agreements, the nature of relationships among the H share company, the P.R.C. government, the company's individual and corporate affiliates, and its suppliers and customers. These relationships can then be disclosed in the context of the offering. To some degree, this exercise appears similar to creating and then disclosing the regulatory structure for a company in a highly regulated business (such as telecommunications, electric utilities, or banking) in a primarily market-driven economy. In the P.R.C., such relationships ultimately express the balance of government and private decision-making in the economy.

At this time, it is not realistic to expect the P.R.C. to subject corporate/governmental economic relationships to determinations by votes of private shareholders. Indeed, H share companies have, in listing on the SEHK, obtained waivers releasing them from compliance with SEHK transaction disclosure and approval rules.<sup>105</sup> Nevertheless, continuing efforts to define and explain these relationships would improve investor understanding and facilitate commitment of capital to P.R.C. enterprises.

## 8. FAIRNESS IN THE TRADING MARKET

The willingness of an investor to provide capital by purchasing stock of a company depends in part on the discretionary ability of the investor, at a later time, to liquidate the investment for fair market value. In Hong Kong, the trading market of the SEHK has achieved a greater degree of market integrity than has yet been achieved on the two exchanges in the P.R.C.

One element of market integrity is a safe and secure process for clearing and settling trades. In Hong Kong, an efficient book entry system has been developed for SEHK trading, and transactions normally settle on the second day after trade date ("T + 2"), with transfer of shares through a book entry system rather than physical delivery.<sup>106</sup> An essentially equivalent settlement pattern

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<sup>105</sup> See, e.g., CHINA EASTERN AIRLINES CORPORATION LIMITED, PROSPECTUS 104-06 (1997); ANHUI EXPRESSWAY COMPANY LIMITED, PROSPECTUS 75-77 (1997); NANJING PANDA ELECTRONICS COMPANY LIMITED, PROSPECTUS 87-89 (1996); QINGLING MOTORS COMPANY LIMITED, PROSPECTUS 48 (1994); MAANSHAN IRON & STEEL COMPANY LIMITED, PROSPECTUS 57-59 (1993).

<sup>106</sup> See SEHK Listing Rules, *supra* note 35, § 8.13A; General Rules of CCASS, Hong Kong Securities Clearing Limited, Update January 1996.

was achieved early in the development of the two P.R.C. exchanges for B shares using book entry procedures and T+3 settlement,<sup>107</sup> and A shares settle on a same or next day basis in reliance on prior deposits of settlement funds.<sup>108</sup>

Trading volumes, the first indicator of liquidity, are higher on the SEHK than in B shares on either of the two exchanges in the P.R.C., though A shares sometimes trade locally in the P.R.C. in significant volumes.<sup>109</sup>

The individual retail investor is significant in the Hong Kong stock market, and dominates the publicly listed A share market in the P.R.C. Institutions have been important in Hong Kong as well. In the P.R.C., institutions are not well established because the government has not encouraged their development and private savings have not grown sufficiently to support such vehicles as mutual funds, pension funds, and insurance products. With a heavy retail influence, both the Hong Kong markets to some degree, and the P.R.C. markets to a greater degree, have been viewed as influenced significantly by speculative activity.

A recent incident exemplifies the risks in the P.R.C. markets. In February 1995, there was aggressive speculation and an attempt to manipulate the market through short-selling of bond futures in advance of an issue of government bonds, conducted by one of the largest P.R.C. securities firms, the Shanghai International Securities Company ("SISCO"); the effort failed, the market gyrated, SISCO suffered huge losses and defaulted, certain trades were invalidated, and trading was curtailed at the request of the CSRC.<sup>110</sup>

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<sup>107</sup> See Shanghai Zhengjuan Jiaoyisuo Jiaoyi Shichang Yewu (Renminbi Tezhong Gupiao) Buchong Guiding [Shanghai Securities Exchange Supplemental Rules of Trading Market Operations for Special Renminbi Shares], Feb. 18, 1992, ch. 6, translated in ISI HANDBOOK, *supra* note 18, SZBSR-1; Shenzhen Zhengjuan Jiaoyisuo B Gu Jiaoyi Qingsuan Yewu Guiding [Shenzhen Stock Exchange Operating Rules for the Trading and Clearing of B Shares], Jan. 31, 1992, ch. 6, translated in ISI HANDBOOK, *supra* note 18, SZBSR-1.

<sup>108</sup> See Shanghai Regulations, *supra* note 47, ch. 10; Shenzhen Operating Rules, *supra* note 50, ch. 5.

<sup>109</sup> See ZHONGGUO ZHENGJUAN BAO [CHINA SECURITIES], *supra* note 74, Feb. 1, 1997, at 6; *B-Shares Find New Lease of Life*, FIN. TIMES, Dec. 9, 1996, at 33; *China Foreign Currency Share Pessimism Prevails*, Reuter Eur. Bus. Rep., Oct. 25, 1996, available in LEXIS, News Library, Eurnews File.

<sup>110</sup> See *Trading in Bond Futures Ruled Out*, S. CHINA MORNING POST, May 1, 1996, at B1; *Revival Plan for Shanghai Futures Firm, Government to Decide Plan to Rescue Sisco*, S. CHINA MORNING POST, Dec. 7, 1995, at 1; *New Stain*

The laws and rules in both the SEHK and P.R.C. have provisions addressing the main sorts of market abuses: fraud, misleading statements about securities, false or fictitious trading, insider trading, manipulation, and short selling.<sup>111</sup> These express the appropriate government desire to maintain market integrity, and restrain and penalize disruptive or abusive market behavior. Hong Kong generally is viewed as having a more substantial securities enforcement program than the P.R.C. However, there has been enforcement activity in the P.R.C. An early reported instance, shortly after the stock exchanges were reintroduced, occurred in 1993, when the CSRC fined the Shenzhen-listed Baoan Group for violating public disclosure rules during a takeover bid.<sup>112</sup> In another more recent example, the CSRC published a decision to impose penalties against a tourism company and a securities trading center for, among other things, insider trading and other securities law violations.<sup>113</sup>

The significance of abuses is more apparent in the P.R.C., as evidenced both in the SISCO case and others. One commentator, on reviewing two CSRC penalty proceedings, found it "somewhat disturbing to discover that there are not yet sufficient regulatory mechanisms in place on the Shanghai and Shenzhen markets to prevent the occurrence of market manipulation capable of increasing share prices by 102% or 157% during the course of one day."<sup>114</sup>

One other element of regulation of the trading market is worthy of mention in considering the interests of investors purchasing stocks in Hong Kong or the P.R.C. — takeovers. In addition to requirements that shareholders disclose accumulations

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*on Sisco Image in Arrest of Executive*, S. CHINA MORNING POST, June 22, 1995, at 1; *Futures Frenzy Continues-Market Waits for Stringent Trading Regulations and Strict Enforcement*, S. CHINA MORNING POST, Apr. 13, 1995, at 1.

<sup>111</sup> See SO, *supra* note 6, §§ 74, 76, 80, 135-139, 147; CO, *supra* note 34, § 40A, 342F; SIDO, *supra* note 33, §§ 22-25; PIO *supra* note 31, §§ 3, 4; SEHK Listing Rules, *supra* note 35, § 6.01; Measures to Prohibit Fraud, *supra* note 42, ch. VII; Shenzhen Provisional Measures on Issuance and Trading of Shares, *supra* note 49, art. 43.

<sup>112</sup> See Kent Chen, *Baoan Fine is First for Securities Watchdog*, S. CHINA MORNING POST, Oct. 23, 1993, at B1.

<sup>113</sup> See ZHONGGUO ZHENGJUAN BAO [CHINA SECURITIES], Jan. 18, 1997, *supra* note 74.

<sup>114</sup> Philip Gregory, *Securities Fraud in the PRC*, CHINA L. & PRAC., Mar. 31, 1995, at 20, 22.

of ten percent or more of the stock of a company, Hong Kong law compels a general offer from any person (including others acting in concert with such person) accumulating thirty-five percent or more of the company's stock in the market; this is regulated under a special code and panel for considering takeover matters in Hong Kong,<sup>115</sup> modeled after a similar structure in the United Kingdom. These arrangements are supposed to ensure that all shareholders benefit from takeovers in a fair and equitable way, and that the disclosures process gives sufficient time for investors to respond and in a manner that would protect their interests.

In the P.R.C., there are disclosure requirements for persons acquiring more than a specified amount, plus a rule requiring an accumulator of thirty percent or more to make a general offer to all shareholders, and more detailed standards for takeover activities in SZSE rules.<sup>116</sup> Takeovers occur with some frequency in Hong Kong, though most are not hostile and many involve controlling shareholders. In the P.R.C. there have been only a few instances of widely-reported takeover attempts.<sup>117</sup> Because of government controls of companies in the P.R.C., hostile takeover efforts by private actors are essentially hypothetical. There have been suggestions, however, that takeovers might be accomplished in the P.R.C. through accumulations and transfers of legal person shares owned by government enterprises — perhaps the beginning of a mergers and acquisitions phenomenon among P.R.C. enterprises.

## 9. BOND MARKET

Hong Kong's debt securities market has developed more slowly than its stock market. The banking industry is dominant

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<sup>115</sup> See Codes on Takeovers and Mergers and Share Repurchases, Securities and Futures Commission, Mar. 1992, amended Nov. 1992, amended June 1994, amended Dec. 1994; Takeover and Mergers Panel established under SFCO, *supra* note 10, § 6(1).

<sup>116</sup> See Provisional Regulations, *supra* note 40, arts. 47-48; Shenzhen Provisional Measures for Listed Companies, *supra* note 48, ch. 6.

<sup>117</sup> See generally Michael Hickman & Benjamin Miller, *Mergers and Acquisitions Yearbook 1997, China*, INT'L FIN. L. REV. (forthcoming, Fall 1997); Foo Choy Peng, *Aggressive SAIC Set to Buy Out Strugglers*, S. CHINA MORNING POST, Mar. 13, 1997, at B1 (reporting plans to transfer state shares in two unsuccessful companies to a successful company).

among financial institutions in Hong Kong, and is the primary source of lending. The Hong Kong government has experienced favorable balances and has had little need to borrow. Nevertheless, in recent years, the Hong Kong government and its authorities have issued bonds and notes, and there is now an active market in them. Further, Hong Kong institutions manage substantial funds and are significant potential bond buyers. There is minimal individual retail investor interest in debt securities in Hong Kong, but with recent growth of government issuance and efforts of the SEHK to list debt securities, Hong Kong has begun to attract a larger volume of debt securities issuance including SEHK listings of bonds of supra-national organizations such as the World Bank and the Asian Development Bank.<sup>118</sup>

The recent development of the bond market in Hong Kong has been facilitated by relatively limited regulation. While various laws and rules in theory could be applied, bond offerings to institutions in Hong Kong are well covered by exemptions and special provisions.<sup>119</sup>

The prospectus disclosure requirements of the CO apply only to securities issued by companies. Accordingly, the Hong Kong government and its instrumentalities, as well as other sovereigns, are not subject to these requirements. The HKMA is active in issuing bills and notes through a tender process for the Hong Kong government, and the Hong Kong Mass Transit and Airport authorities have also issued debt. Further, a company not incorporated in Hong Kong is exempt if its debt issue is distributed only to "professionals," that is, "persons whose ordinary business it is to buy or sell shares or debentures, whether as principal or agent."<sup>120</sup> Many Hong Kong businesses are incorporated outside of Hong Kong, and even those incorporated in Hong Kong can take advantage of this exemption through use of a foreign affiliate as issuer (with the Hong Kong company as guarantor if necessary). There is also an exemption for transac-

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<sup>118</sup> See generally INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT/WORLD BANK, THE EMERGING ASIAN BOND MARKET, BACKGROUND PAPER, HONG KONG (1995) [hereinafter HONG KONG BOND MARKET BACKGROUND PAPER].

<sup>119</sup> These exceptions and special provisions are also theoretically available for equity offerings, but are inconsistent with public distribution and exchange trading of stocks.

<sup>120</sup> See CO, *supra* note 34, § 343(2).

tions not constituting public offerings — a “private placement” exemption — with limitations on offerees (though no numerical requirement) and a six-month holding period.<sup>121</sup>

Rather than rely on the “professionals” or “private placement” exemptions, issuers may seek from the SFC an order exempting an issue from prospectus requirements.<sup>122</sup> Such exemptions are generally granted if the proposed offering document has essentially what would be required for listing the securities on the SEHK, whether or not the securities are in fact so listed. In addition, the requirements for listing bond issues were simplified by the SEHK in 1994 as to “selectively marketed securities,” a term similar to but perhaps broader than securities marketed to “professionals.”<sup>123</sup> Accordingly, listing is now a practical pathway to bond issuance in Hong Kong. A company which lists its debt securities on the SEHK must still obtain from the SFC an exemption from prospectus requirements of the CO and a separate SFC exemption from the SDIO’s requirements that substantial shareholders, directors, and chief executives of listed companies disclose their interests in securities of their companies.<sup>124</sup> In any event, the SFC normally grants exemption from these requirements to issuers of “selectively marketed securities.”

An additional statutory requirement potentially affecting bond issuance in Hong Kong is the PIO, which restricts public invitations to purchase in an issue. If regulated (or exempt) dealers and advisers are the only ones involved in the distribution, their invitations to the public are exempt,<sup>125</sup> but debt offerings often involve foreign distributors. A second exemption is available for invitations relating to offerings exclusively outside Hong Kong or to professionals.<sup>126</sup> A third way to satisfy the PIO is to list with the SEHK, since invitations to purchase are permitted if in the form of a prospectus approved in the listing

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<sup>121</sup> See *id.* §§ 38(3), 48A.

<sup>122</sup> See *id.* §§ 38A, 342(A).

<sup>123</sup> See SEHK Listing Rules, *supra* note 35, ch. 37 (Debt Securities — Selectively Marketed Securities).

<sup>124</sup> See SDIO, *supra* note 32, § 2A(2). An issuer whose equity securities are already listed on the SEHK would be unable to benefit from such an exemption from the SDIO.

<sup>125</sup> See PIO, *supra* note 31, § 4(2)(fc).

<sup>126</sup> See *id.* § 4(3)(9)(vii).



process.<sup>127</sup>

Some Hong Kong government issues and other highly rated Hong Kong dollar issues may benefit from greater liquidity in Hong Kong because Hong Kong banks can borrow on an overnight basis through sale/purchase agreements with the HKMA under its Liquidity Adjustment Facility ("LAF"), using such bonds as collateral.<sup>128</sup> Hong Kong banks will therefore be more likely to buy and own bonds denominated in Hong Kong dollars which can be used in this facility.

There are special legal issues relating to issuance of certificates of deposit, for which there is a significant market in Hong Kong, and a largely theoretical concern that bond issuance could be considered deposit-taking, permitted only for specified institutions in Hong Kong as determined by the HKMA. However, these considerations have generally not disturbed the availability of sufficient exemptions from securities law and regulatory requirements.

This regime facilitates the integration of Hong Kong into the broad international debt capital markets, sometimes referred to as the Eurobond or (when an Asian issuer and primarily Asian investors are involved) Dragonbond market. The investors in this market are largely institutional rather than individual, although a few high net worth individuals participate.

The market for debt securities in the P.R.C. was reestablished in 1981 with the issuance in the P.R.C. domestic market of significant amounts of P.R.C. government debt. Much smaller volumes of debt have been issued by banks and non-bank financial institutions and state-owned enterprises within the P.R.C. In the last several years, the P.R.C. government itself and a few P.R.C. entities, generally P.R.C. banks and financial institutions, have issued debt securities in international markets, mainly denominated in U.S. dollars and Japanese yen. Some P.R.C. financial

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<sup>127</sup> See *id.* § 4(2)(c).

<sup>128</sup> At present, there are three categories of Hong Kong dollar securities that will be accepted as collateral under the LAF, namely, Exchange Fund Bills/Notes, Government Bonds (Category A); Hong Kong dollar debt instruments issued by the Mass Transit Railway Corporation or The Provisional Airport Authority, and Hong Kong dollar debt instruments with an AAA rating by Standard & Poor's or its equivalent (Category B); and other Hong Kong dollar debt instruments considered acceptable to HKMA with rating of (i) A or above if issued by a bank, or (ii) A or above if issued by a non-bank issuer (Category C).

institutions serve as "windows," borrowing in capital markets, and then on-lending to P.R.C. domestic borrowers. In general, P.R.C. banks remain a more significant source of borrowed funds for P.R.C. enterprises than debt capital markets, viewed in comparison to other developed and emerging economies.<sup>129</sup>

As in the case of equity securities issuance, debt securities issuance by P.R.C. entities is subject to strict government controls and approvals. The MOF manages and regulates the issuance of debt of the P.R.C. government itself, mainly Treasury bills and bonds sold to retail investors throughout the P.R.C.<sup>130</sup> This constitutes by far the largest segment of the P.R.C. domestic bond market. Bond issues by financial institutions are regulated by the PBOC.<sup>131</sup> Debt securities of state-owned enterprises, the largest category other than Treasury securities, are issued based on quotas and regulations of PBOC and SPC.<sup>132</sup> The PBOC regulates bond issues in international markets, along with the SAFE.<sup>133</sup> Convertible securities convertible into equity are regulated by both the CSRC and SAFE.<sup>134</sup> Key aspects of regulations include the allocation of access to issuers based on quotas determined under the national credit plan,<sup>135</sup> and the fixing of interest rates for the securities generally based on a spread over similar governmentally determined bank deposit rates.

<sup>129</sup> See generally INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT/WORLD BANK, THE EMERGING ASIAN BOND MARKET, BACKGROUND PAPER, CHINA 1995 (1995) [hereinafter CHINA BOND MARKET BACKGROUND PAPER].

<sup>130</sup> See Zhonghua Renmin Gongheguo Guokujuan Tiaoli [Regulations on Treasury Bills of the People's Republic of China], Mar. 18, 1992, FALÜ FAGUI, *supra* note 3, 4-2-2-III•3.

<sup>131</sup> See Guowuyuan Guanyu Jiaqiang Gupiao Zhaijuan Guanli de Tongzhi [State Council Notice Regarding Strengthening of Administration of Shares and Bonds], Mar. 28, 1987, FALÜ FAGUI, *supra* note 3, 2-6-5-IV•1.

<sup>132</sup> See Qiye Zhaijuan Guanli Tiaoli [Regulations on the Administration of Enterprise Bonds], Aug. 2, 1993, FALÜ FAGUI, *supra* note 3, 2-6-5-III•2.

<sup>133</sup> See *supra* notes 26-28 and accompanying discussion.

<sup>134</sup> The Company Law states that the CSRC must approve the issue by any listed company of a security convertible into shares. See Company Law, *supra* note 36, art. 172. To the extent that the instrument also involves the creation of foreign currency debt, approval by and registration with SAFE will also be required. See Waizhai Tongji Jiance Zanxing Guiding [Interim Regulation on Statistics and Supervision of Foreign Borrowing], Aug. 27, 1987, FALÜ FAGUI, *supra* note 3, 4-2-1-III-5, translated in [1 Business Regulation] China Laws, *supra* note 16, ¶ 8-706.

<sup>135</sup> See Document 68, *supra* note 18.

The most striking feature of the P.R.C. debt market has been the pattern of distribution of government securities. Buyers have been mainly individuals in the retail market, whereas debt markets in other countries and international debt markets are almost exclusively institutional. In the P.R.C., bond issuances have been regarded as similar to taxation, that is, a way of obtaining funds to finance the budget deficit. The MOF, banks and local government agencies have required the purchase of Treasury securities by individuals (and sometimes institutions) throughout the P.R.C., without regard to demand and even though the securities bear interest at relatively low rates; distribution techniques have included levies on wages of individuals. Problems arose with this system, notably an illegal trading market in which securities sold well below par. To correct this situation, the P.R.C. government shortened maturities, reducing the discount in the secondary trading market, and used market-driven underwriting techniques for distribution. But the compulsory or administered character of distribution has not been eliminated, and has resulted in a large portion of the P.R.C. population owning government bonds. While some Treasury issues have been legally non-tradeable, most are now tradeable, and there is an active secondary market conducted throughout the P.R.C., on the SHSE and SZSE, and in bond trading centers around the country using electronic systems.<sup>136</sup>

The P.R.C. Company Law imposes requirements on bond issues by joint stock companies,<sup>137</sup> although issuance by such companies has been minor. Such issues are required to be submitted to and approved by an appropriate instrumentality, State Council, SCSC, or CSRC, an information memorandum with specified information is required, provisions must be made to facilitate transfer of the bonds, and the issuer must meet certain standards of financial size and health, must use proceeds for specified purposes and not to cover losses, and must pay interest on the bonds only up to a maximum set by the State Council (which also has the power to impose other conditions).<sup>138</sup>

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<sup>136</sup> See generally CHINA BOND MARKET BACKGROUND PAPER, *supra* note 129.

<sup>137</sup> See Company Law, *supra* note 36, ch. V.

<sup>138</sup> See *id.* art. 164.

## 10. CURRENT HONG KONG/P.R.C. RELATIONSHIP-RED CHIPS AND H SHARES

The Hong Kong capital markets already play a significant role in generating investment funds for the P.R.C. In recent years, many companies listed on the SEHK have developed business interests in the P.R.C. These interests may be primarily in trading in and out of the P.R.C., but also may involve ownership of assets and production facilities inside the P.R.C. To the extent these companies raise capital in the equity market in Hong Kong, and invest the resulting proceeds in the P.R.C., Hong Kong is already performing the role of capital provider to the P.R.C. Also, some of the companies listed on the SEHK in Hong Kong have enterprises government authorities or from the P.R.C. as significant or controlling shareholders.<sup>139</sup> When these Hong Kong listed companies raise capital, the recipient will be a corporate group controlled or influenced and partly owned from the P.R.C. Proceeds of stock or bond offerings may or may not be invested in the P.R.C., but they will be available to meet P.R.C. economic objectives to the extent expressed through the group and particular company. The most successful of these P.R.C.-related companies are often called "red chips."

One technique for creating these cross-border ownership/investment structures has been a so-called "back-door" listing on the SEHK of a P.R.C. enterprise or business. As in other markets, some SEHK listed companies suffer business declines and become either inactive, or much less active, so that the price of acquiring a significant position in such company is quite modest. P.R.C. interests have sometimes acquired controlling positions in such Hong Kong listed companies, and then revitalized them by selling or transferring to the SEHK-listed company businesses conducted by the P.R.C. enterprise, usually located in the P.R.C. The proceeds of any such sale would flow to the previous P.R.C. business, and would represent new capital for that firm under P.R.C. control. The purchase by the Hong Kong

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<sup>139</sup> For example, China Resources Enterprises Limited, CITIC Pacific Limited, and Cosco Pacific Limited, all SEHK-listed companies, are controlled through indirect ownership by the P.R.C. Ministry of Foreign Trade and Economic Cooperation ("MOFTEC"), and China International Trust & Investment Corporation and the P.R.C. Ministry of Communication, respectively.

entity, and its the ownership and operation of the businesses could be funded by the SEHK-listed issuer with capital raised in the Hong Kong market. The net effect of these transactions is that the Hong Kong market has provided capital to the P.R.C., and the P.R.C. owner — while giving up some ownership of the assets — may still control them through holding shares in the SEHK-listed company. In 1993, the SFC and SEHK released a statement discouraging back-door listing, focused on fairness to non-controlling shareholders, and this practice has faded.<sup>140</sup>

Transfers to Hong Kong companies also may raise issues under P.R.C. law, which may require approvals for P.R.C. entities to own investments, assets or businesses outside the P.R.C. While such approval requirements have not been consistently observed by enterprises or enforced, the issue apparently had to be addressed in H share transactions where in forming the companies, it was necessary to exclude assets or businesses outside the P.R.C. which may have been acquired without all of the arguably required P.R.C. government approvals — inclusion of these assets in the H share company might have prevented counsel from providing clean legal opinions. To the extent that a back-door listing might transfer state-owned assets, the P.R.C. government might now exercise control through the mechanism of prior approval requirements.

A second approach was the creation of off-shore companies to hold enterprises or businesses in the P.R.C. Although P.R.C. interests remained in control, these holding companies then listed and offered shares internationally. This type of listing first occurred in Hong Kong in 1992, and was repeated in offerings on the New York Stock Exchange, the first in 1992 for Brilliance China Automotive.<sup>141</sup> However, the P.R.C. soon concluded that international capital raising should be conducted by P.R.C. rather than foreign entities.<sup>142</sup>

Efforts to raise capital through sales of equity in P.R.C. enterprises outside the P.R.C. became most evident with the 1993 memorandum of understanding on the subject entered into by

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<sup>140</sup> See *SFC and SEHK Increase Scrutiny of Back-Door Listings/Takeover Executive Warns Against Special Benefits*, SFC BULL., May - June 1993, at 4.

<sup>141</sup> See generally *BRILLIANCE CHINA AUTOMOTIVE HOLDINGS LIMITED*, PROSPECTUS (1992).

<sup>142</sup> See Document 68, *supra* note 18; State Council Special Regulation on Foreign Share Offerings, *supra* note 45.

the CSRC and the SFC.<sup>143</sup> Pursuant to that understanding, the SEHK amended its rules to permit listing of enterprises from the P.R.C., with various modifications to accommodate the particular circumstances of P.R.C. companies, and also to impose upon them a higher disclosure standard and a greater responsibility to investors than what would have been imposed under P.R.C. principles.<sup>144</sup> As previously noted, waivers have been granted from certain related-party requirements for H share offerings.<sup>145</sup> An additional accommodation was a relaxation of SEHK Listing Rules to allow elimination of the three year profitability requirement for companies engaged in infrastructure projects including ones in the P.R.C.<sup>146</sup>

From the point of view of innovative regulation, the H share effort has been quite successful — the regulatory understanding was reached and the transactions went forward. There have, however, been some difficulties in subsequent implementation. Questions have been raised, for example, about whether P.R.C. enterprises that raise funds in H share offerings in fact have used the proceeds of those offerings in the manner that was originally indicated in the prospectus. There have also been questions raised about the accuracy of the information provided by those companies to the market, particularly once several H share companies suffered significant earnings declines, prompting concerns about the accuracy of prior financial reports and projections.

In these structures, P.R.C. persons would not own all of the equity of the SEHK-listed company — public shareholders would retain an interest. Particularly when there are transactions between controlling shareholders and Hong Kong listed companies, these situations have attracted the attention of Hong Kong regulators. They have been concerned that such transactions be fair to the company and the other shareholders, and such

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<sup>143</sup> See The Stock Exchange of Hong Kong & Shenzhen Stock Exchange, *Memorandum of Regulatory Cooperation Between China Securities Regulatory Commission, the Securities and Futures Commission, the Shanghai Securities Exchange, the Stock Exchange of Hong Kong, and the Shenzhen Stock Exchange*, SFC BULL., May-June 1993, at 15-19.

<sup>144</sup> See SEHK Listing Rules, *supra* note 35, ch. 19A (Equity Securities — Issuers Incorporated in the People's Republic of China).

<sup>145</sup> See discussion *supra* Section 7.

<sup>146</sup> See *id.* § 8.05(2). See generally STOCK EXCHANGE OF HONG KONG LIMITED, GUIDANCE ON THE REQUIREMENTS IN RELATION TO THE LISTING OF INFRASTRUCTURE PROJECT COMPANIES (1996).

situations contributed to the development of the rather detailed provisions of the SEHK Listing Rules relating to disclosure and shareholder approval of major transactions of a company, especially transactions with connected persons. Nevertheless, the reorganizing of P.R.C. and non-P.R.C. interests in SEHK-listed companies continues to occur under the SEHK rules today, with disclosures and approvals in accordance with those rules.

H share offerings have been approved only for large, often complex businesses being incorporated and partially privatized by the P.R.C. It has been difficult to create the companies to hold the previously governmental operations, and to prepare information sufficient to meet disclosure standards for an international offering. Smaller B share companies have attracted some foreign investor interest, but they trade only on the P.R.C. markets, the SHSE and SZSE. These smaller companies may increasingly seek to raise capital outside the P.R.C., but the SEHK's standards are probably too stringent for them.

## 11. CONCLUSION: THE FUTURE IS CHINA

The Hong Kong and P.R.C. capital markets today differ in important respects. Hong Kong's markets grew under market principles over an extended period, experienced a crisis in the 1987 market break, underwent significant regulatory reform, and now resemble other developed markets around the world. The P.R.C.'s capital markets were created by government decisions in the last decade, and while already substantial, are still undergoing major changes and continue to be viewed by the P.R.C. as experimental. Both P.R.C. and Hong Kong markets and their regulation have been modeled on examples from developed countries, but the results have varied. In the P.R.C., application of market principles in a still government-controlled economy is producing anomalies.

Capital raising in Hong Kong developed from needs of growing businesses and commitment of private savings. In the P.R.C., there was administered distribution to the general population by the government of its debt securities, essentially a form of taxation, and sale of shares in government enterprises to raise capital and respond to public interest in trading securities. Companies can access capital markets in Hong Kong with little regulatory restraint, while access to capital markets for P.R.C. companies is controlled by the government based on both political

and economic factors.

Disclosures by companies in Hong Kong are in the range of those in other developed markets. In the P.R.C., however, information available about issuers, particularly financial information, is still less than satisfactory by international standards. Investors must tolerate varying degrees of uncertainty about continued government involvement in a company, including what could be regarded as troublesome related-party transactions. Continuing government control of enterprise activity suggests that the P.R.C., while seeking the benefits of raising funds in the market, is not entirely comfortable with allowing the market to make capital allocation decisions. Better disclosure, which might improve the efficiency of a market allocation mechanism, may have ambiguous policy implications for the P.R.C and may therefore be slow to develop.

Trading in government bonds and equities has captured the imagination of P.R.C. citizens, and has been dominated by individual retail investors. Systems for trading have been established, and there has been significant interest and participation. The individual retail investors in the P.R.C. tend to have a speculative approach. Hong Kong, with an institutional as well as retail investor base, may be a less speculative market. Both P.R.C. and Hong Kong markets have appropriate rules constraining market abuses. While the markets in the P.R.C. and their regulators have made enormous progress in a short time, compliance and implementation in the P.R.C. is less advanced than in Hong Kong, and the impact of abuses appears greater in P.R.C. markets.

The P.R.C.'s markets remain largely closed to foreign participation, resulting in limited international interest in domestic P.R.C. securities. The B share market has made only a small contribution to generating international involvement in equities, and it may be some time before a broad base of international investors is ready to commit large amounts of capital to the P.R.C. domestic equity markets.

The Hong Kong markets, on the other hand, are open — both international and domestic investors participate actively and have provided significant capital to the P.R.C. both through “red chip” companies with interests in the P.R.C., and more recently, through H share offerings. Red chip, H share, and smaller SEHK-listed issuers with interests in the P.R.C., because they have met



the higher Hong Kong standards, should be effective in raising capital internationally for the P.R.C. for years to come.

It seems less likely that Hong Kong will become a source of equity capital raising for companies not already having significant ties to Hong Kong or the P.R.C. The international element of Hong Kong's bond market has grown recently, particularly with Hong Kong dollar issues of supra-national borrowers being listed on the SEHK. The P.R.C. and Hong Kong have substantial foreign exchange reserves, and Hong Kong has strong banking and financial companies and money management institutions. There is perhaps more likelihood of internationalization in the Hong Kong bond market than in its stock market, but again, new P.R.C. issuers are likely to be the most significant addition.

With Hong Kong's increasing reliance and interdependence with the P.R.C., one must ask whether regulation in Hong Kong will change. By definition, if more issuers in Hong Kong are from the P.R.C., and if the P.R.C. controls access by these companies to capital markets, more of the companies in the Hong Kong market will have been subjected to that process. Political influence on Hong Kong regulators, combined with their power to interpret and apply listing and disclosures standards and other rules, could lead to greater regulatory control of access to markets in Hong Kong. In addition, the accommodations by Hong Kong regulators on related-party disclosures and infrastructure offerings could signal a willingness in Hong Kong to compromise. There is thus some risk that the hand-over may increase governmental, non-market controls on and dilute regulatory standards for capital raising activities in Hong Kong. Nevertheless, Hong Kong markets are likely to retain a substantial advantage over P.R.C. markets for international capital raising from a regulatory and disclosure point of view.

The P.R.C. government may be ambivalent about market processes and may restrain their development in China generally. Yet that very restraint may contribute to the P.R.C. continuing the market experiment in a contained venue in Hong Kong. The SFC has stated a key objective of making Hong Kong the preferred center for debt and equity capital raising activities for the P.R.C.<sup>147</sup> The hand-over promises to enhance Hong Kong's opportunity to serve as China's channel of access to international

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<sup>147</sup> See SFC, CORPORATE PLAN 1996/97 - 1998/99 (1996).

capital markets.